MERCER

SECURING RETIREMENT INCOMES

NEW ZEALAND'S RETIREMENT INCOMES CHALLENGE

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NEW ZEALAND'S RETIREMENT INCOMES CHALLENGE

SINCE ITS LAUNCH ON 1 JULY 2007, KIWISAVER HAS BECOME A PART OF THE NATIONAL CONSCIOUSNESS. WHILE IT'S YET TO CATCH UP WITH RUGBY IN TERMS OF POPULARITY, TAKE-UP OF THE SCHEME IS SIGNIFICANT. AROUND 1.75 MILLION KIWIS HAVE SIGNED UP TO KIWISAVER, AND AUTO-ENROLMENT IS LIKELY TO BOOST THAT NUMBER SIGNIFICANTLY. AND OF THOSE USING OR INTENDING TO USE KIWISAVER, A RECORD 63 PER CENT SAID IT WOULD BE THEIR PRIMARY SOURCE OF RETIREMENT SAVINGS[1]. IN JULY THIS YEAR, AROUND 75,000 PEOPLE WILL BECOME THE FIRST MEMBERS ABLE TO ACCESS THEIR KIWISAVER FUNDS.

Despite this, however, the nation's retirement funding issues are far from resolved. Two years ago, Mercer drafted a paper outlining our view of the most pressing issues in this space, and suggested solutions to address them. Unfortunately, little has changed since the launch of the *Securing Retirement Incomes* paper: New Zealand still faces the prospect of a retirement funding system it simply can't afford.

Mercer believes there are three pillars of an effective retirement funding scheme: a government-funded pension, savings via the workplace, and additional personal contributions on a voluntary basis. Now that a critical mass of savings is emerging, there is another equally important factor: an effective way to draw down on the funds accrued.

This 'decumulation' phase is critical to New Zealand's retirement funding model. However, there are currently few options that go beyond taking it as a lump sum upon retirement. Nonetheless, it's critical that individuals are able to use structures that ensure their savings last long enough, at a level that provides a comfortable lifestyle.

This is particularly important if, as Mercer argues, the current NZ Super model proves to be unsustainable over the long term. As the proportion of tax payers shrinks and the proportion of retirees grows, and individuals live longer than ever, pressure on the non-means-tested government pension will increase. So we need to do everything we can – right now – to boost the ability of individuals to self-fund their retirement, as well as changing our mindset on what retirement looks like.

1. KiwiSaver's popularity takes hit, NZ Herald, Jamie Gray, 16/8/11

COULD NZ BE THE NEXT GREECE?

LEARNING FROM THE EUROPEAN DEBT CRISIS

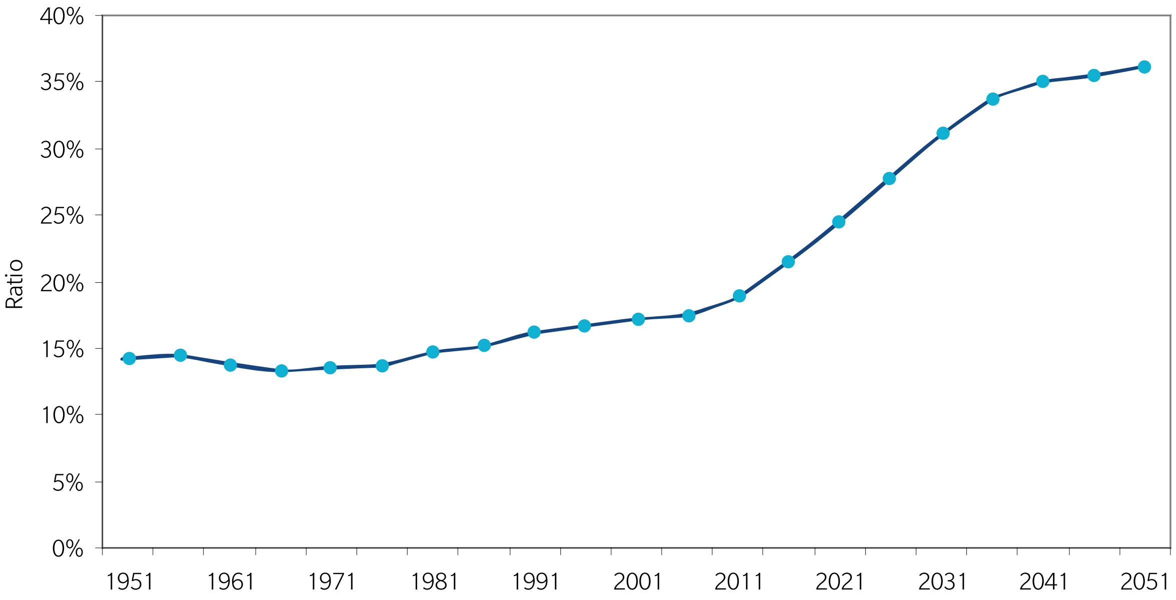
New Zealand is experiencing a surge in national pride, as the afterglow of the Rugby World Cup and the commitment to Christchurch rebuilding demonstrates our strength and resilience.

