Retirement Policy and Research Centre

Commission for Financial Literacy and Retirement Income

# Spending the Savings: Decumulation and Middle-Income Retirement

***SYMPOSIUM PROCEEDINGS***

**30 November 2012**

**Symposium sponsors:** the Retirement Policy and Research Centre, the Commission for Financial Literacy and Retirement Income, the Matthew Abel Trust and The University of Auckland Business School.

# Spending the Savings:
# Decumulation and Middle-Income Retirement

The problem debated at this Symposium by retirement industry and financial sector experts and university researchers is: How can middle-income retirees best use their savings for what might be a very long or very short retirement, either in good health or in catastrophically expensive ill-health?

New Zealand, with its ageing population, has to treat this important topic in retirement incomes imaginatively and with urgency.

Policy developments such as KiwiSaver help people ***accumulate*** savings to provide for their ever increasing expected lengths of time in retirement.

But what do people do with their accumulated lump-sums once they reach 65? There are virtually no New Zealand products that spread the risk of outliving capital, yet individuals and society have a vested interest in facilitating this process.

This symposium focusses on how accumulated wealth could be ***decumulated*** in ways that provide more certainty and stability for the retiree, their family and also taxpayers.

This Symposium Proceedings was compiled by Dr M.Claire Dale, Research Fellow, the Retirement Policy and Research Centre.

Retirement Policy and Research Centre

# *Spending the Savings: Decumulation & middle-income retirement*

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# Spending the Savings:

# Decumulation & middle-income retirement

## Presentations in Programme order:

## Session 1: Setting the scene

### 1. Introduction to the issues, *Susan St John*

Tena koutou — welcome.

This is an exciting first — the bringing together of experts, from a variety of different fields, gathered on one day to address one of the most pressing issues associated with the ageing of the population in New Zealand. A special welcome to Retirement Commissioner, Diana Crossan who is in the last round of her engagements before she steps down in early 2013. Thank you, Diana, for your leadership and for the support of the RPRC by the Commission for Financial Literacy and Retirement Income. Also welcome to our Australian guests, Hazel Bateman and Bridget Browne, and to all our speakers who are giving of their time and energy. We are also pleased to have 5 of the 6 members of the RPRC advisory board here today.

This symposium will focus on a looming problem for middle-income people faced with managing modest lump-sums in the face of uncertainty. Regardless of financial arrangements, an ageing population will require a greater share of society's outputs. How we think about what is fair is an unavoidable ethical issue. Both intragenerational and intergenerational concepts matter in the decumulation debate.

**The aims:**

The purpose of this day is to have some input into the Retirement Commission Review 2013 on this topic; to move beyond simply a collection of well meaning papers to a coherent emergent view that has clear directions of what needs to happen next. Issues we will cover include:

- The incoherence of current policy
- Middle-income insecurity?
- Equity matters and the economics of decumulation

We will undertake to produce a summary position paper distilling the wisdom of today. Len Cook - well known to you all -will also be here to give his perspective and summary of the issues at the close of the day.

But we may be starting a national discussion in a hostile or apathetic climate. For example:

> *Hi Susan*
> *I just heard a news item that stated that you may be advocating drip feeding people's Kiwisaver funds to them to stop them spending large amounts on big items. If this report is true, I can tell you that I do not need any one drip feeding MY FUNDS to me now or any time soon.*
> *I feel that there is too much meddling in individuals lives, and this is just another example. Most of us are quite capable of running out lives.*
> *Anyway hope this helps*
> *Regards, Gary*

Despite the Garys of the world, reality is staring many people in the face.

### Current policy incoherence

In New Zealand, middle-income groups face under-appreciated risks in old age, including outliving capital, and stringent income- and asset-tests for expensive long-term care. Should those over 65 bear more of their own costs, or spread those costs more among themselves?

**Current policy incoherence**

- **New Zealand Superannuation** provides basic longevity insurance
- **Middle income groups are on their own**
  - **Lump sums may be used up too quickly**
    - **KiwiSaver**
    - **Other savings**
  - **Home equity illiquid**
  - **Longevity risk not insured**
  - **Risk of expensive healthcare- Long-term care costs**

While social security, and means-tested social assistance programmes for long-term care protect the least well-off, high income people can always look after themselves, middle-income groups face under-appreciated risks, such as outliving capital or needing expensive long-term care. The working age population may be less willing to bear these costs, either as taxpayers or as the children of long-lived parents.

### Middle Income Insecurity

Among some middle income, modestly well-off people, there is already a growing sense impending doom. Mary Holm gets lots of letters like this one:

> *Hi*
> *We have a freehold house worth on the open market in the $500.000 bracket. We have NO savings, are aged 76 and 73 respectively. My husband, 76 is retired and only has his N.Z super as an income. I am 73, draw the N.Z Super and earn $320.00 per week at a 20hour per week job.*
> *We feel that we need to sell our home (not really wanting to do this after 41 years) but as we have no savings we are dependent on our Super and my employment, which I am mindful I could lose if ill health was to strike. I do not want to work forever!! But is there any way we can use the equity in our home to enable us to remain in it but still have sufficient funds to keep us in our retirement?*

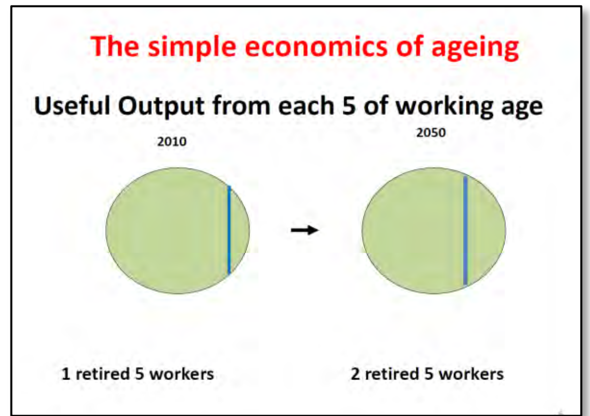
One of Mary Holm's readers commented, "Even with my background in finance, I can see the task of controlling a widely diversified portfolio becoming increasingly onerous as I get older".

### Context

- Population ageing
- Future projections of increased fiscal spending
- Issues of intergenerational equity

We are already seeing the tussle as questions are raised about some Baby Boomers who are getting a pension worth more than the unemployment benefit while still working, in an age of austerity, youth unemployment and high student debt.

This tussle will intensify over the next 20 years, but it is not just a problem that the dependency ratio is doubling. Within this simple picture the problem of ***ageing of the old*** is obscured. It is not just about paying pensions since we know that health-costs are age related and that long-term care is particularly costly.




It is clear that if everyone gets roughly the same share of output, then the working age population will have relatively less. The, so called, burden of ageing does not go away, regardless of how you pay for pensions. It does not change if pensions are financed on a PAYG basis or funded. In fact if people have more to spend in total because of KiwiSaver– the

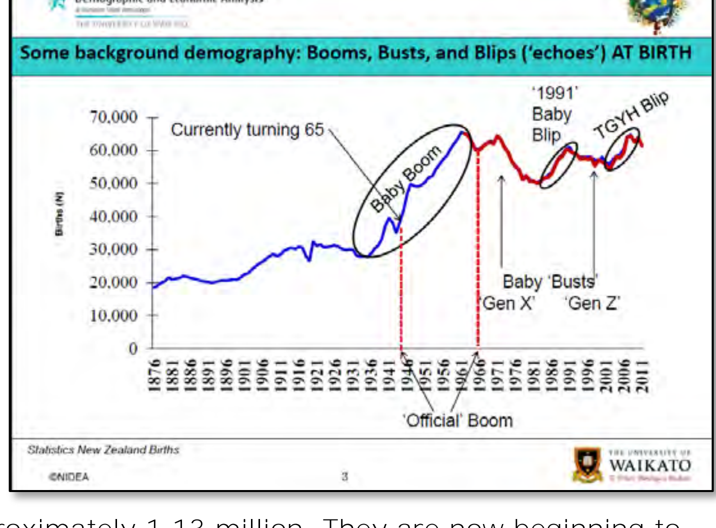
burden actually increases. The critical question is how can sensible decumulation help reduce some of the pressure on the working age population?

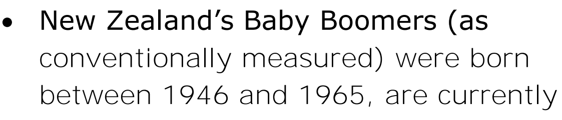
**Our task for today**

- How can people be helped to decumulate in ways that are good for them and good for working age populations too?
- Could we spread the costs more equitably– e.g. making the older, wealthier pay a fairer share? If so how?
- What role might government play?

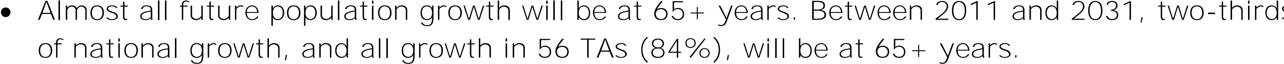
## 2. To whom will we decumulate? An inconvenient truth about population ageing, *Natalie Jackson*

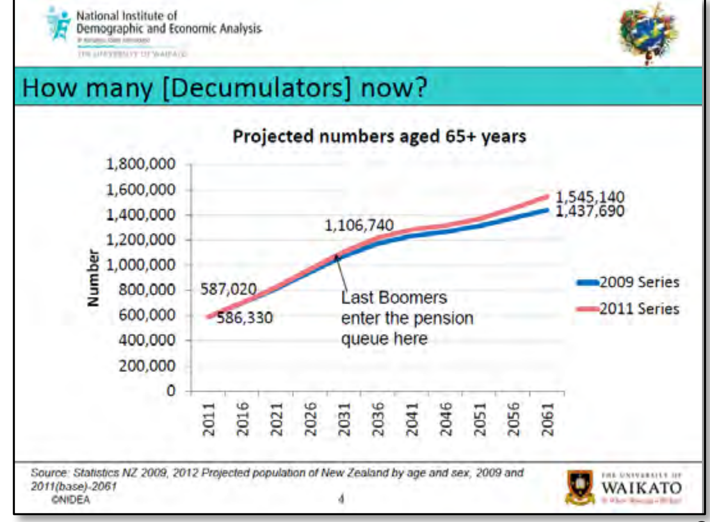
Among matters that need to be given consideration regarding the question of decumulation is 'to whom will New Zealand's baby boomers look when they try to cash in their savings?' Not only does New Zealand face an extended retirement wave due to its distinctively long and high baby boom, but for many boomers, retirement investment has been in the form of home ownership and rental property – much of it not in the main centres. An inconvenient truth about population ageing is that it is driven by declining birth cohorts at the younger end of the age structure, such that extended cohorts of older sellers will inevitably face diminishing cohorts of buyers – especially in the non-metropolitan regions where population ageing is more advanced and is rapidly bringing growth to an end. This paper ponders the situation from a regional perspective.



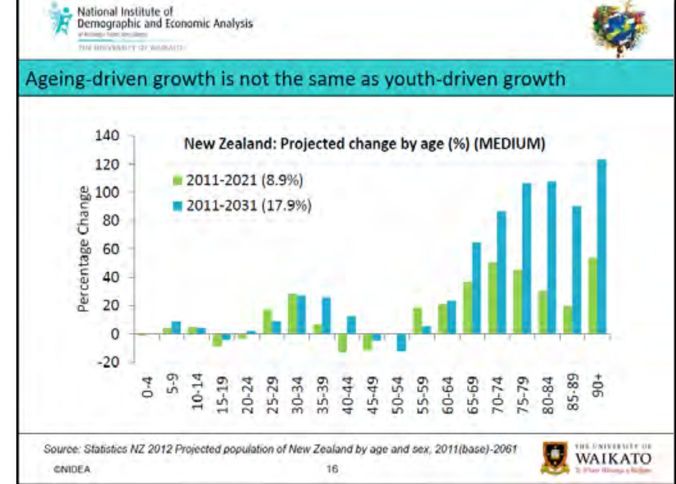
- New Zealand's Baby Boomers (as conventionally measured) were born between 1946 and 1965, are currently aged 47-66 years of age, and number approximately 1.13 million. They are now beginning to swell the 65+ population, numbering almost 600,000 and projected to double by c.2031.
- Almost all future population growth will be at 65+ years. Between 2011 and 2031, two-thirds of national growth, and all growth in 56 TAs (84%), will be at 65+ years.



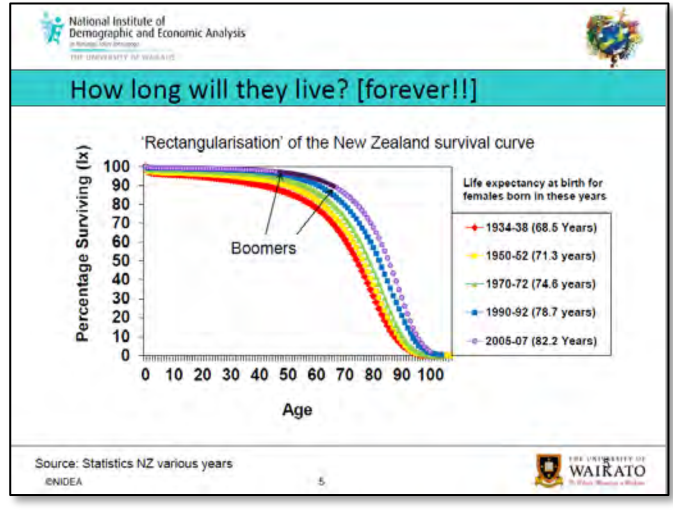



- For the purposes of this paper it is useful to split the Baby Boomer 'generation' into two groups: 'Leading Edge (born 1946-55) and Lagging Edge (born 1956-65). The largest cohorts were born in 1961 and 1962. It is also useful to split the adult population broadly into two groups: Decumulators (65+ years) and Accumulators (25-64 years).
- Decumulators are increasing relative to Accumulators. Presently there are around 2.6 Decumulators per 10 Accumulators at national level; by 2031

this will be 4.4 per 10. The picture differs markedly at subnational level. In Matamata-Piako, for example, Decumulators will increase from 3.5 to 6.4 per 10 Accumulators; in Buller, from 3.4 to 7.6. These differences by location are likely to have a marked effect on realising house values.




- **A first inconvenient truth** is that the changing ratios of old to young (locally, nationally and globally) are also bringing about the end of growth. One-third of New Zealand's TAs will experience absolute decline in size between 2011 and 2031, increasingly driven by the loss of natural increase. The phenomenon is already well under way with 36 per cent of TAs declining from net migration loss since 1996. This will not assist housing values.
- **A second inconvenient truth** is that each successively younger cohort has earned relatively less than each successively older cohort when at the same age, despite increased qualification levels.
- Over the past quarter-century, the highest income-earning age group for males employed full-time has shifted upwards from 35-39 to 45-49 years, allowing four cohorts to 'capture' the highest income earning age groups. The Leading Edge cohorts held the position for three censuses (1991-2001); the Lagging Edge cohort took over in 2006. Females have experienced similar trends, but highest income has shifted from 25-29 to 30-34 years only, and has favoured the largest Lagging Edge cohorts (born 1962-66).
- Leading Edge Decumulators are likely to fare better than the Lagging Edge, in part because they will 'sell' into a larger market; in part because they may have less to decumulate than the Lagging Edge cohorts.




Between 2011 and 2031, **all** 'growth' in 56 of NZ's 67 Territorial Authorities (84%) projected to be at 65+ years; all other age groups (combined 0-64 yrs) projected to decline.

- c.23 of these Territorial Authorities is likely to experience overall decline
- c.12 likely to experience both net migration loss and natural decline

Of the remaining 11 Territorial Authorities:

2 = 95+% of growth at 65+ (Christchurch; Whangarei)

3 = 60-63% growth at 65+ (Waikato; Palmerston North; Waimak.)

3 = 44-46% growth at 65+ (Wellington; Selwyn; TGA)

3 = 36-37% growth at 65+ (Auckland; Hamilton; Queenstown)

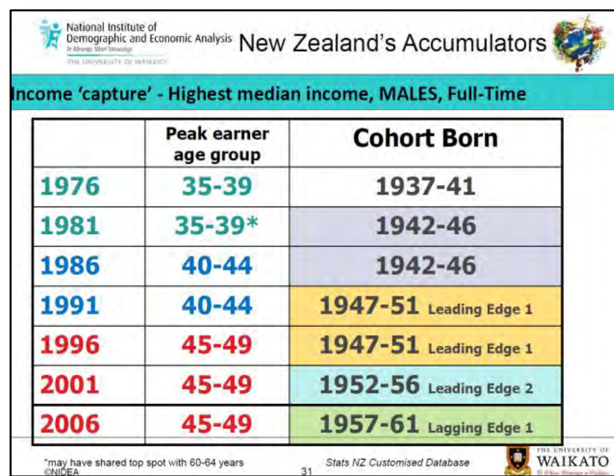
**Projections and their assumptions:**

- YES migration is included (net international gain 12,000 pa)
- YES fertility is included (TFR falling to 1.9 births by 2026)

- YES increasing life expectancy is included (to 88.0 years for males and 90.5 years for females) *[Stats NZ Medium Case projections 2006-base 2012-Update]*

If we were to assume that the current Total Fertility Rate of 2.1 will remain constant; that life expectancy will climb to 95 years by 2061 (Statistics New Zealand's highest assumption) and that annual net migration would reach 100,000 (4 times Statistics New Zealand's highest assumption and 8 times their medium prediction); then by 2061 the population would reach 10.8 million, 22% of which would be 65+ years of age.

To reach 15 million by 2061 would require a net migration gain per year of over 150,000 at replacement level fertility, or a birth rate that has returned to Baby Boomer levels (eg. 3.5 births per woman) plus 100,000 migrants per year.



National Institute of Demographic and Economic Analysis — New Zealand's Accumulators

Income 'capture' - Highest median income, MALES, Full-Time

| | Peak earner age group | Cohort Born |
|---|---|---|
| 1976 | 35-39 | 1937-41 |
| 1981 | 35-39* | 1942-46 |
| 1986 | 40-44 | 1942-46 |
| 1991 | 40-44 | 1947-51 Leading Edge 1 |
| 1996 | 45-49 | 1947-51 Leading Edge 1 |
| 2001 | 45-49 | 1952-56 Leading Edge 2 |
| 2006 | 45-49 | 1957-61 Lagging Edge 1 |

*may have shared top spot with 60-64 years ©NIDEA 31 Stats NZ Customised Database — WAIKATO

National Institute of Demographic and Economic Analysis — Australian males

Income 'capture' - Highest median income, MALES, Full-Time

| | Peak earner age group | Cohort Born |
|---|---|---|
| 1976 | 30-34 | 1942-46* |
| 1981 | 35-39 | 1942-46* |
| 1986 | 35-39 | 1947-51 Leading Edge 1 |
| 1991 | 40-44 | 1947-51 Leading Edge 1 |
| 1996 | 40-44 | 1952-56 Leading Edge 2 |
| 2001 | 45-49 | 1952-56 Leading Edge 2 |
| 2006 | 45-49 | 1957-61 Lagging Edge 1 |

©NIDEA ABS Customised Database 32 — WAIKATO

**As inconvenient as it may be we need to:**

**A**ccept — that the population ageing *is* coming to a decumulating senior near you;

The ratio of Decumulators to Accumulators is rising rapidly; very rapidly in non-urban Territorial Authorities;

Growth is 'over' in most non-urban regions;

It will become increasingly harder for non-urban home sellers to realise desired value;

Leading Edge Boomers are likely to fare much better than Lagging Edge Boomers – but not just because of numbers.

**B**uffer — respond to the demography;

Incorporate demographic change in *all* your analyses and interpretations;

*Encourage higher incomes for younger people – 'we' need them as much as they do.*

**C**elebrate — the advance warning and reflect on intergenerational equity.

## 3. Middle-income retirement: assets and incomes at age 65+, *Michael Littlewood*

**What do we know about:**

1. New Zealanders' savings record?
2. Private provision and its impact on *total* retirement incomes?
3. Retirement wealth as a measure of 'preparedness'?
4. New Zealanders' decisions about work after age 65?

The answer to all these questions is 'not much or not enough'.

We do not know enough about households' net wealth, either at the point of retirement or during older ages. We need better data, in particular, the facts about the baby-boomers' retirement: 2010 to 2020. Total retirement wealth includes the home, other real estate, pensions and other financial assets. Regular income post-65 comprises pay from work, New Zealand Superannuation (NZS), pensions and investment income. We need to know about the shape of these, especially where households use trusts and own other indirectly held assets.

**Point 1: New Zealand's retirement savings record**

- Occupational superannuation
- KiwiSaver
- Businesses
- Other financial assets
- Real estate

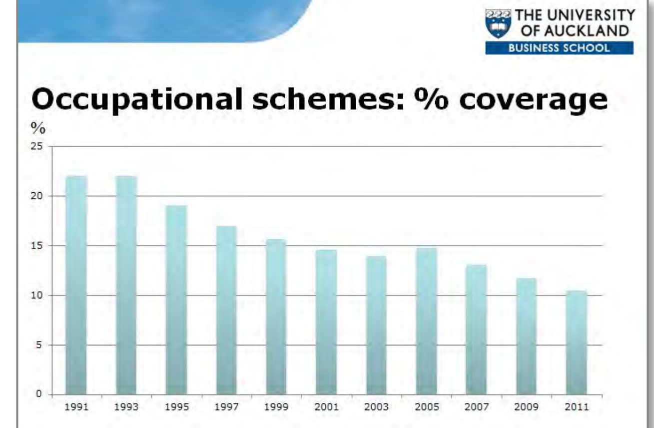
*"Overall, 60% of non-partnered individuals and one third of couples are estimated to require no more saving for retirement. After adjusting these baseline results for more 'realistic' assumptions, these proportions rise to over 70% for non-partnered individuals and one half of couples." (*Le, Scobie & Gibson, 2007)

The following articles give us some data on the retirement savings record of New Zealanders:

- Scobie, G., Henderson, K, (2009). *Saving Rates of New Zealanders: A Net Wealth Approach* New Zealand Treasury
- Claus, I., Scobie, G, (2002). *Saving in New Zealand: measurement and trends* New Zealand Treasury
- Le, T., Scobie, G., Gibson, J, (2007). *Are Kiwis saving enough for retirement? Preliminary evidence from SOFIE* New Zealand Treasury
- Le, T., (2007). *Does New Zealand have a household saving crisis?* New Zealand Institute of Economic Research

There are many ways that New Zealanders save for retirement and the overall impact on the expected retirement wealth has been looked at in reports 2. and 4. above. The general conclusion is that, on average, New Zealanders do seem to be making appropriate financial provision for their retirement. Importantly, this is against the backdrop of a continuing NZS that means, for many, that they do not need to make further financial provision for retirement income. It also, importantly, assumes that when New Zealanders make additional private provision and come to convert that to income in retirement, either they know precisely when they will die, or there is 'perfect' annuitisation. That illustrates, in part, why the RPRC is running today's symposium: how can New Zealanders achieve that in practice?