But underneath this positivity, major structural shifts are occurring in our economy, as our demography comes to be defined by an ageing population.

Treasury projections show that by 2051 you can expect 60 per cent more elderly people (aged over 65), than there are children.

In stark contrast, presently there is about half as many elderly people as there are children in New Zealand. In line with this ageing population, Treasury projects the number of recipients of NZ Super will increase from just over 500,000 in 2010 to 1.3 million by 2050. The number of people aged over 85 will rise fivefold by 2050.

Figure 1: Ratio of population aged 65 and over to population aged 15-65



Source: Statistics New Zealand

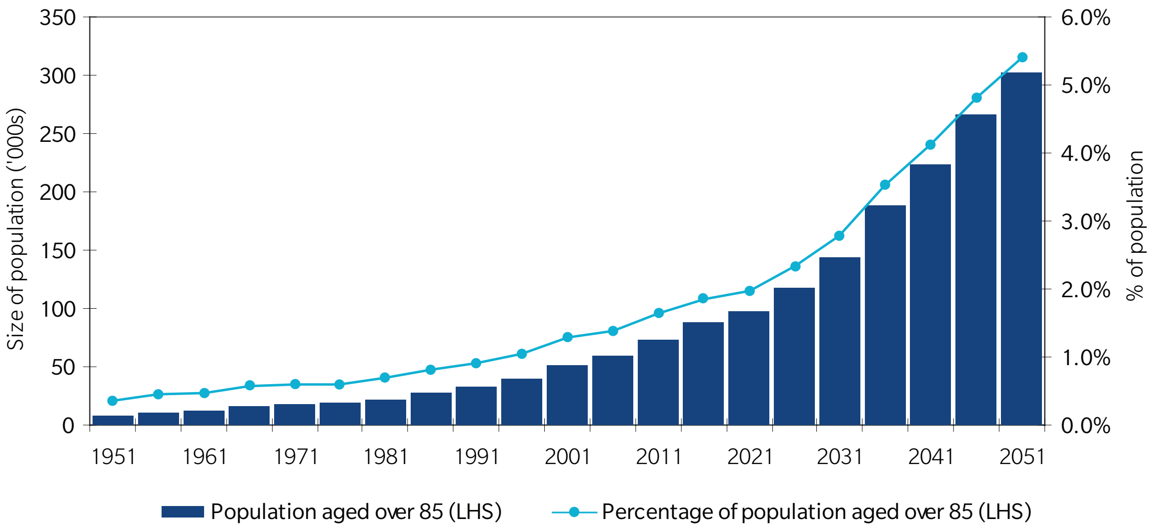
ACCORDINGLY, THE COST OF PROVIDING NZ SUPER IS EXPECTED TO DOUBLE BETWEEN NOW AND 2050 FROM 3.4%OF GDP IN 2007 TO 6.9% IN 2050 - BUT WITH NOWHERE NEAR A DOUBLING OF TAX PAYERS TO FUND IT.

Is this a looming crisis? We believe it is. Consider, for example, that an overly-generous and extremely popular public pension system is a major factor in the financial crisis facing debt-laden Greece.

We are continuing to feel the effects of the global financial crisis of 2008. Imagine, for a moment, we learned that it could have been avoided by responding to warning signs that appeared decades ago. Then imagine we learned that these warning signs were ignored, because at the time the sacrifices appeared too great. In hindsight, would we take the short term pain in exchange for a long term gain?

The financial impact of our ageing population is likened to a crisis that could potentially dwarf the global financial crisis. Except in this case, we have plenty of definitive warning signs. The question is what changes can we make now to address these issues?

Figure 2: New Zealand population aged 85 and over



Source: Statistics New Zealand

SAVING IS ONLY HALF THE BATTLE

KIWISAVER IS AN IMPORTANT INITIATIVE IN ADDRESSING THE RETIREMENT FUNDING SHORTFALL ON THE HORIZON, AND THE MOVE TOWARDS AUTO-ENROLMENT WILL HELP BOOST ITS IMPACT ON RETIREMENT SAVINGS.

Nonetheless, saving is only half of the retirement income equation. How we manage the draw-down phase is just as important.

The issue is becoming ever more timely, as 1 July 2012 approaches, when KiwiSavers will be able to access their accrued retirement savings.

We simply don't have any simple solutions for KiwiSavers that will provide them with an income stream or manage their risks during retirement: both the risk of death before the income stream runs out and the risk of living beyond the maturity date of an income stream.

As the draw down phase draws closer, it's time to have a serious discussion about the models, structures and products that will help Kiwis live a comfortable lifestyle in retirement, without straining the country's public purse.

CAN WE FIX THE ANNUITIES MARKET?

CREATING A SOLUTION TO NEW ZEALAND'S RETIREMENT INCOMES CHALLENGE

Traditionally, products known as annuities, provided by life insurance companies, were used to provide retirees with an income for life. In exchange for a lump sum, the provider guaranteed the retiree a regular income stream for life, regardless of how long they live.

Variations on these products include variable annuities where the annuitant receives, as income, a fixed number of units in an investment fund rather than a fixed payment; this may fluctuate based on investment returns. Or deferred annuities which allow the retiree flexibility to defer their payment to a later date and receive it at either a fixed or variable rate.

In today's market, annuities are unpopular and indeed almost unviable. This is unsurprising, given that they are taxed at 30% - compared to a tax rate starting at 10.5%, which many retirees enjoy.

CLEARLY, THERE IS LITTLE INCENTIVE TO INVEST IN A PRODUCT WITH DOUBLE THE TAX RATE.

Annuities are similarly unpopular with insurance providers - unsurprisingly, given the challenging tax rate and low demand, plus the tendency for healthy people to buy them and subsequently live to a grand old age. Mercer recognises that for a small market such as New Zealand, the structure of annuities products is generally high-risk and low-margin.

Against this background, Mercer believes there is an opportunity for the Government to step in and develop an annuities market.

DELAYING RETIREMENT: THE GIFT THAT KEEPS ON GIVING

Perhaps it's not what everyone wants to hear, but working longer is one of the most effective ways to manage longevity risk and maximise retirement income. Importantly, it has a compound effect. Mercer's modelling shows that all other things being equal (and assuming the entitlement age for NZ Super increases in line with the retirement age), deferring retirement by one year is likely to delay the age at which a member's superannuation balance runs out, by one-and-a-half to two years – up to twice as long as the extra time worked.

Given the continuous increase in life expectancy we have seen over the past 60 years, it's possible that today's working-age population will live significantly longer than any of us could expect.