**Occuptional schemes: % coverage**




There is no doubt that, KiwiSaver aside, occupational schemes have diminished in significance in the last 20 years. The chart shows that their incidence has halved over that period from about 22% of employees being members in 1991 to about 11% in 2001 (source: Government Actuary's annual reports).

**Savings record …2: Occupational superannuation in decline**

This shows some more detail on occupational superannuation scheme coverage in New Zealand.

One important source of annuity coverage (membership of defined benefit schemes) was an already low 7% in 1990; it is now just 2% and will eventually disappear altogether.

The slide shows that there are about double the number of pensioners in the Government Superannuation Fund (the now-closed scheme for civil servants) over those in other occupational schemes.

However, the total number of retirees with defined benefit pensions (at 69,000) is only 11% of the whole population aged over 65. That proportion will continue to fall.

| | 1990 | 2010 | 2011 |
|---|---|---|---|
| Superannuation members<br>- employees only<br>- % of workforce<br>- % workforce with defined benefits | <br>311,000<br>20%<br>7% | <br>244,000<br>11%<br>3% | <br>238,000<br>11%<br>2% |
| Pensioners<br>Average pension paid | 35,747<br>$6,350 p.a. | 21,110<br>$10,753 p.a. | 22,144<br>$11,515 p.a. |
| Government Super Fund<br>- members<br>- pensioners | <br>-<br>- | <br>14,587 (24%)<br>46,855 (76%) | <br>13,433 (22%)<br>46,839 (78%) |
| Sources: FMA Superannuation Schemes Reports; GSF actuarial review 2010 | | | |

Note:$6,350 in 1990 is $10,500 p.a. in 2012 dollars

**Savings record …3: is KiwiSaver the answer?**

- KiwiSaver – the headline numbers (31 March)
  - Membership: 2008 = 487,300 2012 = 1,910,200
  - Assets: 2008 = $700m 2012 = $12.7 bn
- … **but:**
  - Non-contrib.: 2008 = 64,600 2012 = 858,000 (45%)
  - Children: 2008 = 49,000 2012 = 312,000 (16%)
  - Default: 2008 = 309,700 2012 = 447,300 (23%)
  - Av. Balance: 2008 = $1,440 2012 = $6,700

  ➢ Total taxpayers' contributions $4.25 bn (+admin, tax break)
  ➢ Average cost of taxpayers' contributions $2,200 per member
  ➢ Taxpayer cost as % av. balance: 2008 = 58% 2012 = 34%

The financial services industry is, on the whole, fairly pleased with the success of KiwiSaver with, now 1.9 million members and $12.7 billion in assets after only five years. But we should not conclude that KiwiSaver has necessarily been the success that the headline numbers might indicate. Some of the numbers do not look too encouraging.
For example, of the 1.9 million members, fully 858,000 (45%) were non-contributors at 31 March 2012. That probably includes nearly all of the children who belong – 312,000 at 31 March.

The other potentially concerning numbers are the 447,300 members who made no decision to join (default enrolments) and who have presumably made no decision about an appropriate investment strategy (have retained the 'low risk' default option).

And then, despite the large amount of money now held by KiwiSaver schemes, the average balance at 31 March was just $6,700. We have preliminary evidence that only about one third of this was actually 'new' savings – the rest apparently represents a re-direction from other savings. So, at a total cost to taxpayers of $4.25 billion, we seem to have 'purchased' a quite modest change in behaviour; on average, taxpayers as a whole have contributed about one third of the average KiwiSaver balance.

As time goes on, this position will 'improve' but, even if savers arrive at retirement with a significant retirement savings balance in KiwiSaver, we will still not have addressed the issue of a mechanism for reliably running those down in the retirement period. As time passes, it will become more difficult to solve that problem, as Australia has now discovered.

**Is that everything?**

We need much better data on households' retirement wealth. Counting directly owned assets and directly earned income is now insufficient. That's because of the growth of vehicles that 'shelter' income and assets.

Examples of such income/asset 'shelters' include:

- Family trusts: in 2010, the Inland Revenue knew of 237,000 family trusts where the assets (and income earned) are derived from outside direct, personal holdings;
- Portfolio Investment Entities offer a tax-endorsed shelter because they are 'final' taxpayers (although there is a look-back procedure where the PIR has been under-declared).
- Superannuation schemes are also 'final' taxpayers, as are
- Companies.

The point here is that when the state needs to know a family's assets and income (for example to assess entitlements to rest home subsidies), looking at personal incomes and asset holdings is no longer enough. The other family-controlled assets are part of 'retirement wealth' but would not be included in the usual definitions of retirement income.

**Point 2: Private retirement incomes**

For most retirees, private income forms a small part of retirement income.

The table shows the average 'non-government' income by deciles. For individuals and even couples, the bottom four deciles depend either largely or completely on New Zealand Superannuation. From the perspective of annuitising private income, they will not (and should not) be concerned. Any private income is likely to derive from modest levels of bank interest.

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**Point 2:**
**Private retirement incomes**

Mean, weekly, non-government income by deciles: age 66+

| Deciles | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|---|---|---|---|---|---|---|---|---|---|---|
| One person | nil | nil | nil | $1 | $5 | $30 | $100 | $240 | $500 | $1,040 |
| Individuals in couple (each) | nil | $3 | $25 | $62 | $140 | $242 | $277 | $545 | $787 | $2,085 |

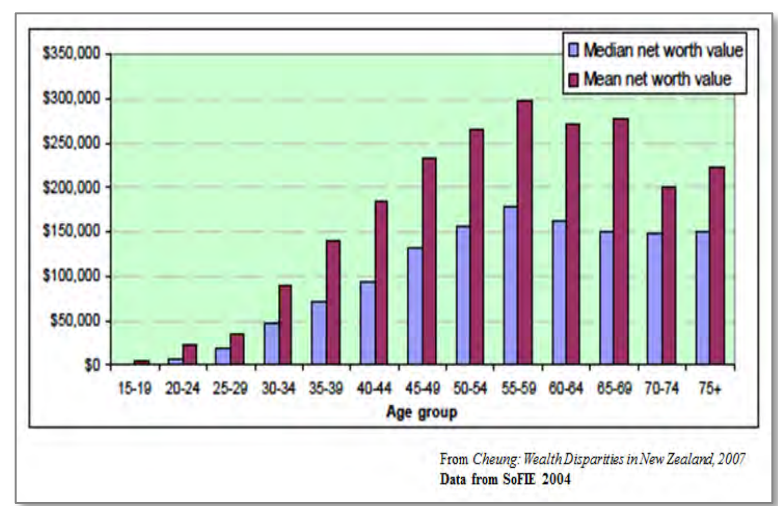
NZS before tax (2010):
- Single $374
- Couple (each) $281

After Perry *Household Incomes in New Zealand, 2012*
*Income from work, private superannuation and investments: HES 2010*

Again, public policy should not be too concerned about the top two deciles with average private incomes of up to $54,100 for individuals in decile 10, and $108,400 for individuals in couples.

The principal public policy focus should be on the middle four deciles 5-8 where private income is modest but a significant share of total retirement income. They face a real challenge in reliably running down their savings so that they neither run out of money before dying nor leave unintended bequests.

**Retirement wealth....3: Median & mean wealth by age groups**



From *Cheung: Wealth Disparities in New Zealand, 2007*
Data from SoFIE 2004

The chart shows another picture of wealth – this time by age groups across the whole population for 2004 (from the first tranche of SoFIE financial data).

There are two main messages from the chart:

- There is a significant dispersal in each age group, illustrated by the difference between the mean and median numbers. For example, at age 65 - 70, the mean (average) was about $275,000 per person but the median (middle value) was only $150,0000 each.

- Despite fluctuations in the average numbers in the age groups after age 60, the median net worth of all four age groupings was relatively flat.

Looking at data from the 2004 and 2006 SoFIE returns, according to Le, Gibson and Stillman (2010) the **mean** net worth in 2004 and 2006 of older New Zealanders (all in 2006 prices) was:

- 65-74: $273,200 (2004) and $346,904 (2006)
- 75+: $257,436 (2004) and $294,416 (2006)

*Household Wealth and Saving in New Zealand: Evidence from the Longitudinal Study of Family, Income and Employment, Motu Working Paper 10-06*

**Point 4: Is work part of the answer?**

For many older New Zealanders, work is becoming part of retirement income provision. For those who are able to find or continue in work, deferring the age from which retirees have to rely on retirement savings has a number of advantages. There is a longer saving period; the period over which the higher savings has to last is shortened and both of those reduce the risk of running out of money in retirement.

Work also benefits employers by retaining access to skills and experience and employees by continuing to contribute and feel part of society.

However, work just defers the issue; the time when the need to start reliably running-down private provision starts.

**Is work an answer? New Zealanders respond 1991-2009**

The OECD tracks what it calls the 'effective retirement age' in its member countries. New Zealand has one of the highest effective retirement ages.

The 'effective retirement age' is the weighted average of net withdrawals from the labour force at different ages over a five year period for workers initially aged 40 or more.

The lowest point was in 1997 when it was age 62.3 for males and 60.6 for females. In 1998, the income test for New Zealand Superannuation was abolished.

The effective retirement age is now 67.1 for men and 65.0 for women – that's an increase of 4.8 years for men and 4.4 for women and, if the trend has continued, that's probably higher now. For both men and women, the effective retirement age is about 2 years older than the equivalents in Australia.

Source: OECD – average effective retirement ages 1970-2009

**Overall...**

New Zealand has the lowest elder poverty levels amongst 30 countries using 50% average wage, ex-housing test (OECD 2009)

There is much to be grateful for as far as New Zealand's retirement income policies are concerned. First, we have one of the lowest levels of financial hardship amongst 30 OECD countries. Next, we have a relatively simple retirement income/savings environment.

However, we must recognise that the bottom 20% of New Zealanders (by retirement wealth) have no private income or assets.

The next 20% probably have a home but no, or little, private savings. 79.5% of all age 65+ own their home: 2006 Census. Those aged 70–74 years were more likely than other age groups to own or partly own the dwelling they lived in, both in 2001 and in 2006 (80.6 percent and 79.5 percent, respectively) (Census 2006, StatisticsNZ).

As already mentioned, the top 20% by retirement wealth are not of pressing concern from a public policy perspective but they would probably welcome some form of competitive annuity as part of their retirement planning portfolio.

It's the middle 40% who are the main target of this symposium.

## 4. How much does a healthy retirement cost? *Toni Ashton*

*From a paper by Jessica O'Sullivan and Toni Ashton:* If health is the standard of living to which we aspire, what is the minimum income needed to live a healthy life in older age? This paper uses research about the prerequisites for health and quality of life to estimate the minimum income that is required to support living an independent and healthy life in New Zealand during retirement. Our estimates are based upon seven categories of expenditure: nutrition, physical activity, housing, social connectedness, transport, health care and hygiene.

Estimates of the Minimum Income for Health Living (MIHL) are made for people living alone, couples, renters and debt-free home owners. In 2009 the MIHL estimates were appreciably higher than New Zealand Superannuation in each case. The results highlight that many New Zealanders are living on an income which may not be enough to support a healthy life.

I will focus today on three categories of expenditure: nutrition, housing and social connectedness.

### 1 Food

- Estimated on energy requirements for a male aged 73, and a female aged 75, of mean height and weight
- Constructed diets based on these requirements
- Diet follows principles of "Eating Well for Healthy Older People"
- Food costed using Woolworth's online shopping
- Reduced by 16.5% - based on "Consumer" price survey of supermarkets

**Weekly costs of a healthy diet**

| | Men | Women | Couple |
|---|---|---|---|
| Cost of diet | 73.50 | 60.44 | 133.94 |
| Upward adjust-ment for wastage | 7.35 | 6.04 | 13.39 |
| Vitamin D supplement | 0.23 | 0.23 | 0.46 |
| **Total** | **$81.08** | **$67.71** | **$147.79** |

Guidelines for older people emphasise the following factors:

- Food variety
- Nutrient density
- Phytochemical density
- Avoiding high fat, high salt and high sugar foods
- High intake of fruit and vegetables (in New Zealand, the guideline is 5+ a day)
- Enjoying meal times
- Eating with others where possible
- Frequent smaller meals
- Ensuring adequate fluid intake.

The price differences between Woolworths and Pak'n Save varied by region, ranging from 12% in Christchurch to 21% in Auckland. The middle of that range has been taken for the purposes of the MIHL.

## 2 Housing

- 70% of people aged 65+ own debt free home
- 8 - 9% rent
- Home-owners: Maintenance, repairs, insurance, rates
- Rent: based on lower quartile market rental for 1 bed-room flat, inflated by 15% for "healthiness"
- Energy: Based on modelling, 21°C in living area, 18°C in bedroom

**Housing**

| | Renter | | Home owner | |
|---|---|---|---|---|
| | Single | Couple | Single | Couple |
| Rent | 178.00 | 178.00 | | |
| Rates, insurance, maintenance | - | - | 97.29 | 97.29 |
| Household energy | 58.66 | 58.66 | 58.66 | 58.66 |
| Less Accommodation Supplement | 45.00 | 66.00 | - | - |
| **Total** | **$191.66** | **$170.66** | **$155.95** | **$155.95** |

## 3 Social connectedness

a. Based on usual cost of attending an Age Concern weekly morning programme

b. Provision to entertain one friend once a week - Tea, milk, sugar, fruit and biscuits

c. The actual weekly cost was derived from the actual costs of the following, once a quarter, and activities: visiting the cinema, the local theatre, a concert and a sporting event, e.g. the rugby

d. The weekly cost of two $10 presents per year (birthday and Christmas) for four grandchildren

e. The weekly cost of one seven day holiday per year. Total holiday cost includes flights or other transport ($200 return per person), transport to and from the airport ($80) and a daily allowance of spending money over and above the normal MIHL budget ($30 per person per day). It assumes no accommodation costs.

f. Based on HES 2006/07, 65+ households earning less than $44.900. Inflation adjusted to September 2009 prices using the Consumers Price Index: Tools and Equipment House and Garden Sub Group.

g. Based on HES 2006/07, 65+ households earning less than $44.900. Inflation adjusted to September 2009 prices using the Consumers Price Index: Grocery Food Sub Group.

h. Based on HES 2006/07, 65+ households earning less than $44.900. Inflation adjusted to September 2009 prices using the Consumers Price Index: Restaurant Meals and Ready to Eat Food

i. 52 stamps at $0.50, pack of 50 envelopes, a 100 sheet writing pad, 3 biros

j. Costs of a fixed home line with a national provider. Package includes unlimited national calls on weeknights and all weekends. The cost of calls at peak times has not been included as this is seeking minimum costs. No additional costs for calls to mobiles, has been included.

k. Cost of a 21 inch TV on special at the Warehouse, a low cost retailer. Cost spread over 5 years.

**Social connectedness**

| Item | Single | Couple |
|---|---|---|
| Admissions, subscriptions | 1.00 | 2.00 |
| Friends in home | 2.80 | 5.60 |
| Entertainment (sport, cinema) | 7.00 | 14.00 |
| Gifts for grandchildren | 1.50 | 1.50 |
| Holidays | 9.42 | 17.30 |
| Gardening | 4.30 | 4.30 |
| Pets | 3.14 | 3.14 |
| Meals out | 10.88 | 21.76 |
| Stationery, stamps | 0.67 | 0.67 |
| Telephone, TV | 17.70 | 17.70 |
| Newspapers, magazines | 4.04 | 4.04 |
| **Total** | **62.45** | **92.01** |

TABLE 7. *Weekly cost of the Minimum Income for Healthy Living (MIHL) for single persons and couples aged 65 years and over (NZ $)*

| | Renter | | Home owner | |
|---|---|---|---|---|
| Item | Single | Couple | Single | Couple |
| Diet/nutrition | 74.40 | 147.79 | 74.39 | 147.79 |
| Physical activity | 14.17 | 28.34 | 14.17 | 28.34 |
| Housing | 191.66 | 170.66 | 155.95 | 155.95 |
| Social connectedness | 62.45 | 92.01 | 62.45 | 92.01 |
| Health care | 16.84 | 33.68 | 16.84 | 33.68 |
| Transport | 21.40 | 35.30 | 21.40 | 35.30 |
| Hygiene | 10.11 | 15.51 | 10.11 | 15.51 |
| Other costs of healthy social living | 62.49 | 79.39 | 60.39 | 78.55 |
| Total MIHL: | | | | |
| NZ $ | 453.52 | 602.68 | 415.70 | 587.13 |
| £[1] | 204.08 | 271.20 | 187.07 | 264.21 |

**Points to note**

- Estimates were done in 2009
- Costs are national averages
- Actual expenditure will differ according to individual circumstances including:
  - Age
  - Region
  - Social support
  - Proximity to shops
  - Vegetable garden
  - etc. etc.

**MIHL and NZS (2009)**

| | Renter | | Home owner | |
|---|---|---|---|---|
| | Single | Couple | Single | Couple |
| MIHL | $453.52 | $602.68 | $415.70 | $587.13 |
| Amount by which MIHL exceeds NZS | $142.57 | $124.30 | $104.75 | $108.75 |
| % by which MIHL exceeds NZS | 46% | 26% | 34% | 23% |
| **Additional annual income required to meet MIHL** | **$7,414** | **$6,464** | **$5,447** | **$5,655** |

## 5. New Zealand's long-term care arrangements and a cross-country comparison, *M.Claire Dale*

Demographic change in OECD countries is driving significant growth in the demand for in-home and residential long-term care (LTC) for frail and disabled seniors, thus stimulating interest in annuities and long-term care insurance. At the same time, people are becoming increasingly mobile. To identify the critical issues and develop a workable policy for LTC provision, a country's total 'aged' environment, including private pensions and access to public pensions, social insurance and the market for private insurance and annuities, and their interplay, must be considered.

Many OECD countries are reviewing their age pension and LTC policies and provision, and age pensions and long-term care are getting worldwide attention.

The 2011 OECD report, *Help Wanted? Providing and Paying for Long-Term Care,* argues the providing adequate financial protection for those needing care is possible, in a way that does not unduly stretch public financing. The Report also states:

> *"But getting these policies right needs to start now, because the challenge to implementing sustainable, responsive and fair long-term care policies is only going to get bigger and bigger, as populations age."*

'Residential' long-term care has changed since this photo from 1905, but like many of you, I can remember the 1970s when the elderly were 'warehoused' for long-term care, surviving their last years sharing bedroom and bathroom, few possessions, no privacy…

By the 1970s, the main change in this picture would be fewer nurses!

Residential care 1905

But in the last 30 years, the environment has dramatically improved, and deep gratitude is due to those who have helped that happen.

Residential care 2005

However, as we heard from Natalie Jackson, enduring demographic change is already on us.

If we continue on our current path, we risk a return to the comparatively primitive conditions of the past.

Whatever we do or don't do, the pension, health and care costs of increasing numbers of retirees and frail elderly will still have to be met.

In the Working Paper, we look at the funding arrangements for LTC in New Zealand, Australia, France, Germany, Japan, England and the US.

To understand current funding arrangements for LTC in each country, we had to look at the whole 'pensions environment' because age pensions and Health budgets are the major sources of LTC funding.

**Questions that need to be answered include:**

- is the age pension universal or means tested;
- is there a mandatory or voluntary, private or public retirement scheme;
- what are the pre-conditions for access to health-care and support, and
- what are the options for in-home care and residential LTC?

**France: 10,600,000 aged 65+, 16.4% of total population (2011)**

Success story for Long-term Care Insurance (LTCI) and annuities

- Age pension from age 60 is a social insurance scheme: publicly run, work-related, defined benefit pension based on adjusted earnings over best 25 years; requires 15% contribution from annual earnings up to €34,600
- Compulsory health insurance funds in-home LTC
- Residential LTC via means-tested, needs-based social insurance plus private contribution
- Large private market for LTCI (3 million policy-holders in 2007)

**Germany: 16,700,000 aged 65+, 20.3% of total population (2011)**

Germany is closer to Japan's situation with over 20% of the population aged 65+. The 2011 PAYG age-pension contribution rate was 19.5% of gross salary, shared equally between employee and employer.

- Four compulsory PAYG/payroll tax insurance schemes: Health, Unemployment, Nursing Care, Age Pension
- Public health-care insurance automatically enters people into public LTC social insurance: universal, non means-tested, PAYG
- 9% of population have a privately provided LTCI scheme offering greater benefits than state scheme

**Japan: 27,400,000 aged 65, 23.1% of total population (2010)**

- Age pension is PAYG, compulsory employee contribution from ages 20 and 60. Entitlement to benefits after 25 years' contributions.
- By 1995, elderly share of total health-care costs was 31% and is projected to reach 50% by 2025.
- Universal public access to LTC.
- Significant means-tested private contribution still required for residential LTC.

In 1990, recognising the growing cost of their rapidly ageing population, Japan began implementing a **universal, compulsory, contributory PAYG system of LTC Insurance**.

In addition to an age pension premium and a health insurance premium, for those between the ages of 40 and 64 years, the LTC Insurance payroll tax is 9% split equally between employee and employer.

### United Kingdom: 9,500,000 aged 65+, 15.7% of total population (2011)

- Combination of social insurance and social assistance for health, unemployment, age pension
- Age pension: flat-rate , age 65 (men), 61 (women), with 30 years' paid contributions; funded by 11.9% of employee's earnings greater than £144 a week (April 2012) plus private contributions to retirement pension
- Means-tested safety-net requires co-payments towards LTC from those with assets above a low threshold

### United States: 39,500,000 aged 65+, 12.8% of 308,745,538 (2010)

- Social insurance scheme for age pension
- Net variable annuity sales approx $34 billion (2011 – see LIMRA) but as with Australia's SG, most private retirement savings drawn as lump sum
- Medicare, Medicaid cover some LTC.
- Private LTC costs  around $100,000 p.a.
- 10% of population aged 60+ carry private LTCI
- US public + private expenditure on LTC services and support was US$203 to US$243 billion in 2009
- Net variable annuity sales approximately $34 billion (2011) BUT, as with Australia's Superannuation Guarantee, much drawn as cash vs annuity (see LIMRA).
- Private LTCI is held by around 10% of those aged 60+.

A person's retirement savings and pension income are drawn on to pay for LTC for as long as it takes, at an annual cost of around $100,000.

### New Zealand: 605,800 aged 65+, 13.9% of total population (2012)

- **Age pension:** NZ Superannuation (NZS) universal, flat-rate, generous, from age 65 (cost $9 billion in 2011)
- **Annuities**: few available **LTCI**: none available
- **In-home LTC**: DHB-funded, universal (cost $224 m in 2010)
- **Residential Care:** means-tested state subsidy + NZS + private charge
- **Residential Care Subsidy**: DHB funded (19,055 subsidies in 2010 cost $800 m)

**New Zealand's spending in 2011/12 was:**

- $25.5 billion Social security and welfare, including $9 billion for NZ Superannuation.
- $13.7 billion on Health (compared to $12.4 billion on Education).

New Zealand Superannuation (NZS), the flat-rate, universal pension, is not means-tested, and is paid out of general taxation on a PAYG basis to all people aged 65+.

NZS is comparatively generous, and makes a significant contribution toward the costs of LTC: of the 19,055 Residential Care Subsidies paid in 2010, only 113 were not in receipt of NZS, Veteran's Pension, or a main welfare benefit.

We will soon have KiwiSaver making a small difference, but like Australia and Japan, most people are likely to draw the cash rather than purchase an annuity or LTC Insurance – and these products are really not even available.

**In-home LTC**: health-care provided free after assessment (DHB-funded). No means-test. In 2010, DHBs spent $224 million providing such services. Around $3000 per person.

**Residential care:** in 2009/10, New Zealand's district health boards spent $800 million, ex GST on RAC for the aged; Residents contributed around $250 million from NZS plus another $400 million.

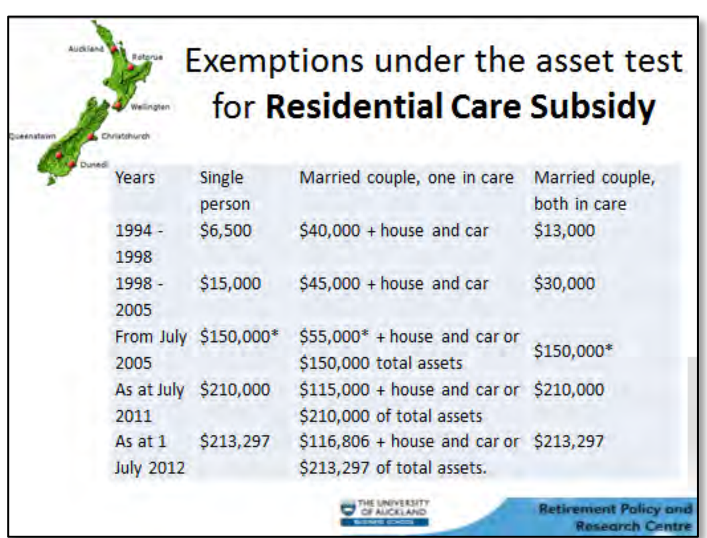
Of those in RAC, about 30% were paying privately up to a maximum limit, while 70% were partially or fully state-subsidised.

The cap on personal contributions for RAC in 2011 was $786 - $864 per week depending on the region (The cost of hospital-level care can exceed $1,500 a week)

The Residential Care Subsidy exemption thresholds were raised by $10,000 each year after 2005 for all groups leading to a spike in the numbers of residents who suddenly became eligible.

However, from July 2012, asset thresholds will increase each year by the rate of increase in the Consumer Price Index (Auckland District Health Board, 2012). This ensures that in the future, more of the financial burden of LTC is a private cost rather than a public cost.

The government IS making changes. We just need to make a lot more.




| Years | Single person | Married couple, one in care | Married couple, both in care |
|---|---|---|---|
| 1994 - 1998 | $6,500 | $40,000 + house and car | $13,000 |
| 1998 - 2005 | $15,000 | $45,000 + house and car | $30,000 |
| From July 2005 | $150,000* | $55,000* + house and car or $150,000 total assets | $150,000* |
| As at July 2011 | $210,000 | $115,000 + house and car or $210,000 of total assets | $210,000 |
| As at 1 July 2012 | $213,297 | $116,806 + house and car or $213,297 of total assets. | $213,297 |

# Session 2. Decumulation policy and products

## 6. The place of decumulation in overall retirement income policy. *Malcolm Menzies*

New Zealand's Retirement Income Policy has multiple objectives, starting in 1898 with the prevention of old-age poverty among "the deserving poor". Objectives broadened through the 20th century, to include participation in society and wellbeing among all retired people. The 2010 review of retirement income policy noted other objectives including longevity risk pooling, lifetime consumption smoothing, intergenerational equity and the promotion of economic growth through fiscal restraint and national savings. Some of these objectives complement each other, while others involve tradeoffs. It can be argued for instance that decumulation fits with the consumption smoothing objective, and the universal payment of New Zealand superannuation throughout retirement helps to dispense with individuals' risk of outliving income. This presentation will canvass eight objectives and identify emerging gaps in policies for managing income in retirement.

Good morning everyone, I'm representing the Commission for Financial Literacy and Retirement Income. We're responsible for reviewing retirement income policy every three years and are currently embarking on the 2013 review. I'll come back to that.

My job today is to ensure that our focus on decumulation is placed in the wider context of retirement income policy. New Zealand's retirement income framework may have some gaps, but it actually works quite well. It appears simple but it's actually complex and I'm sure I don't have to remind this audience that we have to be extremely careful about making changes to it.

Having said that, there have already been changes since the last review of retirement income policy in 2010, and more are on the horizon. For example the growth of KiwiSaver, potential changes to the default scheme and the Treasury's long term fiscal projections.

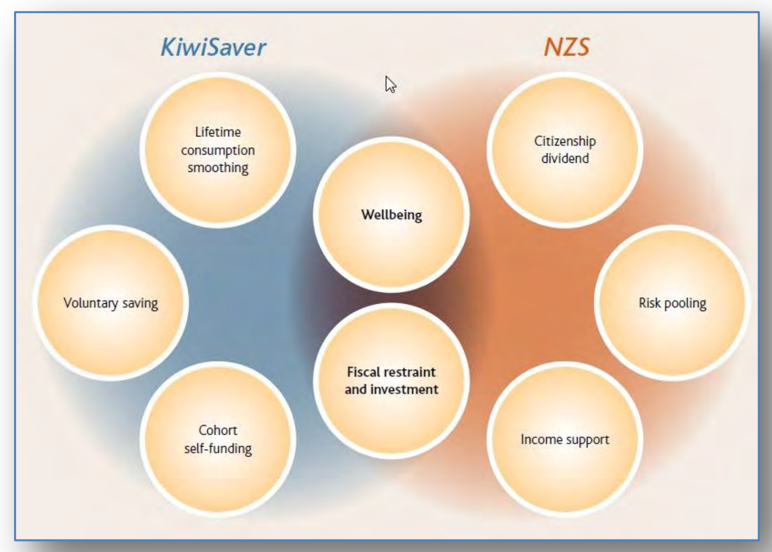
## Topics

- Objectives for Retirement Income Policy
- The place of decumulation
- The role of financial literacy
- Older Kiwis' strategy
- 2013 Review

I want to start by running through the objectives for retirement income policy with a decumulation perspective, then talk about the contribution of financial literacy and finish with some results from a strategy being developed by the Commission for Financial Literacy and Retirement Income for older kiwis (i.e. 55+). These are the people that our research shows are not being as well reached by our Sorted website. Then I would like to briefly talk about the 2013 review of retirement income policy.

### Eight Objectives of Retirement Income Policy

First, I'll remind you of the eight objectives of retirement income policy identified in the 2010 review report. I think Roger Hurnard had a major role in designing these and he's also divided them quite cleverly in this diagram between those that are most closely related to New Zealand Superannuation and those that are related more to KiwiSaver as an element of public retirement income policy.




The first New Zealand Age pension was concentrated on **income support** – avoiding old age poverty – but other objectives have been added over the last 114 years, including "**wellbeing** and **citizenship dividend**" with their increased emphasis on participation in society.

"**Voluntary saving** may need to be reworded as its subheading which is "to encourage personal responsibility, choice and control".

### So how do these objectives relate to decumulation?

For a start, NZS provides a basic "floor" in income that will sustain a no frills lifestyle even for those who have no private savings. 40% of over-65s rely virtually entirely on NZS and another 20% have on average around 80% of their income from NZS and other government transfers.

Toni Ashton's paper has shown that NZS may not be enough to sustain a *healthy* lifestyle.

**The place of decumulation (1)**

1. Income support
   - NZS provides "no frills" income support for 60% of older (66+) New Zealanders
2. Wellbeing
   - Low levels of poverty among older New Zealanders are very dependent on home ownership and complementary services
3. Longevity risk pooling
   - New Zealand Superannuation covers this off
   - One reason for lack of demand for annuities

The outcomes are good for older New Zealanders, given their low rates of poverty in comparison to other countries and in comparison to other generations in New Zealand.

But around one in three older New Zealanders receive more than half their income from sources other than NZS or Veterans Pension and we are potentially looking at a very segmented older population – I'll come back to that.

**Wellbeing** in retirement is not just about income and other policies and programmes are also important – for example to make housing affordable. Our current framework is predicated upon very low housing costs, and dropping rates of home ownership are of great concern. For those who do own their own homes, conversion of equity into income seems to be easier said than done. NZS is payable until the end of life, so covers off **longevity risk** – one reason for the lack of demand for annuities.

So we have low rates of poverty, good levels of wellbeing and no risk of eligible New Zealanders outliving a basic income.

**So what's the problem that decumulation seeks to address?**

Well the problem is first of all a fiscal one. Given current settings, Treasury projections are showing a significant fiscal gap emerging over the next four decades, along with higher levels of debt and debt servicing. NZS and health are key drivers in those projections, due largely to our ageing population. And we don't know where increases in longevity will stop.

> **So what's the problem?**
>
> 4. Fiscal restraint and investment
>    - The fiscal gap
>    - Increases in longevity (where will they stop?)
> 5. Cohort self-funding
>    - Trend towards transfer of burden and risk
>    - Political sustainability

Having said that, changes to NZS have consequences that are far more calculable and certain than in any other area of public policy (is NZS Treasury's low hanging fruit?). The challenge is to accommodate change while also retaining the best features of NZS.

One way is to gradually transfer some of the burden from the public to the private domain. This will need to be done at a pace that's just right in order to not unfairly treat one or another generation (it's no coincidence that Goldilocks was named after a tradeable precious metal and a basic system of securitisation?).

The fairer the transition, the less chance "simmering intergenerational discontent" will turn to a full boil.

**The Placed of Decumulation (2)**

> **The place of decumulation (2)**
>
> 6. Lifetime consumption smoothing
>    - Increasing expectations of the baby boomers and beyond
> 7. Citizenship dividend
>    - A two tiered aged population?
>    - Decumulation for all or just for some?
> 8. Voluntary savings
>    - Possible change in indexation of NZS
>    - Increasing need for private top-up
>    - Growth in KiwiSaver. What to do with balances?

Decumulation is most squarely associated with the lifetime consumption smoothing objective and there are indications that baby boomers may have higher expectations of retirement living standards than NZS alone can provide. For those people, the gap will need to be met through increased private savings and effective management of those savings in retirement. It seems unlikely however that one approach to decumulation will suit everybody. Some will need nothing at all (because they

have no savings); some will need to protect and run down their capital very carefully (because they have just enough to give them some more choices) and others may still be actively investing parts of their portfolios well into retirement.

There's a worry that we'll end up with a polarised old-age population based on very different levels of wealth. There may be a temptation to address this through means testing but that would introduce another type of divide based on resentment and stigmatisation of those receiving the pension. I would argue that New Zealand Superannuation is an entitlement arising from citizenship and contributes to social cohesion – but that's a question that's quite difficult to assess using the tools of economics. It's more a question of values.

As New Zealand becomes more differentiated (fragmented) we need to think about the things that also bind us and give us national identity: reference to tramping, racing, opera where people from all walks of life have mixed together. Is NZS in the same category?

The cost of New Zealand Superannuation is projected to almost double as a percentage of GDP by the middle of the 21st century. Some would say that's still affordable but it's almost certain that some changes will be needed to bring costs down. There will be a gap to be filled by private savings, due to change in the indexation of NZS or to increased expectations or a combination of both. (Because this is short presentation and contributions have been stopped for now, I'm leaving out the collective pre-funding NZSF option, but it also has quite a lot to recommend it). We're fortunate that we have KiwiSaver as a mechanism that will enable us to tweak the PAYGO/SAYGO balance, but the lack of any planning for the decumulation phase is a real worry (hence this symposium).

We do have time to design policies, products and services to address the decumulation issue.

**The role of financial literacy**

- Important at all ages
- Behaviours are core
- Think, shrink and grow
- Life course perspective
- In the right context

But the best response for a large number of older kiwis will be for them to manage their own income in retirement for as long as possible. Ideally they would have learned key behaviours throughout their lives as they have planned (thought); managed debt (shrunk); and grown their net worth. Switching to a decumulation mindset will be easier if it is seen as a natural part of the life course, and the wider retirement income framework remains complementary.

That framework can be seen to consist of **six pillars** rather than the traditional three or four. These pillars need to be protected and enhanced to support living standards in retirement:

1. NZS
2. **KiwiSaver**
3. **Private savings**
4. **Home ownership**
5. Employment
6. Other public services, especially health

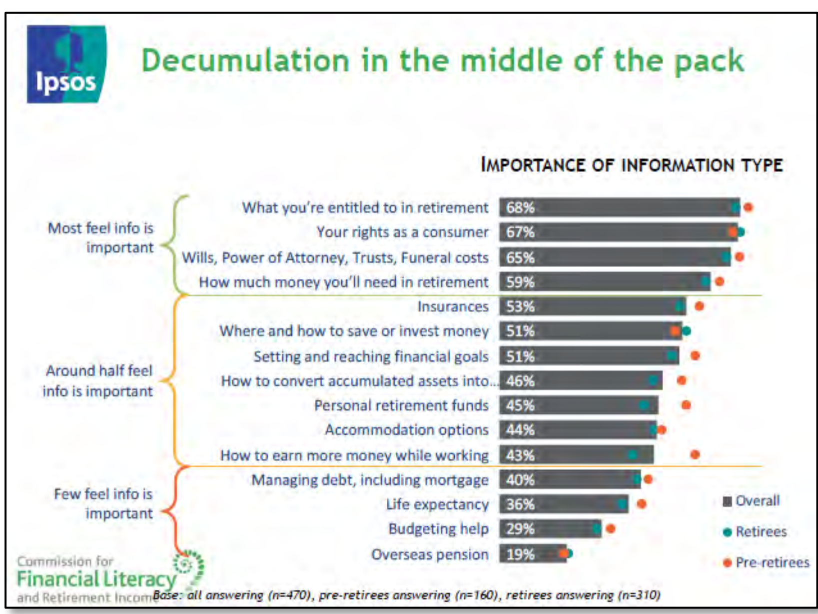
**Older Kiwis strategy**

I want to briefly talk about an exercise that the Commission for Financial Literacy and Retirement Income has carried out over the last year: that is to survey the needs of Older Kiwis aged 55+

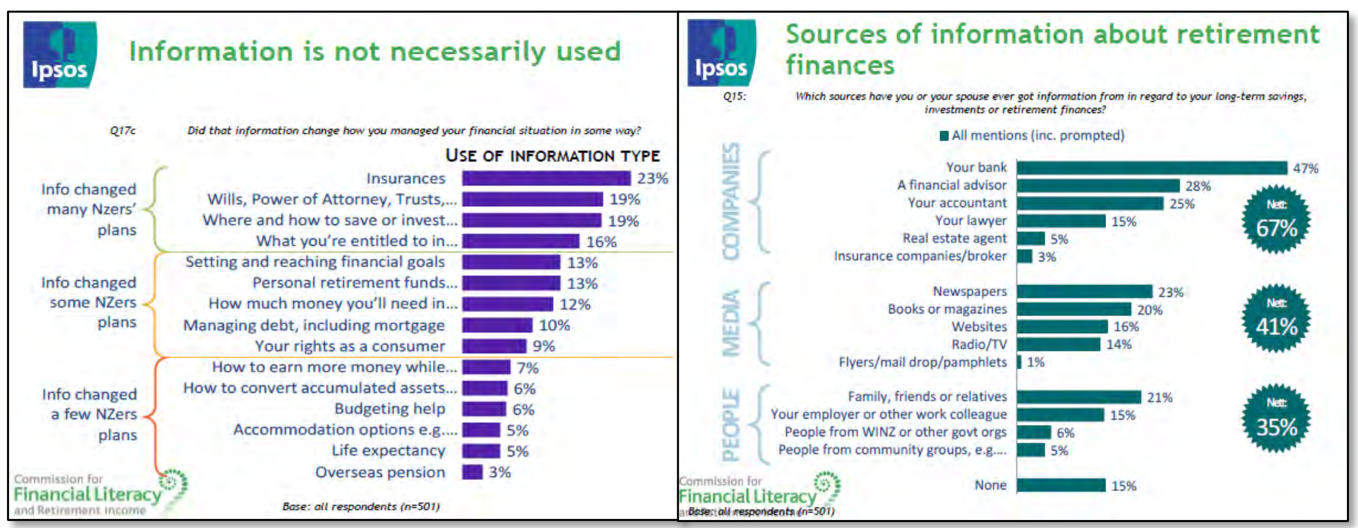
(who have not been our target audience for the Sorted website). Two major groups of pre-retirees and retirees were divided into six subgroups – the names indicate their characteristics.

| *Pre-retirees* | *Retirees* |
| --- | --- |
| – Vulnerable<br>– Middlers<br>– Planners | – Lifestylers<br>– Supporters<br>– Later life transitioners |

In terms of importance of information on the topic, decumulation was the middle of the pack for most of the groups – with one exception which I'll come to.




Even when they got information on decumulation, it wasn't necessarily used.
There lies a challenge for financial educators.




**Where did they get their information?**
Banks come out way ahead. This is consistent with the findings of the 2006 and 2009 financial knowledge surveys.

For various reasons, we will be concentrating our CFLRI OK strategy on two groups: the "pre-retired middlers" and the "retired lifestylers".

### Pre-retired middlers and retired lifestylers

We think they may be the same group, separated by age. They are doing alright but only **as long as "nothing happens"**. They are backing their ability to stay healthy and to earn. That is, they are backing their human capital rather than their financial capital. They need to plan, manage risks, and consider alternatives to working longer and harder.

Interestingly, the older groups have different priorities.

### Later life Transistioners

Later life transitioners needed help converting assets into regular income. Their **priorities are "how much you'll need in retirement", "converting assets into regular income", and "setting and reaching financial goals".**

**"Converting assets into regular income" is an information type** that is a unique top priority to this group. So are there implications for annuitisation at a later stage?

But what about the bequest motive?

Some possible conclusions may go against conventional wisdom:

- Protect the six pillars
- Develop an affordable insurance against loss of income for those betting on working longer
- Invest in financial literacy at all ages
- Self-management of income in early retirement
- Products targeted at older ages.

## 7. Current KiwiSaver products and practices, *Michael Chamberlain*

If New Zealand is to have a viable decumulation product then it will need to be retiree-centric as the value and security hurdles cannot be overcome by the industry if left to its own devices in the current regulatory environment. In order to proceed: the challenges of product design must be overcome, the problems of leaving it to product-centric organisations must be addressed, and The potential role of government needs to be determined.

Spending the savings

- *"How can middle-income retirees best use their savings for what might be a very long or very short retirement"*
- *"There are virtually no New Zealand products that spread the risk of outliving capital"*
- *"yet individuals and society have a vested interest in facilitating this process"*

*Source: Symposium briefing notes*

MCA www.mcanz.co.nz

- the challenges a product design must overcome
- the problems of leading it to a product-centric organisations
- the potential role of government

**Decumulation is not new**. It has been around since the first investor retired. Perhaps it is now topical because returns are currently low and volatile, the retirement period is getting longer and the baby boomers are retiring and want **more. Perhaps it is part of the industry's strategy to** create demand for the next series of products and a continued profit stream.

The fact that we are having a symposium on decumulation, tells me that there is no single practice, product or solution. But why would we expect there to be one? Why do we think that we need a product?

Because there are multiple options, and because we are dealing with an area that is complex, often unique to each individual and where there are conflicting interests of the stakeholders, a “product” in the traditional sense will never be an optimal sustainable solution for the retiree.

But all retirees still **need a solution**. The consequences of an uncertain life expectancy do not go away. The need to manage investments will increase. But I argue that the optimal solution is not a product, but a service and a **thought process**. Unfortunately a service that few retirees, (probably less than 10%) will adopt.

The industry with its vested interests will collectively act to discourage it. The **optimal solution** has to be a retiree centric flexible vehicle that lets individuals control and align their decumulation to their individual expenditure needs; but more on that later.

**The consequences**

- It is unlikely that a suitable third-party product could ever be developed that is “fair” to retirees and taxpayers
- The pricing of the risks make the residual return too low for most retirees
- The profit motive of the industry makes it uncompetitive
- Compliance and costs are prohibitive
- With NZ Super as it is, what benefits do taxpayers and society get?

**The answer** is a retiree centric service and facility which combines a flexible, low cost, transparent vehicle with clear and frequent information and education.

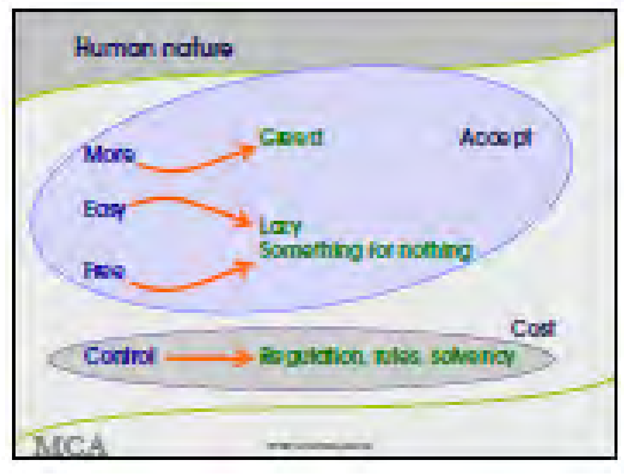
## The basic challenges

There are some basic challenges that a solution must address.

- Human nature gets in the way.
- Buyers have to cope with complexity and are at a disadvantage because of asymmetric information.
- While there are many choices of providers, there is a lack of true competition and there never can be true competition. Choice is not competition.
- The interests of the industry stakeholders are in conflict with those of the buyers. The agendas of regulators, product manufacturers and product distributors, are often in conflict with each other, but all work against the retiree.
- There are too many unknowns and the risks. The costs of having a third party manage the risk, or take on the risk, are too high. You cannot take on risk unless you price it correctly so you stay in business. Therefore, risk must be priced high and with contingencies and generous margins. Retirees cannot get a good solution if the costs they pay are high.

## Human nature

It is very easy to suggest that a key barrier to a solution is government policy or regulation, or the size of the local market or the lack of tax incentives. But possibly, top of the list is human nature itself.