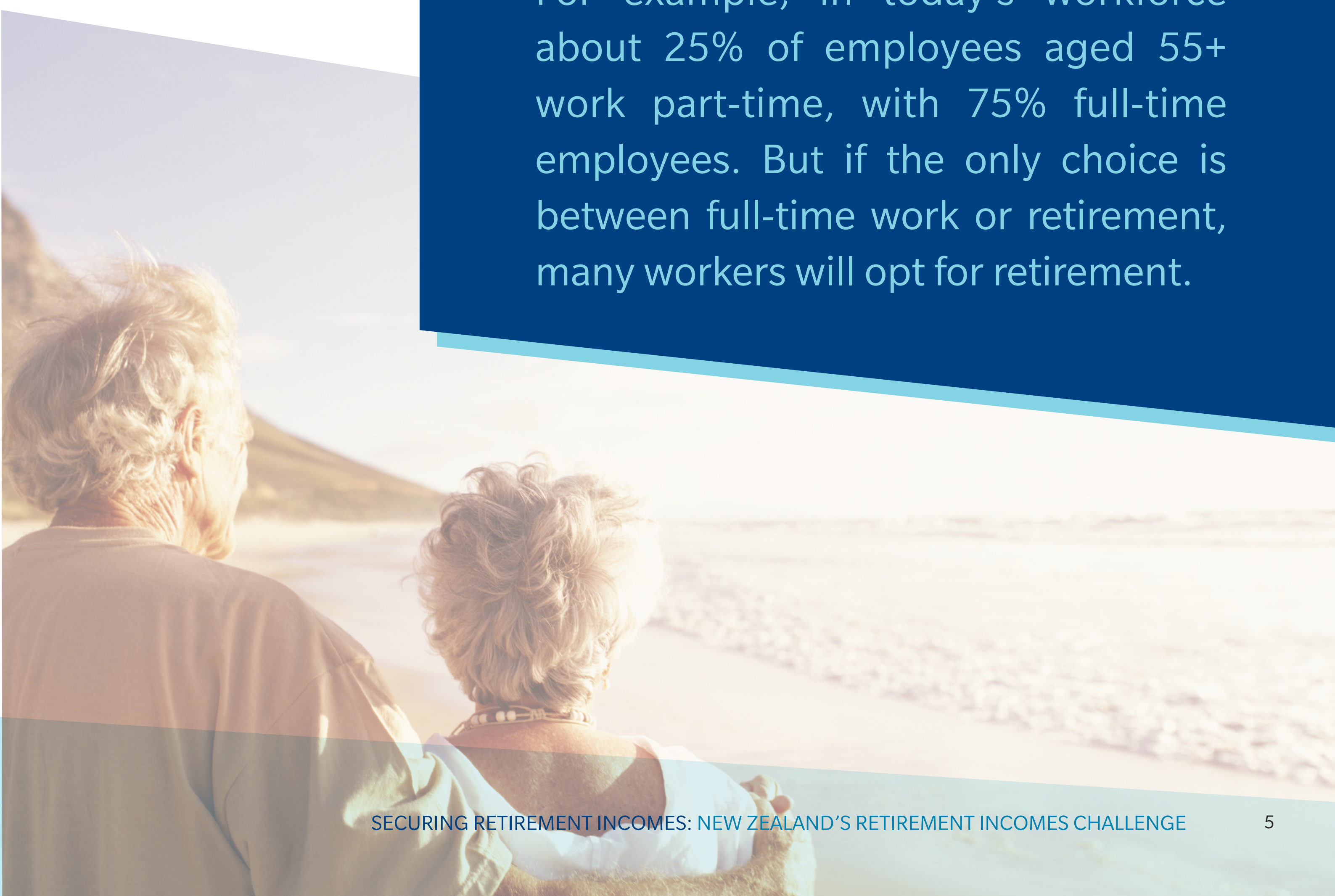
Looking at the bigger picture, lifting the retirement age would have a significant, positive impact on the national economy over the long term.