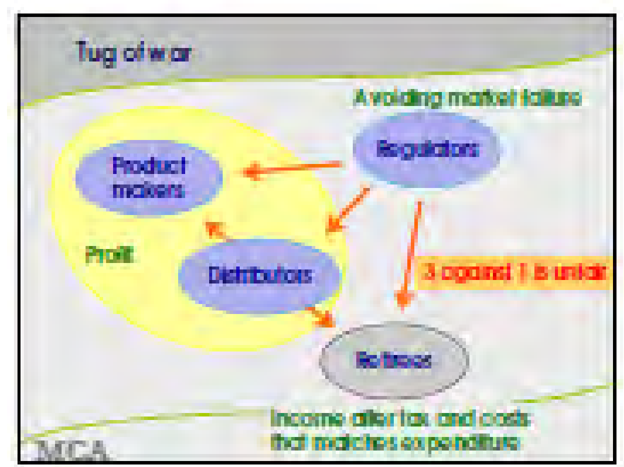

Human nature just does not allow us to accept reality and what is realistic. We are greedy and we like the managers who promise more. We relate better to rosy promises of higher returns than a message of honest reality. We also want it easy. We want someone else to not only do it for us, but to do it for free.

We want more. But if we get more, someone must get less.

Add in the control that the politicians and regulators want, because they know best, and you get a cocktail that looks good, tastes awful and has low alcohol – overall a disappointment. Human nature gets in the way of a good product. Human nature is also why we get a lot of bad products and poor practices.

If we want an effective solution we have to accept that we must take on and manage risk and not expect others to do it for us. The cost of sharing risk in a regulated environment comes at a price. The solution has to involve self-managed risk. I am not sure that human nature will accept personal responsibility.

## Stakeholder conflict




It is important to understand the interests of the stakeholders of products and how they are in conflict with the retiree's interests, and effectively conspire against the retiree while pretending to be their friend.

The retiree wants to convert their capital into income in a cost effective way. To do this they rely on getting a fair return net of taxes, fees and costs. If they choose to use a product, there is a range of stake holders that get involved.

The regulator, the product manufacturer and the distributor, each purport to work together to deliver the best for the retiree buyer. They promise value; risk reduction, increased security and an efficient market. But each operates on a "cost plus" basis, and each wants to avoid risk and/or make a profit. And the poor buyer pays for it all. Their actions do not increase the return.

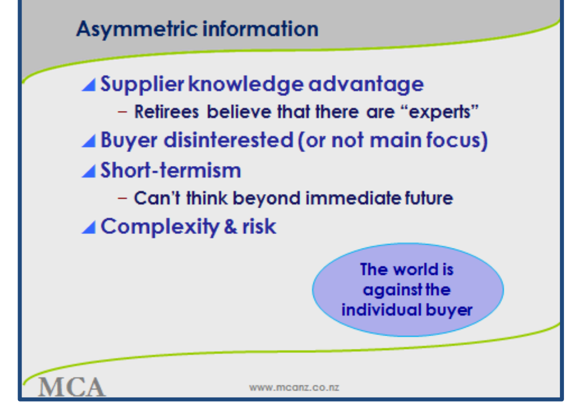
Every new regulation has not only a cost of compliance that is met by the end user, but also means products require more scale and greater standardisation. Regulation also encourages less innovation and less risk-taking by providers, and therefore by definition lowers average returns.

## Competition

There are 30+ KiwiSaver providers offering 40+ schemes but there is minimal product competition. We have choices, but we typically do not exercise those choices and truly rank one against another. Without true competition you do not get the benefits of the free market. If you do not get the benefits, you get increasing regulation as the regulators look to protect you from the bad things. This in turn reduces competition.

Financial services are typically sold not bought. Therefore it is a function of the effectiveness of the distribution and not the quality of product that matters. Good marketing and distribution gets you the business, inertia keeps you the business. But distribution comes at a cost.

The same will apply to decumulation products. Distribution will determine what is bought and who it is bought from and the mis-selling experiences of the UK over the last 30 years will become a feature of the New Zealand financial industry landscape.




## Asymmetric information

- Supplier knowledge advantage

- Retirees believe that there are "experts"
- Buyer disinterested (or not main focus)
- Short-termism
- Can't think beyond immediate future

### Complexity & risk

We typically only have one retirement. We can plan and surmise, but we do not experience it until it is upon us and by then it can be costly to make changes.

As buyers of services, we typically have less knowledge than the product providers, in what is a complex series of interwoven risks. We are therefore at a huge disadvantage. We also have a false level of trust and believe that they are experts and honest. But do not blame the providers.

We also must recognise that the buyers in many cases are **not interested** in understanding their risks and investments. Their focus is on other things. And if we overcome the lack of interest, we still have to overcome the attractiveness of **short-termism** and a lack of appreciation of the need to take a long term perspective. It is hard to appreciate the level of wealth required to sustain your life style well into your 90s.

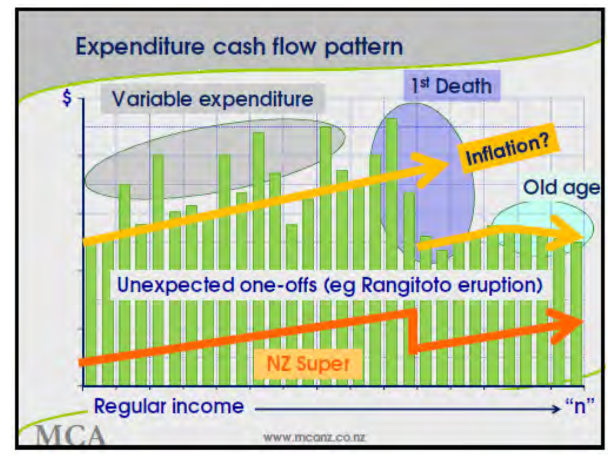
If you have less information, you are vulnerable to be taken advantage of. This can happen even if the product provider believes it is doing the right thing.

The world is against the individual buyer.

## Individual need

The needs of retirees are simple. They want an increasing income for the period of their unknown retirement and that of their spouse. The income needs to be variable and rise with inflation. It needs to cope with death and ultimately old age and reduced capacity.

But from a decumulation perspective we are only interested in the part that needs to be funded above NZ Super.




A product needs to address/cope with each of these and to work, there needs to be sufficient homogeneous people. It just can't happen in a product.

### Understanding the unknowns

- Expenditure cash flows
- Income, lump sums, unexpected events
- Inflation
- Duration (life expectancy)
- Longevity - medical advancements
- Age you lose your "marbles"
- Investment returns
- Average, pattern, income/growth split
- Tax, management fees, costs
- Country/city of final retirement

We do not know how much income we need, when we need it and for how long. We do not know how much we will get from investment returns and what we will pay in tax and fees and costs.

We also do not know where we will retire to and what country our expenditure will occur in.

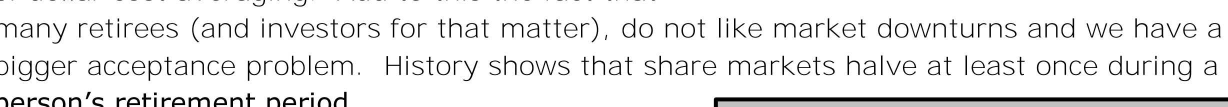
Each of these represents a risk or unknown that has to be managed or accommodated within a product.

To further complicate the problem, remember that retirement lasts for many, more than 25 years. Over this time there are at least 8 elections, a significant turnover of providers and most legislation will change along with the tax regime. Each of these contingencies needs to be allowed for and if the retiree uses a product, provided for in advance. The retiree will pay for them if they happen or not.

- Support: Advice, education, capability
- Legislative change: Regulation, compliance costs, tax
- Product provider survival
- Market share, economies of scale

## Investment returns

Many will disagree, but in my view and in the period of retirement, the portfolio approach to investing doesn't work. Volatility is a curse when you have negative cash flow – it is the opposite of dollar cost averaging. Add to this the fact that many retirees (and investors for that matter), do not like market downturns and we have a bigger acceptance problem. History shows that share markets halve at least once during a person's retirement period.



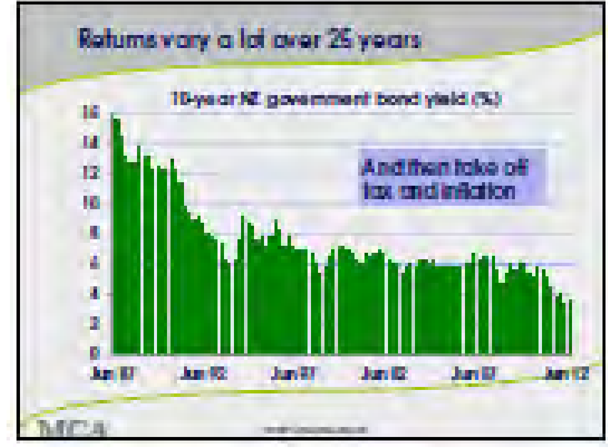
But investors get what is left. The return of an investor can only come from the markets and the investment strategy, or short-term, by borrowing against the income of future generations and so there is a natural cap on what returns can be. From these must come taxes and costs from all sources and it is clear that it is hard for the end-consumer to get a reasonable share of the investment return.

Remember there will be extended periods of low returns.

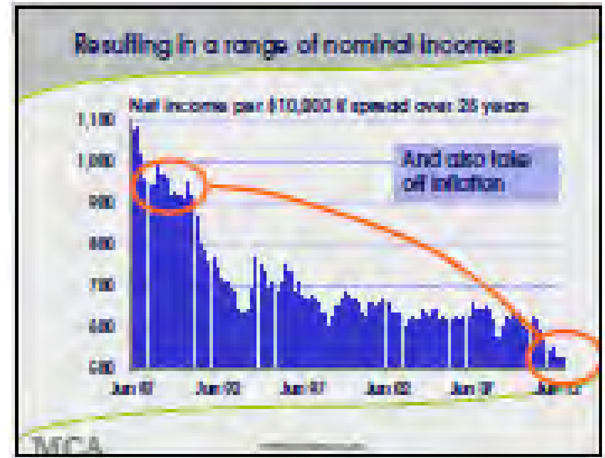
## Returns vary a lot

We know that share markets go up and down. But for a retiree this may be the least important investment factor. For many it is the interest rates at the time of retirement that are important and determine the ultimate return.

Over the last 25 years the 10 year government bond yield has varied from 16% to 3.5%. It has to be hard retiring today. 3.5% doesn't leave much after fees and tax for the retiree.



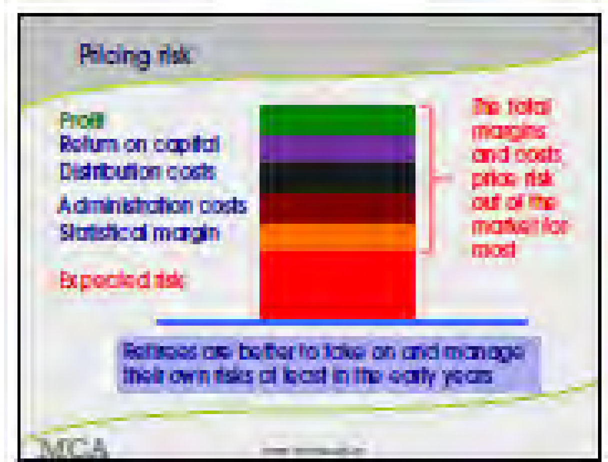
The interest rate at the time of retirement is important as it is a key driver of the return that you receive. Based on the interest yields over the last 25 years the level of income that $10,000 can produce has varied between $1,100 and $520. If you have retired in recent times it is little comfort to know that normally you could have spent $625, but unfortunately now it is only $520.




## Pricing risk

The retiree pays the money and takes on risk even if they choose to use a product to eliminate or reduce the other risks. I argue that if they do this they simple guarantee to lock in a low return. This will make sense for some but not for most.

If risk is transferred then it must be priced. At the point the product that takes on the risk it must allow for contingencies, the costs of sale and servicing and achieve a reasonable return for the shareholders. Pricing this risk to be taken on over very long periods of time will make the product too expensive. There have been many examples of long-term insurance and investment products, which have proven inadequate and not capable of standing the test of time.




The failure of the product design should be a concern of the regulators. Risks have to be taken and managed. You cannot manage a risk by avoiding it.

The answer has to be to manage risk — at least until the residual retirement period is short.

## The role of the government

- Reduce quantity & improve quality of regulation
- Adopt principles and not rules
- Ensure certainty & stability
- Adopt the sunlight gold standard
- Focus on standards of outcomes and not documentation of process (of inputs)
- Improve tax system
- Encourage risk management & not risk avoidance

Let's turn our attention to the role of the government. Some would argue that taking on the longevity risk is the role of the government. I am not sure that on top of NZ Super it needs to do much more and I am not sure that it is in the interests of taxpayers for them to do so.

Also, I hesitate, as philosophically I am against the government doing things unless they are needed to be done and there is no other choice, as I think that history shows that they do not do that well in commercial matters.

Governments want to reduce risk and not manage risk and you can't reduce or remove risk you can only transfer it so it manifests itself somewhere else. It is better to leave it to the individual.

There are some things that the government should do:

- **Sorting out the tax system** is one. It may argue that it has or is, but it has not and is not. The tax system needs to be simple, understood, consistent etc, etc.. It is wrong that there are 11 different ways to invest in BHP shares and get different tax outcomes.

- Making the **regulatory regime clear and principles-based** and not rules-based. Compliance with rules is easy for regulators to check up on, but easy to get around through token "show and tell". It is harder to get around clear principles.

- Move to **manage risks through disclosure** and information and not look to avoid risks. The principle should based on the gold standard of sunlight.

- Move to a **single managed fund regulatory regime** and eliminate the variations of super schemes, unit trusts, group investment funds etc.

- Taking on the mortality risk. The NZ market is probably not big enough for several private sector operators to price it. Without several you will not get the benefits of competition. Therefore if this is important and I am not sure that it is, there is a role for the government.

Overall the role of the government should be to create a flexible environment that has principled disclosure and where products can thrive and not become uncompetitive for investors because of disclosure costs.

But the solution has to be with the industry and not with government.

## Thinking about the solution

The starting point has to be the needs and wants of the user. In simple terms they want an income that will come from the investment earnings and capital. They want the income to align with their expenditure. It sounds simple but it is complex as there are too many unknowns.

We might know today about our future expenditure over the next 12 months, but what about in 25 years' time – there will be inflation, health events, family emergencies; here will be eight elections.

Add in the uncertainties because we do not know how long we will live and what the investment returns will be and we have many unknowns. A buyer cannot get a good or an efficient solution, with unknowns as a third party provider needs to build in large margins that we have to pay for to cover the uncertainties and unknowns.

The solution has to involve a flexible managed income or drawdown facility. It has to include a service whereby the retiree can see the effect of what happens if they live longer than average. It has to manage the investments to the expenditure needs of the retiree, with what I call the bucket approach. It has to recognise that the retiree's investment requirements are not conservative or balanced, but for a combination of liquidity, income and inflation protection.

The solution has to involve no surprises, has to have low core costs and be able to be tailored to each individual. In simple terms it needs to be an efficient flexible facility supported by self-service education and tools – a retiree-centric solution and not a product.

*"If something cannot go on forever, it will stop."*

*Economist, Herbert Stein*

## 8. What would it take to have a New Zealand market for annuities? *Peter Neilson*

A range of issues means there are very few willing buyers and willing sellers of annuities currently in New Zealand. The Financial Services Council (FSC) has suggested that an option or requirement to purchase a fixed term pension from KiwiSaver balances to supplement New Zealand Superannuation (NZS) at retirement might be a way to address some of these issues. Most of the remedies for the deficiencies of the annuities market would require the taxpayer, through the Crown, to take on more risk and to make commitments on behalf of future taxpayers. That inevitably generates issues about intergenerational fairness and redistribution from those with shorter to those with longer longevity.

Members of the FSC manage about 80% of the KiwiSaver funds in New Zealand. My comments on what has prevented an annuities market developing in New Zealand are based on conversations I have had with my members and the work the FSC has done on the topic which was included in our report *Pensions for the Twenty First Century: Retirement Income Security for Younger New Zealanders*.

Chris Coon from Partners Life will talk about the commercial considerations in creating a bigger market for annuities in New Zealand.

**What are we trying to achieve with Retirement Income Policy?**

- NZS to remove absolute poverty in retirement or old age.
- KiwiSaver and other policies: to provide as many New Zealanders as possible with a comfortable retirement.
- For most of us $350 a week is insufficient income in retirement to achieve a comfortable retirement. Most New Zealanders think this can be achieved by an additional $300 a week ($15,600 a year). Just to achieve such a top up with no indexation for inflation would require savings above $300,000 by retirement.
- Fidelity Life, the FSC member most active in the annuity space, currently sells around 3 annuities each year so the market is currently extremely small in New Zealand.
- The countries with a more active market for annuities such as the UK or Germany either have some element of compulsion or annuities are strongly tax favoured.

These are my definitions of what our retirement income policy should be rather than what is in place currently. If most New Zealanders aspire to have a retirement income about two times the level of NZS to be comfortable then there will need to be a second tier of income, probably by way of some additional pension above NZS, possibly in the form of an annuity.

**So why are consumers not keen on annuities?**

Most fund balances at retirement are quite modest and are used to purchase interest bearing investments, real estate to rent out or are placed with banks on term deposit. This can be expected to change as KiwiSaver matures and coverage and contributions grow.

It would appear that most New Zealanders have issues with the control of their wealth and a preference for do-it-yourself options. At current interest rates you pass over a very large amount of your wealth to obtain a relatively modest ongoing income if you are expected to live a further 20 to 40 years. The descendents of the potential annuitant often see this as giving up their inheritance.

This perceived value for money issue is made worse by the tax treatment of annuities where all the income from your annuity pension is taxed as if it were interest when part of what you are receiving is the return of your capital. This means in effect that annuities are overtaxed relative to term deposits and investments in rental property where you pay tax on the net rental income or interest but not on the repayment of capital.

New Zealanders appear to prefer DIY (Do-It-Yourself) options for providing a second tier of retirement income.

At the moment most retirement savings balances are quite small and interest bearing financial instruments, term deposits and investment in rental properties are preferred over annuities. In a low investment return environment people believe they give up control of a lot of capital to receive a modest ongoing income.

Annuities combine an interest component and a capital return part but are unlike rental property or a term deposit where the capital repayment does not attract taxation. For an annuity you pay tax on both components and that makes annuities less attractive.

I suspect one of the major reasons that consumers don't see value in purchasing annuities is that they are underestimating their likely longevity in retirement:

- Most of the discussion about longevity relates to life expectancy from birth which is not all that useful for accurately estimated longevity in retirement. Why is this?
- Many people are referencing their family history for those already died rather than the trend towards increasing longevity after 65 now moving up by an additional 2 years each decade.
- If they were to refer to the NZ Statistics projections they would most likely select the mid series projections which have consistently underestimated the improvement in 65+ longevity.

Most people do not understand the difference between period and cohort analysis of longevity trends which also pushes people toward underestimating their 65+ longevity.

The major reason why annuities are not perceived as value for consumers is that we appear to underestimate our likely longevity in retirement. Annuities are priced based on expected longevity. If consumers consistently underestimate their likely longevity then the return from an annuity appears unattractive.

**Underestimating Longevity**

Last year the FSC asked Horizon Research to ask New Zealanders of all ages how long they expected to live past 65. The results below indicate that most people are likely to be underestimating their likely life expectancy past 65. The estimation gap is largest in those age groups where they are most likely to be able to save for retirement.

FinancialServicesCouncil.

| Year of Entitlement for NZS Aged 65 | Expected Lifespan (years) | | | | | |
|---|---|---|---|---|---|---|
| | FSC "Lancet" Projections | | Survey Reported Self-expectation | | % Gap | |
| | Male | Female | Male | Female | Male | Female |
| 2011 | 86.1 | 89.1 | 86.5 | 86.3 | -0.4% | 3.2% |
| 2012-2021 | 87.1 | 90.0 | 84.1 | 83.4 | 3.4% | 7.4% |
| 2022-2031 | 88.9 | 91.8 | 81.6 | 83.3 | 8.3% | 9.3% |
| 2032-2041 | 90.9 | 93.7 | 83.6 | 84.9 | 8.0% | 9.4% |
| 2042-2051 | 93.0 | 95.7 | 83.4 | 84.1 | 10.3% | 12.1% |
| 2052-2058 | 94.9 | 97.6 | 85.8 | 86.0 | 9.6% | 11.9% |
| 2059-2061 | 96.1 | 98.7 | 88.0 | 94.4 | 8.4% | 4.4% |

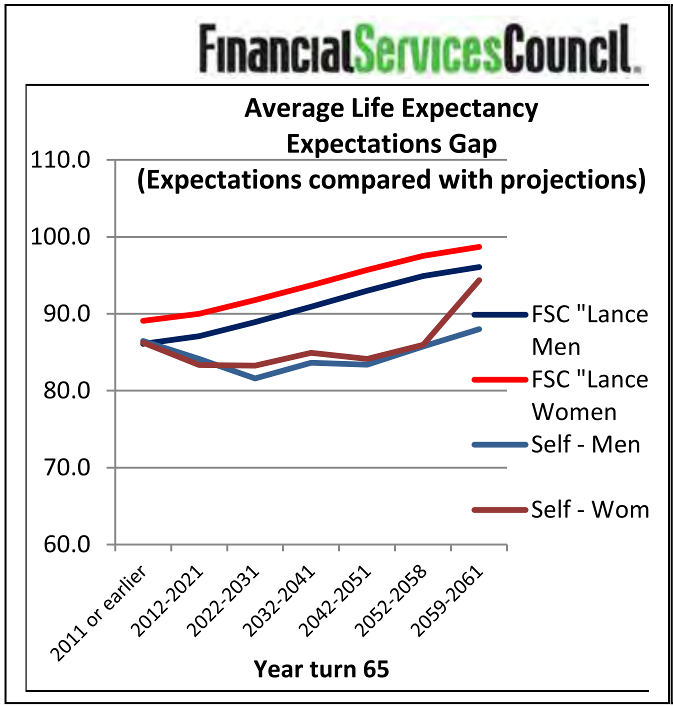
*Source: FSC Horizon Research Dec 2011*

growing and protecting the wealth of New Zealanders

The same research indicated that most people had an understanding of what they would need to be comfortable in retirement but most people could not make a good estimate

about how long it would take to double their money from a certain interest rate and keeping the interest in the account to earn interest on interest. Other research undertaken internationally reveals that most people have difficulty understanding what size of retirement savings pot would be needed to fund a level of pension.

It is notable that the underestimation of longevity is currently greatest for those furthest away from retirement when saving would be most effective in boosting retirement income.



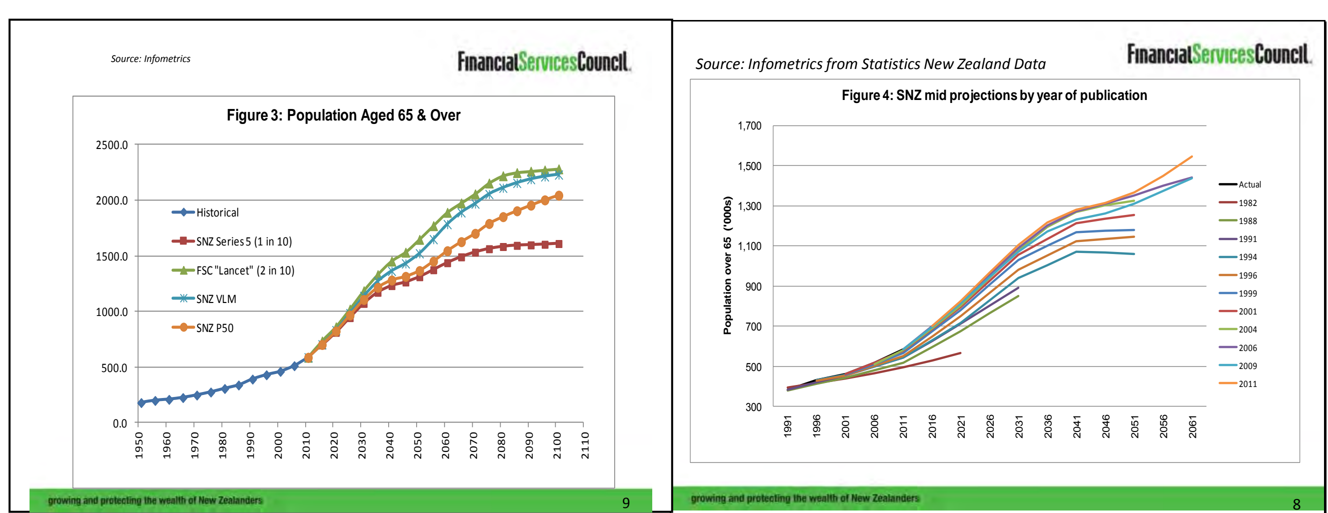

FinancialServicesCouncil

***Table 1: Life Expectancy at Birth***

| | | *Historical* | | | *P50* | *VLM* |
|---|---|---|---|---|---|---|
| | | *1900* | *1950* | *2000* | *2061* | *2061* |
| *Males* | *Period* | *57.4* | *67.2* | *76.3* | *88.1* | *95.0* |
| | *Cohort* | *58.2* | *77.3* | *88.6* | | |
| *Females* | *Period* | *59.9* | *71.3* | *81.1* | *90.5* | *95.0* |
| | *Cohort* | *63.1* | *82.0* | *91.6* | | |

*Source: Statistics New Zealand*

It is not just individual New Zealanders that have been underestimating their longevity after 65. Statistics NZ, like almost every official statistics service around the world, had consistently underestimated the likely over 65 population looking forward and each update has seen their projection of the expected over 65 population increase over its earlier ones. Even small differences in assumptions produce large errors in predictions about future population trends.




## Why do we have problems on the supply side?

Currently there is insufficient demand but that will change with time.

There is an unwillingness to carry the inflation, investment, interest rate and longevity risk for what is likely to be a very long period. Evergreen contracts that last 20 to 40 years are

extremely rare and usually contain review clauses or involve a much greater sharing of risk than a traditional annuity contract.

There is also currently a lack of financial assets to match the very long financial liability that an annuity contract represents. For example, the existence of a 40 year crown inflation proof bond would help with the pricing of long term assets such as infrastructure bonds that spread the cost of infrastructure assets over the generations that will benefit from them which would help an annuities market develop by allowing annuity risk to be securitised.

Most financial institutions are reluctant to take on a 40 year contract to manage inflation, interest rate and longevity risk. Forty year contracts are extremely rare other than for mortgages and such contracts usually contain review clauses or other mechanisms to share the risks between the contracting parties.

The major challenge for the financial services industry is adverse selection, that is, people who have good reason to expect they will live a long time in retirement, will want to purchase annuities where as those who have reason to expect a shorter than average retirement will not.

So if Susan St John knows her family members typically have a 30 to 40 year retirement she will want to buy an annuity, whereas someone who expects to live only 10 years in retirement may not find the annuity offering attractive. Providers therefore will trend to price on the basis that the longevity of the typical purchasers will exceed the average. It is these sorts of reasons why most countries provide a base pension that is paid for the whole of your life and covers off the longevity risks for those living the longest and those who might expect a short retirement.

These issues are likely to become more difficult as advances in genetics and the reduced cost of screening by individuals makes this information asymmetry greater.

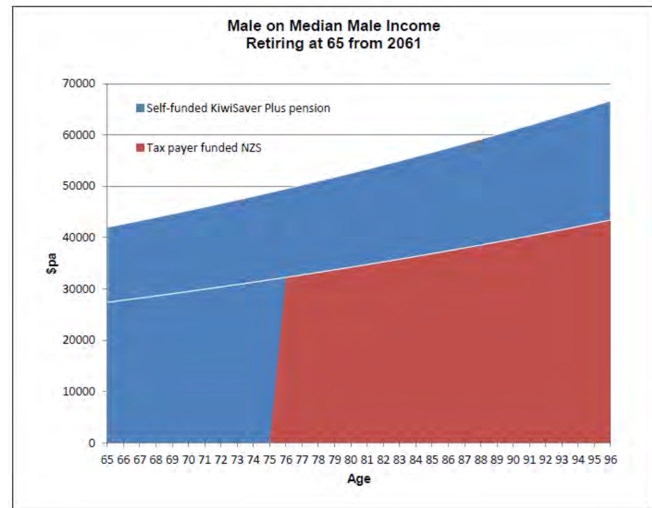
The annuity provider is also at risk of advances in medical treatment that may extend longevity. Such as organ replacements grown from stem cells and highly customised medical treatment based on individual genetic and protein production screening.

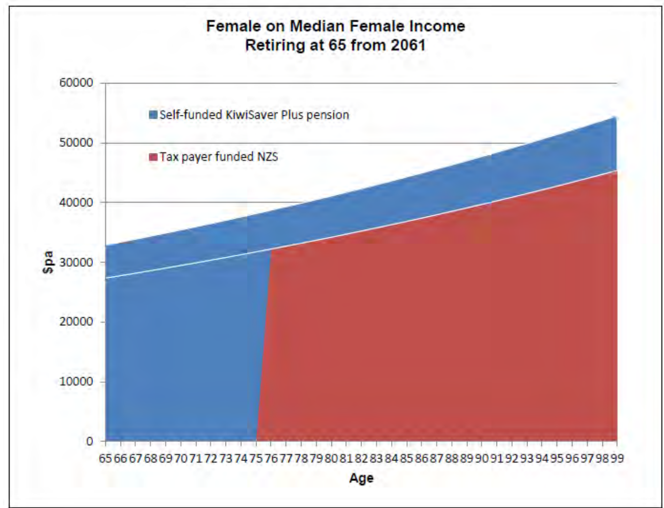
**To address some of these issues the FSC has suggested that:**

- Employees be encouraged to save 10% of their income with a proportion of those savings being used to purchase a gender neutral fixed term pension to supplement NZS.
- The Crown tenders for those fixed-term pensions yearly for that year's cohort taking them up.
- A fixed term pension on top of NZ Super removes the longevity risk but does leave potentially a period toward the end of your life when you will be depending on NZ Super only.
- The Government consider indexing the age of eligibility for NZ Super with 65+ longevity.
- We also suggested bundling a level of life and income protection insurance within KiwiSaver that could, after age 45, be used to purchase aged care or health insurance. This could be extended to allow for the purchase of an end of life annuity policy to cover risk that you will live beyond the end of your fixed term pension.

The FSC solution was to recommend that KiwiSaver be used to fund a fixed term pension for the expected duration of life after 65. If you were to die before that expected duration your beneficiaries or family would receive the balance of the weekly payments. We suggested this could be supplemented with insurance for aged care if you were to live longer than the expected longevity for which you were paid the fixed term pension.

The area above the white line in the figures below is the fixed term pension that you can elect to take up any time from age 65.




If you delay the time for which you pick up the pension you can increase the amount you receive. The fixed term pension proposed would be indexed to wages like NZ Super. Under the FSC proposal you would only be required to purchase a fixed term pension up to the level of $300 per week (but you could purchase a higher fixed term pension if you so choose) and you could take any balance above that required to purchase the fixed term pension as a lump sum.

These issues were not unique to New Zealand. The recent report by the Australian Institute of Actuaries is worth reading for an Australian perspective on these issues.

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## 9. Annuities in the Decumulation Period, *Chris Coon*

partnersLIFE

We're retiring earlier and living longer. Other countries have experimented with guaranteed variable annuities to supplement other income sources after retirement as well as provide the advantage of guaranteed benefits. But are these guarantees worth the price and what about the longevity risk? How might they work in New Zealand? Could a unit-linked fund be a feasible way to usefully decumulate KiwiSaver lump sums?

Currently, the number of working age (20-64) to those aged 65+ is over 4:1. Over the next 40 years this proportion will fall to under 2:1, putting massive financial pressure on the nation if the retirement age is not raised. If retirement age increases to 67 fairly shortly and to 75 by 2053, the (working age)/(retirement age) will remain at close to 4:1.

New Zealand faces considerable ageing problems – like many countries

| Year | Life Expectancy From Age 65 | Population Proportion Aged 65+ | Balanced Retirement Age |
|---|---|---|---|
| 2003 | 20 years | 12% | 65 |
| 2013 | 22 years | 14% | 67 |
| 2028 | 26 years | 20% | 70 |
| 2053 | 32 years | 26% | 75 |

### New Zealand's 'Pensions industry'

New Zealand's 'Pensions industry' collapsed after the Government introduced the TTE (tax/tax/exempt) basis in 1989. Many pension funds were closed to new members, and funds that were planning to open, shelved those plans.

Most other countries are still on EET (exempt/exempt/tax), a much fairer basis. The logical reason for the EET basis is that a Pension is a liability taken on by the company. Reserves are put aside each year to meet the liability building up – thus the expense should be tax deductible. The reserves allow for interest and gains to be made on the investments, thus these should also be treated as tax deductible. The Pension when it is paid is equivalent to deferred wages and thus should be taxed.

One spin-off of the 1989 changes was low demand for long term bonds, hence a market did not emerge.

### Problems with standard annuities

Standard annuities meet the longevity risk need – life expectancy at retirement age is about 20 years on average, but actual life span will range from 0-50+ years. Also, annuities are effectively taxed at the corporation tax rate of 28% rather than the typical individual PIE rate of 17.5%.

These problems are exacerbated by the lack of long bonds for investment; and by the lack of flexibility for the annuitant to extract additional sums.

The public generally see annuities as poor value for money, in part because they underestimate life expectancy. Certainly early deaths are losers, but it is possible to build in to the annuity a guaranteed term.

### The Standard Annuities market in New Zealand

In 2012, there are less than $20 million in annuities in force in New Zealand, and less than 1,000 annuitants.

Current rates would be approximately:

- Annuity rate 6.5% if proper PIE tax rate
- Current annuity rate about 6.25%
- Under normal interest conditions annuity rate likely to be about 8%
- Bank net tax deposit rate about 3.75%

### Guaranteed Draw Variable Annuities

Guaranteed Draw Variable Annuities started in the USA about 20 years ago. Very few have been issued in Australia although 3 companies offered the product. Interestingly, a large number of these annuities have been issued in Japan, but unfortunately poor hedging in place caused damage during the global financial crisis (GFC).

The product is a natural continuation from Kiwisaver in the decumulation period.

The Guaranteed Draw Variable Annuity product provides:

- Guaranteed annuity for life; the fund is expected to reach zero after about 25-30 years
- Fund balance is paid out on death
- Flexibility with partial withdrawals

**Guaranteed Draw Variable Annuities**

- Developed in USA about 20 years ago
- Introduced in Europe about 8 years ago and Australia and Japan about 5 years ago – none yet in NZ
- Unit-linked fund - decumulation phase of Kiwisaver
- Guaranteed annuity for life, even when U/L fund reaches zero – longevity charge against fund
- Remaining fund paid out on death
- Flexibility to make partial withdrawals – annuity level then reduces
- Reserving does require a strong margin for longevity risk – longevity bonds unnecessary with our small market
- Investment strategy should be reasonably conservative as it is a shrinking fund as money is withdrawn

partnersLIFE

- Strong reserves required to pay annuities when fund reaches zero. These reserves are built out of the fund charge, typically 1.5% where husband & wife and death benefit are included.
- A reasonably conservative investment strategy is required, for example, about 35% of the total in equities.

Volumes of this product are likely to be low in New Zealand as in Australia. It is important for the public to be made aware of both the need for this type of product and longevity risks.

**Home equity release**

Home Equity Release (HER) would be an ideal product for those with little savings apart from home ownership, in particular, as an annuity by deferred premium, that would be paid on the eventual sale of the home.

The market tendency with current HER products is to draw down the maximum amount available within 5 years, not leaving anything to cover later needs.

Home Equity Release

- Good addition to product range would be an HER annuity for life – i.e. annuity by deferred premium paid on sale of home
- I think there is a tendency in the market for clients to take available funds early and not leave anything for the later years
- The old tax basis would have been very penal for this product – current basis fine

There is likely to be huge demand for this product through a combination of the ageing population and the damage caused by the GFC and finance company failures.

# Session 3. Home equity release

## 10. Putting Housing Wealth to Work: The role of home equity in decumulation. *Judith Davey*

Older home owners can use their housing wealth/home equity, in various ways. The first choice is between preservation and mobilisation. The second is whether they wish to remain in their homes or to relocate. “Trading down”, moving into rental accommodation or into a retirement village are ways of releasing capital (decumulating). Other options entail remaining in the home and borrowing against the equity, including commercial equity release schemes. Reverse mortgages and variations have become synonymous with home equity release in New Zealand. Flexibility in the use of funds tied up in housing can provide older people with improved quality of life so why has take-up been comparatively low in many countries? Research has identified deeply-held beliefs which work against the acceptance of the equity release concept. Never-theless, in future governments may look to equity release as a way to reduce fiscal demands, as the population ages. Current policies on residential care funding provide an example.

In this presentation, I take as read:

- Population ageing
- High levels of mortgage-free home ownership among older people: asset rich and income poor
- Home ownership as the main and often the only significant asset for many older people
- Concerns about levels of public sector support for older people in the future

**Options for the use of housing wealth**

The first choice is between preservation and mobilisation. If assets are not used within the lifetime of the owners they will pass on to others,

| Mobilise | | | Preserve | |
|---|---|---|---|---|
| ***Sale*** | ***Intensify use*** | ***Use of Equity*** | ***For a rainy day*** | ***Inheritance*** |
| Trade down | Share | Mortgage | Residential or home care | |
| Rent | Convert | Home reversion | Assistance to family | |
| Share | Build on | Reverse mortgage | Emergency use | |
| | | Other options | | |

either deliberately or by accident (that is, through 'inefficient' decumulation).

The "rainy day" consideration: Many people, especially older people, like to feel that they have financial reserves for unexpected expenditure and that it is dangerous to erode home equity except as a "last resort". This may be linked with the contemplation of future health problems, views on inheritance and the ability to assist in family crises. Several New Zealand survey respondents, who took part in face-to-face interviews, said that, before they took up equity release they were eroding their "nest eggs" through day-to-day spending and thus they went into the schemes to create "something to fall back on".

The second consideration is whether they wish to remain in their homes or to relocate. "Trading down", moving into rental accommodation or into a retirement village are ways of releasing capital for use (decumulating).

There are also several options which entail remaining in the home and borrowing against its equity. These include commercial equity release schemes.

### The history of equity release schemes in New Zealand

The history of such schemes in New Zealand goes back to the 1990s, but the concept itself is much older and a variety of schemes has been available in overseas countries.
Equity release schemes are a recent feature in New Zealand, although they have existed in the UK and North America for decades.

The Housing Corporation of New Zealand began a pilot scheme - *Helping Hand Loans* - in November 1990. Funds released could be used for housing purposes only. The scheme was soon overtaken by changes in housing policy and never extended.

Commercial reverse mortgage products were marketed through the Invincible Life Assurance Company in Wellington from 1991. There were several RAM (reverse annuity mortgage) products, with different eligibility ages and sets of conditions. They used first mortgages over clients' property to secure annuities and all costs were deferred until the mortgage was repaid, with compounding interest. In the last decade several new schemes were introduced, mainly reverse mortgage-based, providing lump sums, annuities and line-of-credit. Note: see following Sherpa Presentation for recent information.

### Use of Equity Release (ER) funds

Flexibility in the use of funds tied up in housing can provide older people with financial security/freedom, improved quality of life and peace of mind, as well as the ability to stay in their own homes and to help family members.

It can also provide greater financial security, especially given concern about the sustainability of retirement income support.

Other advantages include the provision of timely access to elective surgery, reducing pressure on the public health system.

If these advantages are real, then why has take-up of equity release schemes been comparatively low in New Zealand and many other countries?

Use of ER Funds

Potential to provide greater financial security and improve the quality of life of older people through:

- Supplementing NZS to allow a more comfortable lifestyle and to support social contribution and involvement
- Access to health services – speeding up access to elective surgery
- Housing quality - may be the only way for low-income home- owners to carry out house maintenance, renovation and adaptation
- Funding for services to support ageing in place
- Ability to help family members

### Deeply-held beliefs work against acceptance of equity release

Having spent many years paying off a mortgage, people may be reluctant to take on debt (as they see it) again. The current older generation is financially conservative and risk-averse, unused to "living on credit".

Oncoming generations may be more used to handling debt as part of everyday money management and may be more comfortable with it. This may make them more open to borrowing against their home equity, for example, paying off sums owed at much higher interest rates, such as credit card and unsecured debt, or for consolidating debt.

**Deeply-held beliefs work against acceptance of equity release**

- It is important to be debt-free
- A mortgage-free home is a strong aspiration and part of New Zealand "psyche"
- It is 'nice' to leave an inheritance for one's children
- Older people are entitled to support from society through government - 'It is my turn now'
- Suspicion of commercial equity release schemes

There is some evidence that attitudes towards inheritance are changing. Greater longevity is increasing the possibility that assets will be required to sustain living standards in old age; older people often see their children as better placed financially that they are themselves; and they are more willing to put their own comfort in old age ahead. Also there is an often-expressed desire for independence and "not become a burden".

In New Zealand, there are expectations of government fostered by decades of welfare state provision. However, there is now a growing acceptance among younger people that the state will be less generous in the future.

There are also problems of Perceptions and Image. There is widespread suspicion about new financial products, and Media articles and letters to the editor have sometimes depicted equity release schemes as "ripping off" older people, based on the cost of the schemes, the effect of compounding interest and the removal of choices once equity has been eroded.

Lack of knowledge about ER schemes and options obscures the potential value for money of such schemes.

### Beliefs which may support to use of equity release in decumulation

- Older people should be independent
- they should use their housing wealth to help themselves and the decision is theirs
- Government support cannot be sustained in an ageing population
- There could be a trade-of between family care and inheritance

These attitudes are illustrated by consumer survey responses (Davey and Wilton 2006: 43-44).

- It is important to leave some of your assets to the next generation (41% agreed, 52% disagreed).
- My children/relatives are quite comfortable and do not need my money (82% agreed).
- I think it is better to use my assets to help me in my old age than to leave them to other people (94% agreed).
- Older people should think more about their children and grandchildren's future than about their own comfort (84% agreed).
- Inheritance is not as important as it used to be (80% agreed).

### Relevance to policy

There are several purposes for which personal financial assets, in the form of home equity, can be mobilised to improve wellbeing in later life. Some of these already figure in policy and others may be considered in time.

The policy of using housing wealth for residential care may be accepted on a cost-sharing basis but its use to pay for health and home care services is a new idea, which may provoke resistance.

Most people have yet to grasp or accept the concept of a trade-of between family care and inheritance.

Set against this are the strong feelings which older people expressed in the research: that they do not want to be dependent on their families, that they should use their housing wealth to help themselves and that the decision is theirs.

Relevance to Policy – present and future

- Payment or part-payment for residential care
- Payment of home care costs
- Direct payment of health costs, especially hospital and surgical costs
- Payment of local authority rates
- Payment of long-term care and health insurance premiums
- Maintenance of national housing stock and adaptation of housing to assist ageing in place.
- Transfers within families and charitable donations

Any policy initiatives made in these areas must recognise the strength of these aspirations. Most housing wealth is preserved for transmission to younger generations through inheritance, but there are a range of actual and potential uses for it during the lifetime of those who have accumulated it, and for inheritors. These uses have the potential to both improve wellbeing and, if carefully handled, to reduce fiscal demands on governments as the older population grows.

**Conclusions**

There is potential for innovative products in the equity release market to play a larger part in decumulation and in the provision of retirement income.

- The future of home equity release depends on attitudinal factors - towards decumulation and inheritance- and the building of trust
- Home equity release is relevant to how responsibility will be shared between individuals, families and the state when numbers of very old people are much increased

***"While equity release can play a precautionary role, representing a store of value what can be drawn on when facing uncertain income and unanticipated expenditure in retirement, it should not be viewed as a substitute for adequate levels of retirement saving."*** (Scobie, G., Le, T. and Gibson, J. (March 2007) Housing in the Household Portfolio and Implications for Retirement Saving: Some initial findings from SOFIE. NZ Treasury, Wellington.)

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## 11. The future of home equity release products, *Rob Dowler*

In this presentation, an international overview of the potential use of the home to meet a retirement funding gap precedes an outline of the types of home equity release products available. What is the data on home equity release loan penetration in New Zealand, and what do we know about the uses of those borrowed funds? What are the market constraints, possible solutions and the future outlook? Can the key equity release borrower risks be mitigated by meeting current and proposed legislated regulatory structures and the voluntary SHERPA Code of Conduct?

I begin by commenting briefly on the limited solutions available to bridge a retirement funding gap. I will finish the presentation discussing the use of non-income producing assets, principally property, such as the home, to produce capital or income.



**Retirement Funding Gap**:
The AVIVA research results show that, in Europe, home equity has the potential to cover 33% of the total pension savings gap. It is clear that property is the largest pool of untapped resources to close this gap. To find the report, just Google "AVIVA mind the gaps report."

And to quote from the just released update on the USA National Retirement Risk Index report: "*Even if households work to age 65 and annuitize all their financial assets, including the receipts from reverse mortgages on their homes, more than half are at risk of being unable to maintain their standard of living in retirement*."

New Zealand is yet to have the debate already undertaken in Australia via the Australian Productivity Commission work and report titled "Caring for Older Australians" identifying the role of property in caring for the aged. Differences in superannuation and pension structures are also well documented. I'm also sure that we will hear more on the Australian experience from the next speaker, Hazel Bateman.

Toni Ashton has stated that 70% of age 65+ own a debt free home, with only 8-9% renting, thereby suggesting that property can also potentially play a significant role in New Zealand in meeting a funding gap in retirement. However, it remains an open question as to how much any New Zealand government will want to overtly pursue using home equity release to close retirement funding gaps.