Employers, governments, KiwiSaver providers and financial advisers all need to work towards improving awareness of the benefits of working longer, as well as putting in place the frameworks to facilitate it.

Traditional thinking about the workplace – including how jobs and retirement are defined – needs to be challenged. Developing patterns of work that appeal to older people - such as job-sharing, flexible hours and mentoring/coaching roles - will help to keep them at work.

It also benefits employers by reducing skills shortages and retaining valuable corporate knowledge.

For example, in today's workforce about 25% of employees aged 55+ work part-time, with 75% full-time employees. But if the only choice is between full-time work or retirement, many workers will opt for retirement.



DELAYING NZ SUPER

KIWISAVER PROVIDERS AND FINANCIAL ADVISERS NEED TO SHOW THAT DELAYING RETIREMENT IS A COMPELLING FINANCIAL PROPOSITION, BY PAINTING A PERSONALISED AND MEANINGFUL PICTURE OF AN INDIVIDUAL'S RETIREMENT EVERY TIME THEY INTERACT WITH MEMBERS.

This measure would involve a person continuing to work after age 65 and electing to delay the start date for the receipt of NZ Super (for example, until age 70). In exchange for this deferral, the person would be entitled to a one-off higher NZ Super payment, once payments commence.

The effect overall on pension costs would depend on the level of additional entitlement once NZ Super payments commence. The additional entitlement should only be a proportion of NZ Super entitlements foregone in the deferral period, given the individual would have had the opportunity to earn employment income in that time.

The proposal may also encourage more New Zealanders to remain in the workforce after age 65, potentially improving productivity and increasing the amount available to use for retirement income outside NZ Super.

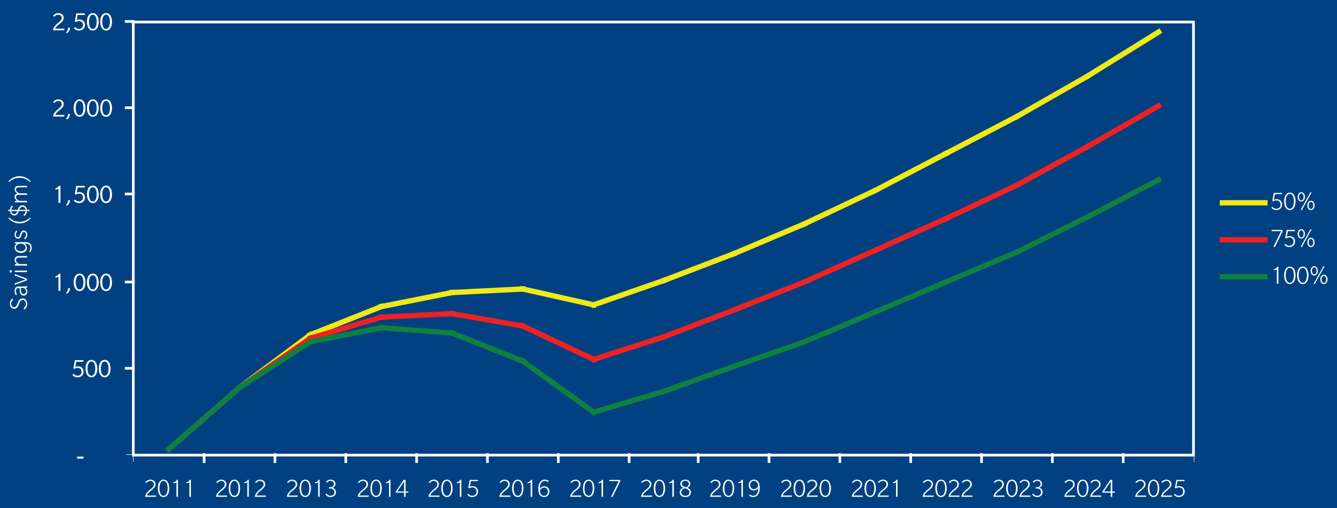
DOING THE SUMS

MERCER HAS MODELLED THE EFFECT OF PEOPLE COMMENCING NZ SUPER AT A LATER AGE, BASED ON THE FOLLOWING SCENARIO:

- Individuals receive a one-off higher NZ Super payment once payments commence.
- The additional entitlement comes from a proportion of foregone entitlements, based on the opportunity to continue earning a salary.
- We have modelled the additional entitlement at 50%, 75% and 100% of foregone entitlements, assuming people can start deferring receipt of NZ Super from this year.
- We have also assumed that 50% of people will continue to take NZ Super from age 65, with the remaining 50% spread over the next 5 years to 70 (i.e. 10% at 66, 10% at 67, etc).

By 2025, the projected annual savings in NZ Super costs would be approximately $2.4bn (for those with an additional payment of 50%), $2.0bn (75% additional payment) or $1.6bn (100% additional payment).

Figure 3: Annual savings in NZ Super when allowing late retirement, with a back payment lump sum equal to a percentage of NZ Super entitlements foregone in deferral period.



Source: Statistics New Zealand, Treasury forecasts

PROVIDING FLEXIBILITY TO BALANCE RISK

In any investment strategy, the key is to balance the level of risk with the need to generate returns. In terms of superannuation, this has generally been achieved by creating a particular mix of 'defensive' and 'growth' assets. However, there is the potential for these terms to become too vague and lose their meaning.

During retirement, investors typically look for more defensive asset strategies, with the 'fixed interest' asset class at its core. Mercer's analysis suggests that this is still too broad a label, because even within fixed interest, there are further variations in risk.

For example, when markets experienced a sharp downturn during the Global Financial Crisis, it became apparent that some securities in this category, such as global credit, are actually far more correlated to equity markets - and therefore carry far more risk - than other fixed interest assets, such as sovereign bonds.

In fact, the Global Financial Crisis revealed a failure of diversification, where corporate credit securities actually produced a negative return rather than providing the capital security usually expected from fixed interest investments.

The lesson here, we believe, is whatever constitutes a traditional 'growth' or 'defensive' asset mix is always evolving, and this needs to be reflected in asset allocation over the long term. Whether it's at the level of a super fund's portfolio construction, or related to an individual members' investment profile, what's needed is an expanded set of asset classes with clearly defined risk characteristics to choose from, and the flexibility to design a portfolio attuned to their specific needs.

The key is to ensure the right balance between protection - especially once the member can no longer make contributions - and delivering sufficient investment returns to support the member's retirement lifestyle over a long period. And with potential investment horizons of 30-40 years in retirement, it's crucial to keep reviewing and adjusting the portfolio over time.

PROVIDING MORE RETIREMENT INCOME OPTIONS

A LONG RETIREMENT MEANS CHANGING NEEDS

As life expectancy improves, the length of retirement will stretch out from what was traditionally one or two decades, to become 30 or 40 years - and beyond. So it's likely that an individual's needs will change over this time, perhaps as follows:

▶ **Active**	Immediately after retiring, income needs are higher due to travel and socialising
▶ **Passive**	As health, energy and activity declines, retirement income needs are reduced
▶ **Frail**	When higher care is needed in very old age, income needs are likely to rise again

In the long-term, however, flexibility must sit at the heart of any solution. Retirees may have such a broad range of KiwiSaver balances and other assets, as well as lifestyle expectations, that it is important to provide a range of post-retirement options. These products will provide varying levels of risk, income and flexibility, but the key is for KiwiSaver funds and advisers to work with individuals to assess what is most suitable for them.

BOTTOM LINE: WE ARE ALL PART OF THE SOLUTION

Ultimately, funding our retirement is a challenge for all Kiwis. Individuals can do more to build their savings and then spend them wisely. Governments can provide the legislative framework to facilitate this effectively. Financial services providers can apply their innovation and insight to develop better solutions. However, none of these steps can be taken in isolation, and we need to identify the issues, work collaboratively and act now to get the process moving.

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