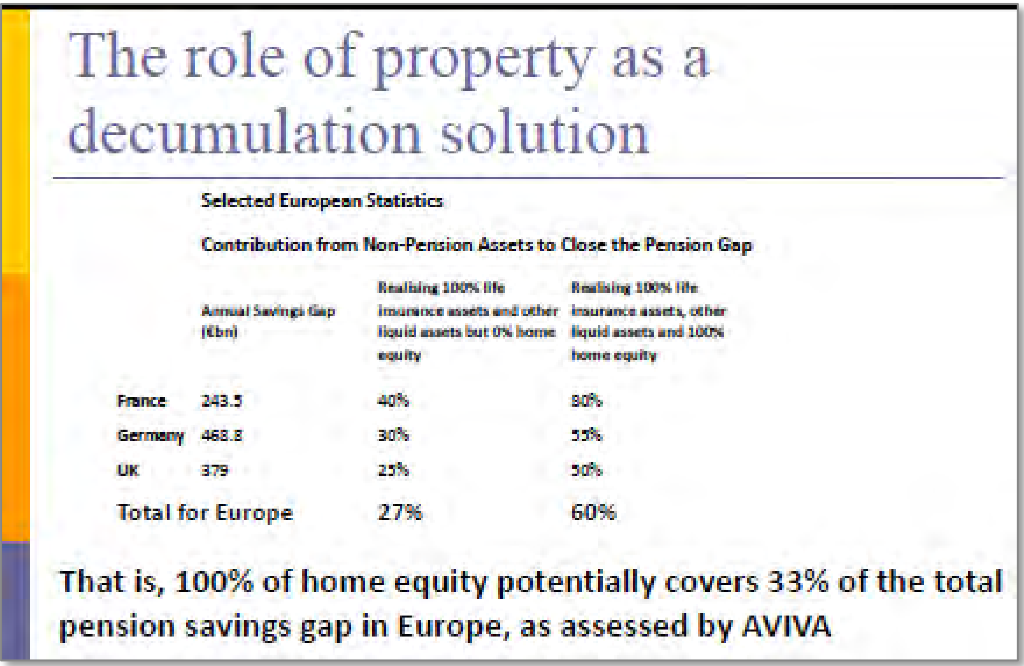
Briefly, there are 4 methods available to release equity from a home:

- Home equity release loans (reverse mortgages
- Reversion plans
- Shared appreciation
- Downsizing

Lumps-sums released may be applied to one-off needs such as home improvement, or to the purchase of an annuity.

I note that only Home Equity Release (HER) loans and downsizing have really been available in New Zealand. Experience in New Zealand to date suggests that home equity release solutions are best placed to help cope with one-off expenses and life shocks. Those using regular drawdowns to fund day to day living expenses are likely already evidencing a systemic funding gap that will eventually turn and bite hard when no further draw down capacity remains.

While lump sums released could be used to purchase an annuity to reduce longevity risk, in New Zealand this option is not readily available (as already covered by other speakers).



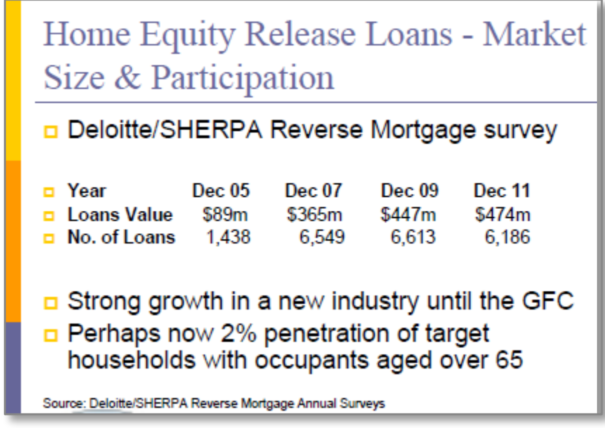

**Focusing on Home Equity Release Loans**

Research by Sentinel found the typical borrower profile to be:

- Aged 73 years old
- Will have a house worth $330k
- Will likely borrow around $43k for their initial loan
- This will be 65% of what they are entitled to borrow
- Or 20% LVR

Now a quick run through the statistics gathered in recent years via the Deloitte/SHERPA HER loan survey. In 2011, the proceeds of HER loans were used for:

- Home improvement 23%
- Car 8%
- Travel 10%
- Debt repayment 22%
- Aged care purposes 7%
- Other/unassigned 27%




The slide helps demonstrate how new the product category is, with rapid growth from virtually nothing in 2005 (despite starting in 1990) to more than $365 million just two years later, before the GFC impacted on funding. The statistics available to date also highlight the low level of penetration, yet need must be increasing, based on the general economic environment following on from the GFC, Finance company collapses, lower income & asset returns & economic weakness meaning help is not available from family, and often family need help themselves.

Also worth noting that use of money still largely lump sum and needs based, rather than being a regular income drawdown.

**Market Constraints and Solutions:**

**Limited consumer knowledge –** Judith Davey has outlined some issues arising with consumer attitudes, but these are also changing rapidly as the depression generation is superseded by the

baby boomers. A highly conservative approach and desire to provide for an inheritance is being replaced with an attitude of greater risk taking and a belief that it is okay not to leave an inheritance. The change is, in part, driven by increasing longevity, such that inheritance occurs much later in the life cycle.

However, there is still limited knowledge and significant misconception about home equity release. This will continue to be a barrier to a high level of penetration and will only be overcome where there is a high personal need and appropriate support (in the form of increased promotion or advertising, education and advice).

**Mainstream lenders –** The main banks in New Zealand and internationally have limited involvement in equity release products. Often the primary use for the product for banks is simply having it available to assist those heading into retirement and unable to maintain regular loan payments, thereby turning a potentially distressed loan back into a good loan.

The main reason for this limited involvement by mainstream banks may simply be that the product category is so new, small and niche. For example, the standard mortgages issued in two weeks by one large Australian bank equals the total HER loans ever issued in Australia since product initiation. Recognising this size issue, mainstream lenders may be reluctant to invest in the policies and procedures necessary to control or mitigate mis-selling risks via thousands of frontline staff, this investment being required to reduce the risks of wider reputational damage for the bank. It may be that it is easier to simply avoid the issue by not promoting or offering the product.

**Non-bank participants –** There seems to be a greater willingness of non-bank participants to enter the market but, as is clearly evident right now, on-going and consistent access to funding is an issue.

The solution lies in capital markets getting back to work, confidence improving and securitisation working again, but we still need to look for a solution on how to maintain funding during downturns. One possible solution would be if superannuation funds with long dated liabilities were to increase interest in providing funding.

**What does the future hold? –** I have already mentioned the difference in attitudes between the depression and baby boomer generations. The slide highlights the circumstances faced by baby boomers (and lenders), helping emphasise that property will have to be part of a decumulation solution.

Credit markets will improve, promotion and advertising will occur and are a key to building consumer knowledge and removing misconceptions, and that increased penetration will result as a necessary outcome to fulfil the needs and desires of the baby boomers.

What Does the Future Hold?

- Baby Boomers
  - Increasing funding gap arising from:
    - Loss of wealth during the GFC
    - Higher debt levels at retirement
    - Increasing health costs
    - Improving longevity
    - Pressure on state pension systems
  - Changing attitudes – e.g. to leaving an inheritance
  - Desire to age in place, maintaining independence, mobility & remaining near known amenities & friends

**Industry Governance: Is it safe?**
**Consumer risks**

The risks facing home equity release borrowers are the same as any borrower, including: borrowing too much, reduced flexibility if circumstances change, inappropriate use of funds, fraud, coercion, mental capacity, borrow to invest schemes, breach of loan terms & foreclosure.

The key difference is that the consumers that are the target market for these products, aged consumers with limited resources do not have an opportunity to recover from any financial mistake that is made.

Appropriate and proportionate regulation and self-regulatory codes are the key solution, not ignoring advertising, education and advice, as previously mentioned. Some of the risks faced by consumers that can increase with age (e.g. capacity to make decisions, coercion, etc) are mitigated through the SHERPA Code, such as the requirement for mandatory legal advice.

- Current statutory regulatory protections
  - Credit Contracts & Consumer Finance Act
  - Proposed introduction of responsible lending
  - Financial Advisers Act
  - Financial Service Providers (Registration & Dispute Resolution Act
  - Fair Trading Act (& proposed amendments)
  - Office of Senior Citizens voluntary Code of Practice

However, regulation should also try to avoid unintended consequences, potentially limiting consumer choice of the most suitable product solution for individual circumstances.

Current regulatory protections suggest that consumer protection and the industry should be in relatively good shape. Note that the OSC Code was originally proposed to be enshrined in statute but subsequently a political decision was taken that the code should remain voluntary.

**SHERPA self-regulatory Code of Conduct: Key Consumer Protections**.

Anyone using their home to raise money should ask themselves three fundamental questions:

- Do I have the right to live in my property for life?
- Do I have the freedom to move to suitable alternative property without financial penalties?
- Do I have a guarantee that whatever happens I will not owe more than the net sale proceeds from my property?

Other protections include:

- Mandating that the borrower obtain independent legal advice performed by the solicitor of their choice
- Encouraging borrower discussion with family and the seeking of independent financial advice
- Borrower access to independent dispute resolution
- Accurately identifying all costs to the borrower
- Illustrating the potential effect of future house values, interest rates & capitalisation of interest on the loan
- Following SHERPA procedural guidelines in the event of a loan default condition arising

SHERPA's focus on consumer protection is not only good for consumers and industry participants but has been well received by government agencies and consumer groups.

SHERPA
SAFE HOME EQUITY RELEASE PLANS ASSOCIATION

**In conclusion**, I suggest that property must form part of a decumulation strategy in providing retirement funding, the maths say so. Policy development should focus on removing barriers to the use of property for this purpose.

# Session 4. Meeting the risks of ageing

## 12. Do Australians do it right? *Hazel Bateman*

In 1992, Australia was one of the first developed countries to introduce a mandatory private retirement saving system: the Superannuation Guarantee. This complemented a safety net public age pension and voluntary occupational superannuation which covered less than 50% of workers.

Initially policy development focussed on the accumulation phase and attention has only recently turned to decumulation. In early 2012 the Minister for Superannuation and Financial Services convened a 'Superannuation Roundtable', with broad representation across the superannuation industry, financial services, welfare groups and academics, whose aim included the consideration of policies to support decumulation products. The traditional form of benefit for Australian retirees has been a lump sum. However, in recent years a small market for retirement income stream products has developed.

**Outline**

- Introduction to Australia's retirement savings arrangements
- The market for retirement benefits
- Barriers to growth of the annuity/income streams market
- Policy proposals and current market developments
- Contributions from academic research
- Lessons for New Zealand

**Overview**

- Well developed private Defined Contribution pension scheme in the accumulation phase
- Less developed in the decumulation phase
- Very small market for retirement income products – caution by government and reluctance by industry
- Limited consumer engagement, skill level and product knowledge

**Retirement Income Policy has 3 components:**

1. **Public Age Pension**
    - General revenue, 27.7% average earnings, means tested (75% eligible)
    - Eligibility: Residency and age → 65; 67 from 2017; 2.7% GDP
2. **Superannuation Guarantee**
    - Since 1992, minimum 9% employer contribution (12% by 2019)
    - Defined contributions, individual accounts, private superannuation funds
    - Persons aged 18-70 earning >$A450 month (7% earnings)
    - Benefits from age 55 (60) – CHOICE of lump sum/income stream; tax free
3. **Voluntary superannuation and other saving**
    - Encouraged by tax concessions, 1/3 make additional contributions of around 6% earnings; homeownership (85%), financial assets, investment property

**Payouts from superannuation in 2012**

- **Lump sum:** (50% retirement benefit payouts)
    - invest outside the superannuation system
- **Income stream:** (50% retirement benefit payouts)
    - Account-based pension: phased withdrawal from superannuation account. (Around 98% of income streams, by assets)
    - Annuity: (Around 2% term annuity, only 111 new life annuities, 2011)
    - Hybrid longevity products: minimum payment guarantee (New, ready to be launched)

    ** Reverse mortgage: around 42,000 current loans, mainly lump sums

**Evaluating decumulation policies/products:**

Consider: Replacement risk
Investment risk

Longevity risk
Inflation risk
Contingency risk
Regulatory risk
Political risk

**What is an account-based pension?**

- Account stays with superannuation/pension fund, or can be moved to a different provider, individual retains control, choice of asset allocation.
- Choice of withdrawal pattern – with tax concessions if follow a minimum drawdown – but considerable flexibility.
- No guarantee of account balance or income - does not cover for investment risk, inflation risk, or longevity risk.

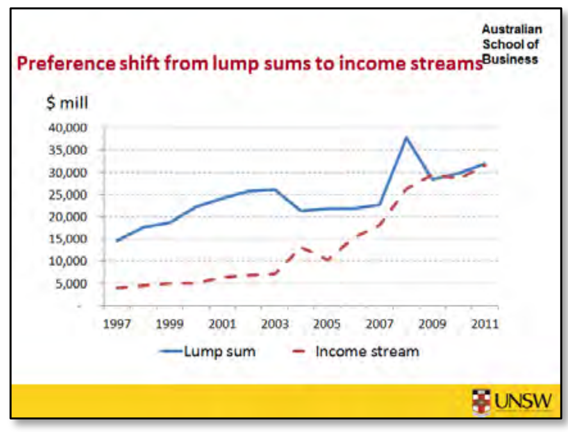
| Age | Per cent of account balance |
|---|---|
| under age 65 | 4% |
| 65-74 | 5% |
| 75-79 | 6% |
| 80-84 | 7% |
| 85-89 | 9% |
| 90-94 | 11% |
| 95 and over | 14% |

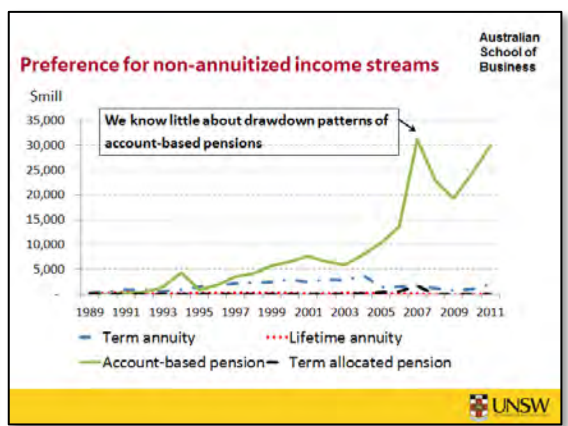
**What types of annuities are available?**

- **Term annuity**: guaranteed income for a specified period, indexed/not indexed, single/joint, reversionary, guarantee period, with return of capital
  - Cover for investment risk (and inflation risk if indexed)
- **Life annuity**: guaranteed income for life, indexed/not indexed, single/joint, reversionary, guarantee period, with return of capital
  - LIFE annuities DO cover for investment risk and longevity risk (and inflation risk if indexed)

**What types of annuities are NOT available?**

- **Deferred lifetime annuity**: As for a life annuity, but payments are DEFERRED (ie, start in the future, such as at age 85)
- **Variable annuity**: Payments linked to share market returns, but provide a guaranteed payment




**Why is annuity demand so low?**

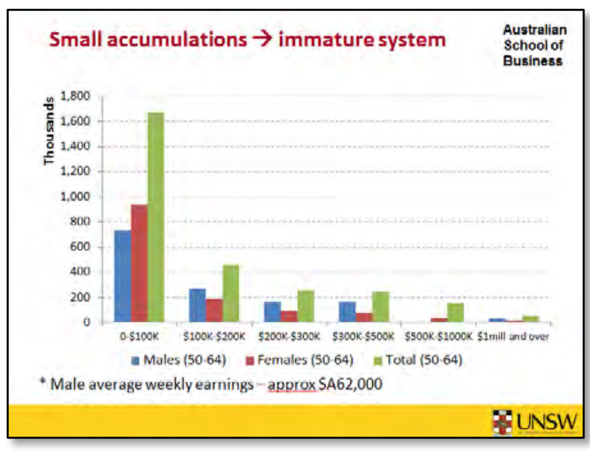
The demand issues:

- Long term practice of taking lump sums
- Lump sum is generally the 'default' option
- Consumers not familiar with and don't understand the annuity product

From a 'representative' survey of 920 superannuation fund members aged 50-75 years:

- 37% had never heard of a product called a LIFE ANNUITY
- Only 22% knew that it provided income FOR LIFE
- Only 8% knew it offered GUARANTEED income level
- (similar ignorance about account-based pensions)

- Poor levels of financial literacy – eg, similar to many other countries many Australians have trouble understanding inflation, interest and diversification – and the benefits of annuities
- Behavioural: loss aversion (view annuities as bad investments), framing, mental accounting, desire for control etc.
- The Age Pension is a type of indexed lifetime annuity
- Previous tax and social security means test preference for life annuities were gradually withdrawn over mid 90s-07
- Third party involvement:
    - Financial Advisors unlikely to recommend – as annuities represent a 'one off' purchase – not a continuous flow of fees
    - Commissions banned under new legislation designed to improve the quality of financial advice
- Account balances are small, as the mandatory superannuation arrangements are still immature




**Supply side issues → Regulatory barriers:**

- The definition of 'annuity' in the tax law and the social security law and the superannuation law requires that payments be 'immediate' and 'fixed'
    - Deferred and variable annuities are not eligible for tax concessions or preferential treatment under the Age Pension means tests
- Prudential regulation, reserving requirements: =>Barriers to product innovation
- Financial service providers reluctant to offer life annuities
- Number of providers of life annuities dropped from 14 in 1990s to 2 in 2012
- Concern about lack of products to hedge longevity risk, interest risk, inflation risk
    - Difficult to predict improvements in life expectancies

## Policy proposals and government response

**Review of Tax and Superannuation system (Henry, 2008-09):**

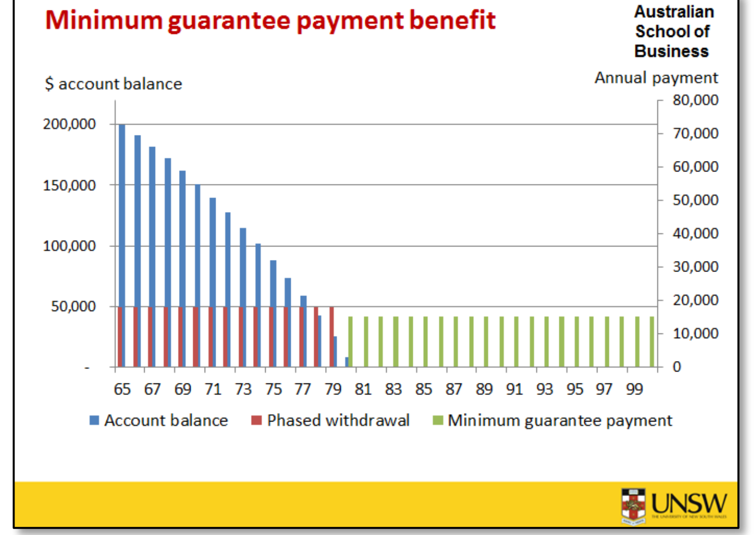
- Did not support mandatory annuitization
- Recommended:
    - Change to regs to allow deferred and variable annuities
    - Government increase supply of long term indexed bonds
    - Government consider entering the annuity market

**Review of the superannuation system (Cooper, 2009-10):**

- Recommended life annuity be the default benefit

**Government response:**

- No support for the recommendations → established a 'Superannuation Roundtable' of experts to consider and review tax changes and retirement benefit proposals




**Industry response:**

Development of HYBRID longevity products:

- Minimum guarantee payment for life
- Insures against longevity risk and market risk
- Payment similar to a deferred life annuity commences when wealth (retirement accumulation) is depleted due to either market conditions or longevity

- Currently such products do not receive the tax and social security means-test concessions provided to life & term annuities & account-based pensions (phased withdrawal products)
- Industry ready to launch when (if) government changes regulations
- Fees?*!?

**One financial service provider is actively marketing annuities.**

> *'I should be cutting back my garden, not my spending'*
> *'It's time for me to control my income, not the market'*

The campaign commenced following the global financial crisis - the message is not that shares are bad investments, but that we need to make sure that at least some of our capital is protected by buying annuities. http://www.challenger.com.au/know/OurAdvertisingCampaign.asp

## Contributions from Academic Research

**The CPS "Retirement benefits choice experiment":** (See: Bateman, Eckert, Geweke, Louviere, Satchell and Thorp (2012) 'Engagement: A Partial Solution to the Annuity Puzzle', CPS Working Paper)

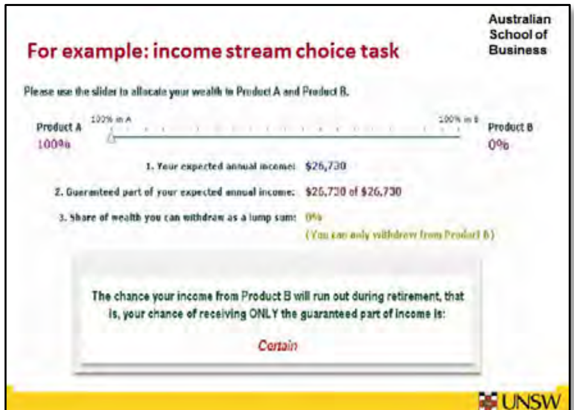
The experiment was motivated by very low demand for life annuities globally. The research questions used were:

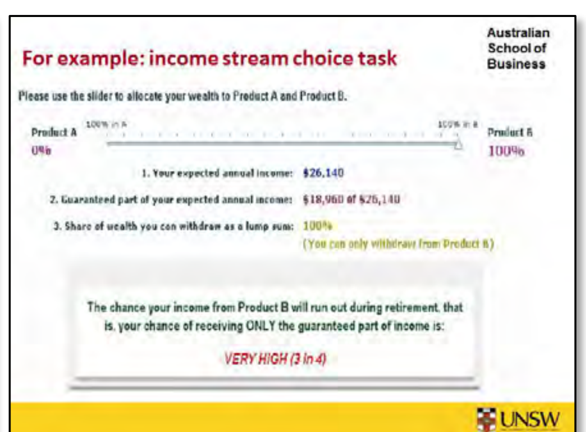
- o How do retirement savers make retirement benefit decisions?
- o What kinds of skills and demographics matter in this decision making?
  - ▪ Financial competence
  - ▪ Commercial product and system knowledge
  - ▪ Demographics
- o Engagement: measurement and impact

**Experimental task:**

- Subjects choose allocation of retirement wealth to two types of retirement benefits in online experiment:
  - – Life annuity vs. Account-based pension
  - – Life annuity with 15 year guarantee vs. Account-based pension
  - – Repeat 4 times for each product pairing (4 levels for the risk of ruin → the probability that Product B will be depleted before the end of life):
  - – 1 in 10 (LOW); 2 in 4 (MEDIUM); 1 in 2 (HIGH); 3 in 4 (VERY HIGH)
- Age Pension payments included if subjects nominate at least eligibility age or older for retirement age

EACH RESPONDENT MAKES 8 BENEFIT CHOICES



Were the respondents 'engaged' with the experimental task i.e. how did they score on the recall quiz? One third of respondents did not recall the product features.

| | Product A % Correct | Product B % Correct |
|---|---|---|
| I can withdraw a lump sum for unforeseen events | 77 | 67 |
| If I die, payments stop | 62 | 74 |
| I will receive a regular income for as long as I live | 60 | 71 |
| My account balance will fluctuate with financial markets | 75 | 68 |
| Payments are guaranteed to me or my beneficiaries for the first 15 years | 84 | 81 |
| None of these apply | 88 | 90 |

**Engagement with the 'experimental task' increases with ....** Australian School of Business

| OLS estimation of task engagement (Recall quiz score at the dependent variable) | Coefficient *=10%, **=5%' ***=1% |
|---|---|
| Numeracy | 0.113*** |
| Basic financial literacy | 0.074*** |
| Sophisticated financial literacy | 0.064*** |
| Commercial product knowledge | 0.167*** |
| Subjective understanding of finance | -0.010** |
| Planning of financial aspects of retirement (Higher = more advanced planning) | 0.017*** |
| Quality of life (Higher = better quality of life) | -0.056** |
| Subjective survival expectations (Higher = more optimistic) | 0.001** |
| Gender (female = 0, male = 1) | -0.028** |
| Wealth sector ($50K, $125K, $250K, $1,000K) | -0.00004** |
| Intention to retire before age 65 | 0.020* |
| Constant | 0.703*** |

**Sensible choices are directly explained only by engagement and numeracy** Australian School of Business

| Logit estimation: Dependent variable (not consistent) = 1 if subject decreased annuity % when risk increased (or did not move slider at all) | Coefficient: *=10%, **=5%' ***=1% |
|---|---|
| Numeracy | 0.501** |
| Basic financial literacy | 1.311 |
| Sophisticated financial literacy | 1.130 |
| Commercial product knowledge | 1.034 |
| Subjective understanding of finance | 0.993 |
| Planning of financial aspects of retirement (Higher = more advanced planning) | 0.952 |
| Quality of life (Higher = better quality of life) | 0.542 |
| Subjective survival expectations (Higher = more optimistic) | 1.001 |
| Gender (female = 0, male = 1) | 1.154 |
| Wealth sector ($50K, $125K, $250K, $1,000K) | 1.000 |
| Intention to retire before age 65 | 1.319 |
| Engagement score | 0.117*** |

### Benefits choice experiment: what did we find out?

- Pre retirees have poor product and system knowledge, many not planning for retirement
- Pre-retirees do consider purchasing fairly priced annuities – when products described in terms of their features rather than commercial product names
- A large minority make 'sensible' allocation decisions by increasing allocation to products with longevity insurance (life annuities) when risk of ruin (ie, risk of depleting income) increases
    - More likely to make sensible benefit decisions when respondents are 'engaged' and have numeracy skills
    - More likely to be engaged if financial skills and product knowledge, plan for retirement, high subjective life experience.

### Lessons for New Zealand

#### Demand issues:

- Retirement income products and annuities are complex financial products →Don't assume consumers understand the products and can make 'rational'/sensible decisions
- Low take-up should not be perceived as 'actual' demand
- In Australia – lack of evidence to support optimal drawdown patterns (but evidence of underestimation of life expectancy)

#### Supply side issues:

- How to (re)generate a market for retirement income products
- Innovative product design
- Mass market but personalised financial planning

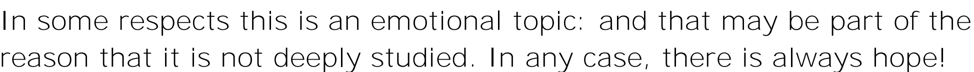
**Role of government:**

- Likely that retirement income streams market will not develop without government support
- Minimise regulatory barriers to product development, while enhancing benefit security/solvency of providers
- Facilitate consumer understanding and engagement
- Policy simplification

## Session 5. A way forward?

### 13. Long-term care insurance: is there hope for private provision? *Bridget Browne*

Long Term Care Insurance exists in various guises around the world. In its private, voluntary forms there is considerable debate as to whether it can be considered a success. This talk aims to introduce the insurance product and to critically review this debate, using examples from selected insurance markets.



In some respects this is an emotional topic: and that may be part of the reason that it is not deeply studied. In any case, there is always hope!

There may be others here with much more experience, and I am only quoting a few sources. There may be much other relevant work – and I would be interested to hear about it!

**Agenda**

- What is Long Term Care Insurance (LTCI)?
- Where does LTCI exist, and why?
- Where does LTCI not exist, and why not?
- What are the barriers?
- Can LTCI be considered a success?

Australian National University

Selected countries

| Insurance product exists | No insurance product |
|---|---|
| France | UK |
| USA | Australia |
| Japan | New Zealand |
| Germany | … |
| Singapore | |
| Israel | |
| Spain | |
| … | |

LTCI is an insurance product that is pre-funded, that is, purchased before the contingency of needing care arises. It is usually a regular premium product, but can be single premium. The benefit is paid when the person develops a need for assistance. This is usually linked to a needs- assessment by the State and thus a person may need private funds to contribute to the cost of the assistance, be it care at home or in residential aged care.
The benefit can be a fixed monthly amount or based on reimbursement of actual expenses.

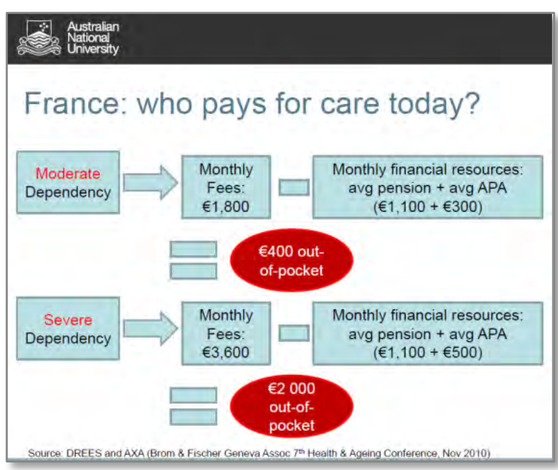
So I am not talking about immediate needs annuities or reverse mortgages that support payment of aged care fees once you need care or require residential care.

**Focus on France** **and UK**

And in particular on the development of an insurance market in response to the way Aged Care is structured in the country. Note how country-specific regimes and hence private markets are –

saw this somewhat in Claire Dale's presentation. As well as private vs public or social provision, and voluntary vs compulsory insurance, there is more to it.

### France: the context, the product type, and product "success"




Plisson estimates that in France, 'who pays for care' could be 50/50 public vs private.

Reasons for LTCI success (Durand):

- Favourable environment
- Sustained effort by insurers
- Definition
- Cash benefit => choice
- "A simple product for a complex risk"

The favourable environment was created in part by the Government publicizing that there was insufficient public support for costs of long-term aged-care. This is in contrast to Germany's social insurance model; and Japan, where growth in the private sector was crowded out by public system.

The media attention in France raised awareness in the general public, which was followed by a sustained effort by insurers.

Durand and Taleyson maintained that AG2R (a French mutual insurer) was visionary and courageous in that they took the lead in launching the first "true" Long Term Care insurance product in France in 1985. In 2000 Predica (the insurer group of Credit Agricole, one of the largest French banks) was innovative in introducing the first "progressive" benefits that depended on the severity of needs – even before the state introduced this concept with the APA (state benefit) and AGGIR (assessment tool).

Plisson (2011) in "Pourquoi les Français ne souscrivent pas davantage de contrats d'assurance dépendance?" SCOR Papers, (the title translates to "Why don't the French take out more Long Term Care Insurance?") compared the French and US markets, but it appears that the authors didn't recognise the relatively high level of confidence the French have in their financial advisors or the very high level of financial conservatism of the French, which we will come back to later.

However, here we have a market where individuals may have to contribute substantially to their aged care costs and a substantial private market has come into existence, without tax incentives or compulsion.

### In the UK, who pays for care today?

- For those with approximately £23,000 and up:
    - Private LTC insurance products
    - Private savings
    - Selling of assets – house, car, land etc
    - Support from family, friends and other organisations
- For those with approximately £23,000 and under:
    - Supported by Local Authority (Elliott et al, 2012; Association of British Insurers, Kirwan, UK Health & Care conference May 2009)

Most care other than nursing is means-tested (ie personal, housing, "hotel"), and that means testing is pretty severe with the exception of Scotland which provides free personal care.

As soon as you have £23,000 you fall back on own resources, *including the family home*, unless the spouse or a close relative is still living there.

So in reality, individuals must fund a lot of the estimated cost themselves. This cost is estimated in the Green Paper to be an average of £30k with 5% of people paying £100k.

So there is a vibrant Private LTC insurance market in the UK? **No!**

**Why doesn't LTCI exist in the UK?**

I was involved in an informal survey conducted for the UK Institute and Faculty of Actuaries involving practitioners from insurance, reinsurance and consulting. The results were reported at the Health & Care Convention 2009. Note: this survey was conducted and reported before the Green Paper (July 2009); the White Paper (March 2010); the change of Government (May 2010) which put all options back on the table; and obviously before the Dilnot report (2011) and before the current UK Government's responses to that report.

5 Questions on Long Term Care

1. What do you view as the **main reasons** why LTC hasn't taken off in the UK market?
2. What **obstacles** are there in terms of the tax code, regulation, NHS integration etc..
3. **Is there a place for LTC** in the UK market or is there in reality too much overlap with existing UK products in this space – annuities (especially medically underwritten ones), equity release, critical illness/TPD etc...
4. **What else** could providers such as insurers or reinsurers do **to assist** this product? Is there an alternative approach which perhaps the market should consider?
5. Any **additional comments** you may have not covered by the above queries?

Classic British responses!

- "Is LTC under-priced in France?"
- "I advised my company not to proceed with LTC. I was called a dinosaur by the then CEO, but the board was with me. That decision saved a lot of money."
- "The typical story is going into a home with three month's life expectancy and 18 months later still having three months' life expectancy...). That blew many of the assumptions that actuaries actually believed to be quite conservative back in the early 90s."

**Q1 What do you view as the main reasons why LTC hasn't taken off in the UK market?**

- Pre-funded LTC is very expensive and very hard sell.
  - "People who need it often can't afford it at their time of life and people who can afford it when they are younger never believe they will need this sort of cover!"
- Lack of incentive for customers to 'save'/pre-fund for their care costs in retirement.
  - "The logic here is simple: if it is difficult to persuade people to take out disability insurance in their working years or to contribute fully to their retirement income needs, then it will be even harder to persuade them to protect themselves from disability in their 70's and 80's."
- There is huge faith in the NHS and a feeling that the State will provide. The reality is very different.
- Degree of apathy with the British public around LTC. Many think they'll use proceeds from their house to pay for it if needed.
- FSA Sales Regulation in 2004 drove out a lot of IFAs who felt that low sales volumes didn't justify effort.
- Lack of effective integration with state benefits

- Lack of tax incentives
- Lack of state compulsion for minimum cover

**Q2 What obstacles are there in terms of the tax code, regulation, NHS integration etc**

– "FSA regulation is a real barrier to entry, both for providers and (especially) for advisers. Passing the necessary exams is really tough for most advisers. Beyond that, the barriers are surmountable, but not really for any one provider on its own."

– NHS Wealth Trap: "The NHS requirement to draw down on any assets before receiving state benefits (even to extent of selling home) makes people feel that their self-provision is used to finance their LTC benefits anyway, so why save even more to reduce cost for state."

CLASS Act in the US attempts to address this Wealth Trap concern

**Q3 Is there a place for LTC in the UK market or is there in reality too much overlap with existing UK products in this space?**

- Pension Provision — Already insufficient for retirement needs so can't be expected to provide for LTC needs as well
- Immediate Needs Annuities — "I think the immediate needs market is the only way that Britons en masse would be prepared to consider LTC without a tax break and I don't see a tax break forthcoming."
- Home Ownership
  - "While home ownership is high, there's probably limited scope for sales as people feel they can fall back on equity release."
  - "Before the property crash equity release was seen as a very obvious way that LTC could be funded."
- State/NHS Provision
  - "Lack of historical and current clarity around Government provision means people may think the State will look after them or that things will change, putting their LTC pre-planning in jeopardy (moving target etc…)"
  - "If the Government pulls away from providing LTC due to the aging population, then LTC products could see a large increase in sales."

**Q4 What else could providers such as insurers or reinsurers do to assist this product?**

Implication here is that insurers would be prepared to offer something should the market conditions generate sufficient volume be present.

Not sure this is the case in Australia, judging by the Productivity Commission report.

In regard to lack of awareness: this is a sensitive issue to raise – back to the point that people don't want to think about this at the best of times – what is the right angle to take?

- Major Industry Marketing Initiative

  – "To get any breakthrough may require at least 6-12 good providers, saturation marketing (so that advisers cannot hide!), a huge PR campaign (which, in turn, will mean working hard with an established care industry, with its existing intellectual and charity infrastructures) and a new generation of product solutions."

  – "People are generally unaware of the costs of LTC (something like £600 per week for fairly basic care and in London more!) and unaware of the lack of state support. I think this extreme lack of awareness is a major factor. An awareness campaign could be a positive contributor to improving demand, but not in itself enough to generate a market, in my opinion."

**Q5 Any additional comments you may have not covered by the above queries?**
**Personal experience is an important trigger of awareness.**

- Target Customers
  - "key target customers are probably children of currently elderly relatives as they will be most conscious of need and most likely to be able to afford cover, if they start now"
- Equity Release
  - "Releasing equity from pensioners homes is the most immediate method with which care costs can be funded through private means. Of about 11.5m pensions, some 9m own their own homes representing a substantial level of equity that can be released to provide for care."
- Advertising Message
  - I first committed time to LTC in 1990.we looked at what advertising messages could be used to sell these (pre-funded) products.
  - The most effective was an old lady praying in Church "please Lord don't let me be a burden to my children". At that moment more people understood what LTC was all about than through any number of product specs.
  - But translating that into action given the obstacles involved has proved beyond us as an industry despite some superb specialist advisers in this market

The French study shows that those who have cared for someone are more likely to take out cover (Courbage Roudaut, Geneva Papers):

> "*LTC insurance is purchased not only to preserve bequests and to financially protect families in the event of disability, but also to reduce the burden on potential informal care givers. Risk behaviours as well as experience of disability also play a significant role in explaining the demand for LTC insurance in France*."

**Supply side barriers (Berry; Lloyd)**

Uncertainty dominates; we see concern about the risk, for sure, but also about integration with State benefits

- Uncertainty over the extent or composition of future demand for care insurance products, due in part to uncertainty over the future relationship between life expectancy and health life expectancy.
- Uncertainty over future costs of long term care provision.
- Uncertainty over future design of care provision in the UK and the future role of informal carers; it is therefore difficult to design complementary products.
- Limited market profitability due to current market size.
- Costs associated with, and uncertainty as to the trustworthiness of, assessments of individual care needs.
- The reputational risk associated with decisions not to pay meet insurance claims of policy-holders in certain circumstances.
- Regulatory constraints
- Lack of knowledge about long term care and/or care insurance products by independent financial advisors.
- The risk of adverse selection, that is, that demand for care insurance comes largely from individuals with a higher risk of care needs arising – asymmetric information means that insurance companies may not be aware of the higher risk profiles of their customers.

**Demand side barriers (Berry; Lloyd)**

- Ignorance of the risk that care needs will arise in the future, exacerbated by a lack of advice on risk and/or products, and a lack of financial capability.
- The unpredictable nature and extent of future care needs, and how much the required care services will cost; people may believe, justifiably, that even if care insurance is purchased, it will not cover the costs of their care in full.
- The complexity and high cost of care insurance products.
- The bequest motive, that is, a desire to preserve assets for future generations; some people may also expect to receive an inheritance from older generations which would cover the cost of care should need arise.
- A belief that long term care is funded entirely by the state through general taxation, or an expectation by individuals will qualify for free care under a means-tested system.
- A belief that family members will provide care informally, and/or a desire to preserve assets to support informal carers rather than surrender them to insurance companies to cover a need that may not arise.
- Distrust of financial services.
- Behavioural barriers such as hyperbolic discounting.

**What does the economist say? (Barr)**

In his summary of "conditions for insurability", Barr concludes from his analysis that LTC is not suitable for private, voluntary insurance, but is better suited to "social insurance".

Regarding systemic risk: longevity in and of itself has systemic characteristics. For example the population as a whole, on average, is living longer. But in combination with other risks, for example LTC, mortality and even non-life risks (maybe less so) and this transformation, is something insurers and reinsurers do. Diversification of risks is possible.

Happy not to take on a certainty: no insurance service there.

Adverse Selection: underwriting

Moral hazard: state assessment and cash benefits

Information problems: can't deny

- Supply side – insurers – technical problems
  - Risk Pooling
  - Individual Risk, not common shock (systemic risk)
- Risk, not certainty
  - Information Problems
  - Risk, not uncertainty
  - Adverse Selection (hidden knowledge)
  - Moral Hazard (hidden actions)
- Demand side – individuals – information problems.

However I believe Barr is too prudent with respect to insurers and uncertainty: they don't love it, but they have mechanisms for dealing with it equitably. First among them, profit participation/bonus systems, followed by reviewability. I don't want to speak for any individual insurer, and their appetite for risk/uncertainty certainly varies, but the French product is a living, breathing example.

**So how/why do the French do it?**

That remains to be seen: these are early days in the life of such a long term product. However, here I share my views on the reasons for the French success, against the criteria cited by the Australian Productivity Commission that mitigated strongly against the development of a private voluntary insurance market.

| | France | NZ |
|---|---|---|
| Difficulty to predict need | Inherently financially conservative, strong emphasis on planning ahead | ? |
| Affordability, especially with increasing age | Insurers encourage take up at younger ages + introduction into Group schemes during working life | ? |
| Low incentives to insure (safety nets) | Is this the key difference? Inheritance laws and means testing | ? |
| Long term incidence and duration uncertain | Participating products with reviewable premiums and benefits | ? |
| Adverse selection | Medical and other underwriting | ? |

**Agenda**

I have looked at the first four points. A success? Even as an optimist, "glass half full" kind of person, I accept that the product cannot really yet be considered a success; not globally, nor in any individual country … yet.

- What is Long Term Care Insurance?
- Where does it exist (and why)?
- Where does it not exist (and why not)?
- What are the barriers?

**Conclusion**

- It is not that the risk is uninsurable
- Complex combination of circumstances and attitudes required to provide "trigger"
- Unlikely to be one insurer alone, or even unilateral effort by the industry
- Would require concerted effort from government and industry
- And a bit of serendipity!

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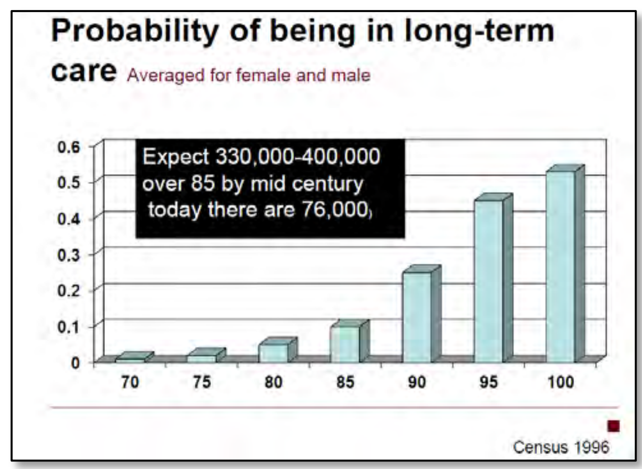
## 14. Decumulation instrument with a long-term care insurance add-on, *Susan St John*

*From a forthcoming article in NZ Population Review Vol. 38 by Susan St John, M.Claire Dale & Toni Ashton.*

> *"As older populations are ageing in OECD countries, new ways are needed to meet and pay for the associated costs especially the costs of expensive long-term care (LTC).*

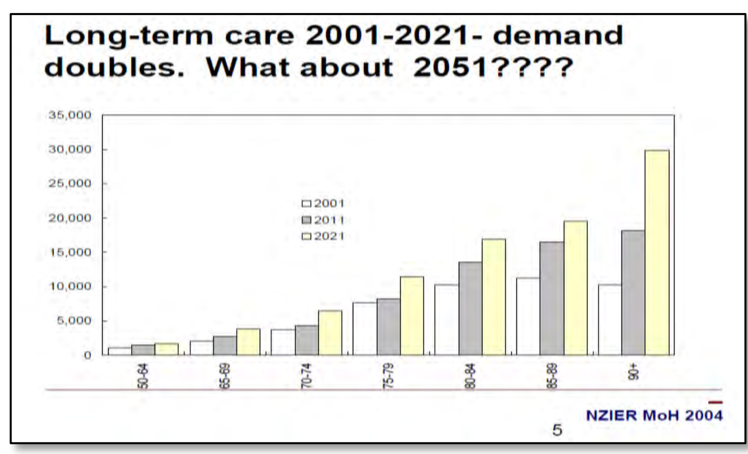
*In New Zealand the shrinking taxpaying working age population may not be willing to bear these costs when lump-sum KiwiSaver pay outs have been dissipated too early. Inter-generational equity and intragenerational equity may be improved if the 65+ group could both bear more of their own longevity and LTC costs, and spread those costs among themselves by means of tailored, social insurance approaches."*




The risks of middle income retirement include:

- Living a long time and outliving capital
- Investment risk
- Needing expensive end of life care

Pensions and annuities such as Government Superannuation offer benefits of longevity and inflation protection and have ensured that some have had a very good retirement., and have had funding for on-going medical costs such as hearing aids and assisted living or long-term care. As noted by Michael Littlewood these pensions and annuities, especially if inflation proofed, are a thing of the past for most new retirees.




What is needed is a paradigm shift. The risk of needing long term care later in life suggests that this is an insurance issue. Importantly we know that there will be an increased demand for long-term care, especially once the babyboomers start to turn 85 from 2030.

The current means test for long-term care subsidies has two parts. First assets must be used until the asset threshold is reached. Then once assets are below the limit, income, including NZS is to be used to meet the capped fee.

Paying for old age care in New Zealand

Contract price

| State pension only | Low assets Some other income | Failing means test |
| --- | --- | --- |
| Subsidy | Subsidy | Top-up subsidy |
| | Other Income | Other Income and assets |
| State pension | State pension | State pension |

Maximum Capped personal contribution

While as Claire Dale mentions, the asset test was to be progressively removed as promised in the 1996 agreement with Winston Peters by increasing the threshold by $10,000 a year, this was halted in 2012.

The annual capped payment for Auckland residents is $46,400. If net NZ$ = $16,400, then other income needed: = $30,000.

Note the additional Government top up may be as high as $27,000 for high level of care.

**Currently the burden of long-term care falls:**

- On working age population- subsidies, NZ super, asset test avoidance
- On unlucky families, through means test

But whose claim on resources should be reduced? **Intragenerational sharing** would impose more of the costs on the generation aged 65+. This would spread costs from those who die early or live longer without needing care, to those who live longest and need care. In doing so it may Improve perceptions of intergenerational equity.

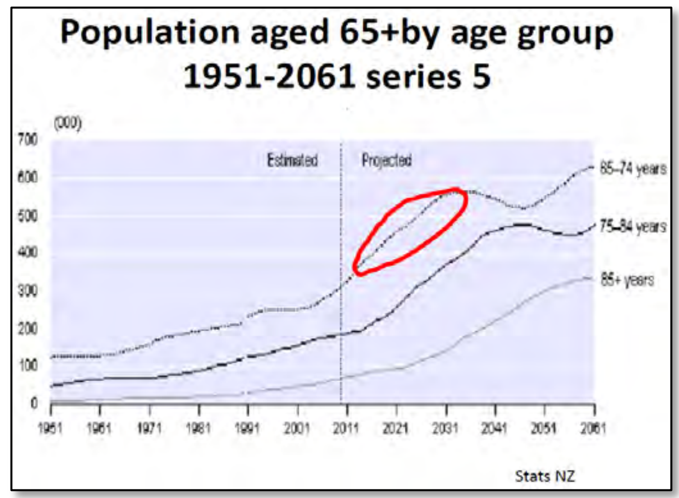
**The Asset Test**

| Years | Single person | Married couple with one in care | Married couple, both in care |
|---|---|---|---|
| 1998 – 2005 | $15,000 | $55,000 + house +car | $30,000 |
| July 2012 CPI adjustment | $213,000 | $118,000 + house +car *or* $213,000 total | $213,000 |

The four **options to improve intragenerational equity are**

- Long-term care insurance?
- Expand use of annuities?
- Life insurance and long-term care
- Life annuities and long-term care

Of these the problems of private provision of Long-term care have been outlined. The current annuities market almost non-existent. Pure life annuities appear expensive and poor value for women. Timing is a lottery, there is no protection from inflation or growth in living standards. There are Institutional risks and no guarantees. The fourth option of combining a life annuity with long-term care has promise.




### A Blueskies product for New Zealand?

Toni Ashton's paper suggests a healthy retirement requires about another $8-10,000 of income per annum. Coupling an annuity with long-term care insurance may be a way of offsetting risks. It is proposed that the government offers an inflation-adjusted gender-neutral Life annuity of value of up to $10,000 pa. This would treble on the determination of the need for long term care. It would be purchased either at age 65 or between 65 and 74 with cash and if suitable, equity share in housing.

### What could the government do?

- Agree that the social advantages would flow from annuities and that the growing group aged 65-74 should be encouraged to annuitise
- Offer a limited annuity with long-term care rider as a top up to NZ Super
- Retain and strengthen the means test for LTC

Some tentative costings (assuming no overheads, 2% real interest) suggest that an enhanced annuity of $10,000 with these features could cost about $160,000, or $170,00 with a ten year guarantee. The annuity could be added to NZS and indexed along with NZS.

**Ball park figure for $10,000 annuity- averaged M&F- at age 65, 2% real interest rate**

| Annuity | Annuity Guarantee 10 years | Annuity With LTC rider | LTC With Guarantee 10 years |
|---|---|---|---|
| $144,400 | $154,200 | $157,700 | $167,900 |

There are many issues to be researched, eg should the scheme be SAYG or PAYG? How could home equity be used to help provide the capital sum needed? Would middle income people like it? How could the risk of long-term care be better included in the model, acknowledging that people can spend very short or very long times in care.

**Conclusion**

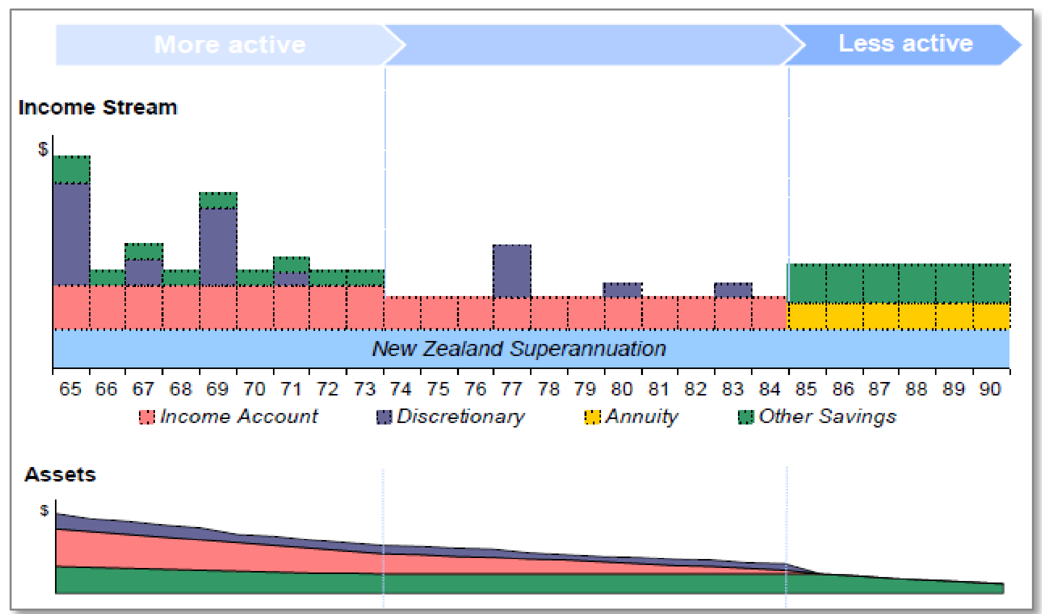
- If the older group buy insurance in young-old-age the risks are spread
- Tentative costings suggest that this product is feasible
- It might look attractive to both middle income men and women
- For New Zealand a limited subsidy which covers the improving longevity risk and the inflation risk for an annuity of $10,000 may be justified in a voluntary savings regime when there has been little subsidisation of accumulation phase.

## 15. Is there a way forward? *Mark Channon*

Individuals should be encouraged to use their retirement savings to provide an income within a flexible framework. To facilitate an income culture, focus should be given to improving financial literacy and providing products that drawdown savings in a controlled manner.

Whilst the topic of this session is about designing a decumulation product, for them to be successful it is important that people are encouraged to think of retirement savings as providing an income, rather than a lump sum. An appreciation of the level of lifetime income afforded from savings would help individuals ensure they are saving enough to fund the lifestyle they desire through their retirement years. Correcting misconceptions about life expectancies should form part of this education to smooth the consumption of savings through retirement. The calculators available on the Sorted website are useful in this regard but I'd like to see a more direct approach with KiwiSaver providers or retirement savings schemes including an estimate of the income afforded from balances into annual benefit statements - actively engaging with members.

There is no one-size fits all approach to decumulation, so once an acceptance of incomes is established, there needs to be a range of products available for drawing down savings that allow for flexibility and are also easy to understand. Different people will have different expectations of




a suitable retirement income, and their needs through retirement will vary by factors such as age, health status and level of wealth.

I've shown on the slide how potential retirement spending may vary for a middle income retiree through time and a proposed decumulation system that can be used to provide the security and flexibility to meet these needs. The top chart shows expenditure – noting that there is likely to be a need for income in excess of the base level provided by NZ Super, with additional amounts needed at infrequent times to fund irregular spending such as overseas holidays or a new car. The proposed system for meeting these needs involves splitting retirement savings into two parts – income and discretionary accounts.

The *income account*, illustrated by the pink block and bars 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* shown in purple can then be used to meet the 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. The use of restricted income accounts as a decumulation strategy could be achieved by compulsion, incentives or, perhaps less effectively, encouraged through financial advice and education.

As well as the option to manage their own investments in line with their risk tolerances, individuals have the option of using their funds (and any other savings) to purchase an annuity at any time, as illustrated by the yellow bars. By deferring an annuity purchase for 20 years post retirement an individual could 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 to manage their own savings during the early years of retirement. The example here illustrates the purchase of the annuity using the unspent balance from both accounts at age 85, but this could also be achieved through setting aside designated funds at retirement or the payment of on-going premiums from regular income.

Global experiences show that Government interventions are likely to be needed to produce a viable private sector annuity market. One solution 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 those well into their retirement.

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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.

## 16. Some choices and frameworks, *Jonathan Ericksen*

**Life time annuities – current limitations**

- Low interest rates – poor terms
- A bad deal for those (and their families) who die prematurely
- Solution: 10 year guarantee?
- Tax?

- 10 year guarantee so get value for pension even if die prematurely
- Deferred annuities from 75
- Drip feed retirement savings from KiwiSaver and master trusts
- What about from corporate super schemes
- Need 25 year nominal and inflation linked bonds.

**Possible draw-down providers**

- Life insurers
- KiwiSaver managers and Master Trust providers
- What about corporate super schemes?

**The role of the government and/or private sector:**

- Education
- Compulsion
- Tax change

- Appropriate assets are essential to match annuity liabilities…

**Long term assets for investment:**
- Government to issue 25-year nominal and inflation linked bonds.
- Innovation – longevity bonds?

# Session 6. Designing a decumulation product for 2020

## 17. Summary of the Symposium: *Spending the Savings, Len Cook*

### The uncertainties that constrain government and market responses

Perhaps the most critical finding that must be made from this symposium is that in New Zealand we are not well enough informed or equipped to establish clear pathways for the very necessary decumulation in later years of housing and financial assets built up during an active working life, yet it is a serious and urgent policy matter.

The availability of houses and cash deposits for exchange into a steam of regular cash payments until death may be more certain than the demand, because that requires the capacity to estimate manage and average risks throughout an uncertain future period. The risks so far seem to be on the down side for the purchaser of the housing or financial assets, so may result in undervaluing of such assets at the point of their transfer, when they are exchanged for lifetime income streams.

The presentation by Professor Natalie Jackson pointed to the demographic uncertainties, including the tensions that will undoubtedly result as the structural shift in population growth dominates regional populations. In the twenty odd years to 1970, the population of New Zealand grew by some 1 million, and there were 1.1million babies born over that period. Between 2011 and 2031, we will see another 1 million added to take the population to around 5.5 million, and of this increase, some 85-90 percent will be of people aged 65 years and over.

Associated with such a shift in the national population we will see;

- Huge variations in local population structures which will exacerbate any disconnect between national trends in economic outcomes and those seen locally
- Uncertainty about the compression of morbidity may be reflected in overly pessimistic estimates of the level of dependence of the older populations (aged 65-80) of the future.
- Significant shifts in household and house composition will likely reduce the extent of traditional mutually supportive arrangements
- An acceleration of urbanization trends, and the concentration of the New Zealand population in Auckland
- Greater inequality in the distribution of income among younger cohorts, and lower mean incomes of younger cohorts that those now retiring had at comparable ages.
- High levels of emigration and immigration, at increasingly younger ages.

A reminder of the difficulty of developing policy when we know little about the future is seen in the findings of the 1972 Royal Commission on Social Security in New Zealand. The Commission said of state pensions that:

> *"…the present system has worked to the advantage of the nation since 1938, it has become part of the economic and social fabric of the nation, it is capable, with certain changes, of serving its purpose adequately in the foreseeable future, and… no alternative would be likely to do better…"*

The Royal Commission on Social Security could not have imagined how much this political consensus would be soon reduced, especially influenced by the impact of the extraordinary inflation during the 1970s, the loss of the British market for New Zealand goods from 1973, the share market collapse in the mid 1980s, and a prolonged economic recession up to 1993. Since 1974, a series of policy changes and reversals has led to successive modification, or attempted modification, of public provision for retirement, generally within the mix of components established in 1938.

Indeed, the policy context is made somewhat fraught by the need to take account of a multiplicity of factors, including;

- Who is the underlying beneficiary of policy (older citizens, or their children)
- The absence of a comprehensive tax system
- The rigidity resulting from adoption of TTE tax regime for superannuation funds
- The concentration of the wealth of households in particular forms of equity
- The impact on personal risk, and perceptions of risk, of periodic, and continuing failures of financial institutions.

### Issues for policy

Bringing together the presentations and discussion of the variety of issues that make up decumulation, then it seems that a comprehensive policy for decumulation will need to embrace;

- Institutional integrity, as this is fundamental to collective solutions enabling risk averaging
- Strengthening our understanding of life course shifts, particularly those that affect the physical and mental capabilities of citizens, but also attitudinal and economic shifts
- Recognition of the multifaceted ways in which New Zealand Superannuation has impacted on behaviour of individuals and households, and the form of financial services available. NZ Superannuation has
    i. Encouraged one of the highest rates of labour force participation in the OECD among those aged 65-69 years, through the absence of punitive claw back abatements on additional income.
    ii. Provided the first floor continuing payment equivalent to an annuity
    iii. Provided a degree of gender equity not possible with earlier income tested benefits
    iv. Given an adequate standard of living to retirees, although this has been contingent on housing costs.
    v. A presumed homogeneity of circumstances, which is likely to be increasingly heroic.
- The impact of poverty in the early lives of children, on education and working life options, and on later life health outcomes.
- A decline in the working life real incomes, and consequential capacity to accumulate financial reserves, of the lowest deciles of the younger workforce
- A capacity to influence the form of the tax system, currently designed to meet a multiplicity of other obligations.
- Retirement provision is more than simply about pensions, or even housing, but it embraces education, family form, health, place, skills, and household assets.
- There are many dimensions of equity to be considered. This includes;
    i. Intergenerational
    ii. Across households
    iii. Gender
    iv. Ethnic
    v. Economic position
    vi. Regional/place
- The annuity market reflects the risks that result from expectations of longevity and inflation, and the variability in judgements that results from the uncertainty that insufficient information brings.

- The relative price of home ownership and land generally, continues to rise.
- While financial markets offer choice in services and products, the extent of competition may be much less.

**Conclusion**

The issue is a very serious one, and already significant opportunities have been missed, particularly through the failure to plan for decumulation options on the inception of Kiwisaver. (also an issue in Australia). Incoherent policies, such as the absence of a comprehensive tax base, need to be reviewed as part of a wider strategy. In particular, the TTE regime, may constrain opportunities for within cohort transfers

The issues require an understanding of demographic, attitudinal and economic aspects of the lifetime wellbeing of each cohort, and uncertainty in these issues is reflected in an unwillingness to take on the risk associated with the exchanges of assets over a long duration, without unreasonable impacts on price or conditions of exchange.

The multifaceted dimensions of decumulation span many aspects of policy, and piecemeal, incremental progress that this brings is unlikely to provide the required policy leadership or solutions.

## Presenter Biographies in Programme Order

### Susan St John

PhD, Co-director Retirement Policy and Research Centre, Associate Professor in Economics, the University of Auckland. Susan's New Zealand-focused projects include analysis of suitable decumulation products, tax reforms and the family tax credit system, overseas pensions policy, child poverty and family income assistance, long-term care policy, the role of home equity release, and the economic implications of Accident Compensation. Her research and teaching interests include public sector and retirement policy, international pension systems, tax and welfare, and applied macro-economics. She has developed local, national and international forums for policy debates in accident compensation, welfare, and retirement incomes. s.stjohn@auckland.ac.nz

### Natalie Jackson

PhD, Professor of Demography, Director of the National Institute of Demographic and Economic Analysis (NIDEA) at the University of Waikato. Natalie holds a PhD in Demography from the Australian National University and Master of Social Science degree in demography and anthropology from the University of Waikato. In 2010, after 11 years at the University of Tasmania, she returned to New Zealand to create the new institute, NIDEA. Her research mainly focuses on the challenges and opportunities of population ageing for all levels of government and industry, particularly the labour market, workforce planning, and changing supply and demand patterns in the social and economic structure. nojackso@waikato.ac.nz

### Michael Littlewood

Co-director RPRC. Michael, BA, LLB, is co-director of the Retirement Policy and Research Centre and the principal editor of www.PensionReforms.com. Until his 2008retirement, he was an adviser, manager and service supplier to employers on employee benefit issues in several countries and over many years. He is still deeply involved in the debate on public policy for both public and private retirement incomes. Michael has written extensively on aspects of public and private provision for retirement, including ***How to Create a Competitive Market in Pensions – the International Lessons*** (London, 1998). Michael.littlewood@auckland.ac.nz

### Toni Ashton

PhD, Professor of Health Economics, Health Systems, School of Population Health, the University of Auckland . Toni's research interests lie in the field of funding and organisation of health services from an economic perspective. Most of her recent research has been on aspects of health reform in New Zealand over the past two decades. Recent research topics have included long term care, cost of obesity, elective surgery, and effectiveness of pedometer use by older people. Toni has served on several government working parties and taskforces, and has undertaken a range of consultancies, including for the WHO. toni.ashton@auckland.ac.nz

### M.Claire Dale

PhD, Research Fellow, RPRC. Claire, Research Fellow with the Retirement Policy and Research Centre, has research interests in economic theory and policy development, including tax and welfare, decumulation, and an ageing population. Her current research aims to foster greater understanding of the issues around longevity risk and long-term care provision. Another project: action research on microfinance in a developed country is well-advanced. She recently completed a 5-year term on the Insurance and Savings Ombudsmans Commission, and is on the executive of Child Poverty Action Group. m.dale@auckland.ac.nz

### Malcolm Menzies

PhD, Research Manager, Commission for Financial Literacy & Retirement Income (CFLRI). Malcolm is the Research Manager for CFLRI, Monitoring international trends in retirement income policy and financial literacy; commissioning and managing research on key issues; and management of the 2013 Review of Retirement Income Policy. Previously Malcolm was Divisional Manager of Accent Learning, leading a professional learning and development organisation through rebranding and changes in business processes. From 1996–2008 he was responsible for business development at Victoria Link Ltd. Malcolm has a PhD in Public Policy from Victoria University of Wellington and is a former Chairperson of the New Zealand Futures Trust. Malcolm.Menzies@cflri.org.nz

## Michael Chamberlain

MCA NZ Ltd. Michael, BSc, FNZSA, FIA is an actuary and an adviser to large investors on strategy. He is also part-owner of Aventine, the ultimate manager of SuperLife (a master trust) and the SuperLife KiwiSaver scheme. Michael@mcanz.co.nz

## Peter Neilson

Chief Executive, Financial Services Council. Peter was appointed as Chief Executive of the Financial Services Council (previously the Investment Savings and Insurance Association of New Zealand Inc) in 2011. Before that he was Chief Executive of the New Zealand Business Council for Sustainable Development for seven years, driving the campaigns to: put a price on carbon, create markets for fresh water quality management, add a levy on solid waste and include sustainability criteria in public procurement. Previously, as a Cabinet Minister, Peter had oversight of the financial sector. After graduation as an economist, he was initially employed in corporate finance. peter.neilson@fsc.org.nz

## Chris Coon

Born in the UK and trained as an actuary, Chris arrived in New Zealand at the end of 1986 with plans to launch a new life company. After a couple of years putting the plans together, Sovereign Assurance was launched at the start of 1989 and is now the country's largest life insurer. Sovereign was listed on the NZ share-market in early 1998 before being purchased by Commonwealth Bank of Australia at the end of 1998. Chris stayed on at Sovereign for a further 3 years and then started planning the launch of a home equity release business - specialising in "equity release solutions for seniors" or reverse mortgages. Sentinel was launched in 2003 – in 2004 the business went global through Seniors Money International. Chris is also a joint founder of PartnersLife – a new life company launched 2 years ago and now the 2nd largest life company measured by new business volumes.chriscoon@partnerslife.co.nz

## Judith Davey

PhD, Senior Associate, Institute for Governance and Policy Studies, Victoria University of Wellington. Judith was Director of New Zealand Institute for Research on Ageing from 2002 to early 2007. Prior to this she was Associate Professor of Social Policy at Victoria University of Wellington and a consultant on social policy and social research. Judith's research focus is the ageing of the population and its policy implications. She has researched issues for older people, including income, transport, housing, home equity release and inter-generational issues. She has published extensively, and provided advice to policy-making bodies in the public, private and voluntary sectors. Judith.Davey@vuw.ac.nz

## Rob Dowler

Executive Director, Safe Home Equity Release Plans Association (SHERPA). Rob has spent the last 34 years working in the financial services sector including 13 years as a retail share broker, 12 years in senior roles in corporate superannuation administration, sales and servicing for major life companies including 4 years managing settlements for the fund management team. In 2005, he formed Red Owl Consulting Ltd, a financial services consulting firm specialising in operational risk management, compliance and government interaction. As executive leader of industry bodies, SHERPA, representing reverse mortgage lenders, and the NZX firms' Securities Industries Association (SIA), Rob is fully engaged in policy development and regulatory change affecting the wider financial services sector. info@sherpa.org.nz

## Hazel Bateman

PhD, Associate Professor, Director of the Centre for Pensions and Superannuation, University of New South Wales. Hazel's research interests are in the areas of public and private provision for retirement, including superannuation choices, individual decision making and superannuation literacy, retirement income adequacy and policy design, retirement benefits, and the governance, regulation and performance of superannuation and pension funds. Hazel has been a consultant on retirement income issues to a range of Australian and international organisations including the OECD, the World Bank, the Social Insurance Administration (China), APEC, CEDA and the CPA. H.Bateman@unsw.edu.au

## Bridget Browne

Senior Lecturer in Actuarial Studies, Research School of Finance, Actuarial Studies & Applied Statistics, College of Business and Economics, Australian National University. Bridget, BEc, FIAA, FIA, Actuaire (IA) has research interests in actuarial studies, life insurance, longevity, long-term care, mortality modelling, and life insurance-linked securities. Her time in France gave her exposure to the global life reinsurance industry and has provided insights into what is possible in long-term care insurance. bridget.browne@anu.edu.au

## Mark Channon

Senior Associate, Mercer. Mark, an Actuary in Mercer's Retirement business, predominantly works as both an analyst and consultant for stand-alone superannuation schemes, and is also involved in the production of much of Mercer's commentary on New Zealand's superannuation environment. Mark started with Mercer in 2005 in the UK before moving to New Zealand in 2008. Mark.Channon@mercer.com

## Jonathan Eriksen

Managing Director of Eriksen & Associates Ltd, NZ. 1985 - 1995 Chief Executive, William M. Mercer Ltd NZ. Fellow of the Institute of Actuaries of London (1975), Associate of the Society of Actuaries of America (1977), Fellow of the Institute of Actuaries of Australia (1979), Inaugural Fellow of the New Zealand Society of Actuaries (1989). Jonathan has been deeply involved as a consultant on superannuation issues to employers, financial service providers, and government departments. In 2010 he investigated the unit pricing of a managed fund for a regulatory body, and reported on Kiwi-Saver schemes for a Government department. jonathan@eriksensglobal.onmicrosoft.com

## Len Cook

Senior Associate, Institute for Governance and Policy Studies, Victoria University of Wellington. Len was head of the UK Office for National Statistics from 2000 to 2005 after being New Zealand's Government Statistician 1992 to 2000. He was a member of both the 1987-88 Royal Commission on Social Policy, and the 1997 Review Committee on Social Science Research. He now works in a mix of areas involving the public sector, official statistics, long term planning and population studies. He is currently President of the Institute of Public Administration. Len has been involved for nearly three decades in presenting on aspects of retirement provision. Len is a Companion of the Royal Society of New Zealand. len_cook@xtra.co.nz