WHAT NEXT FOR KIWISAVER: MERCER DECIPHERS THE DEBATE

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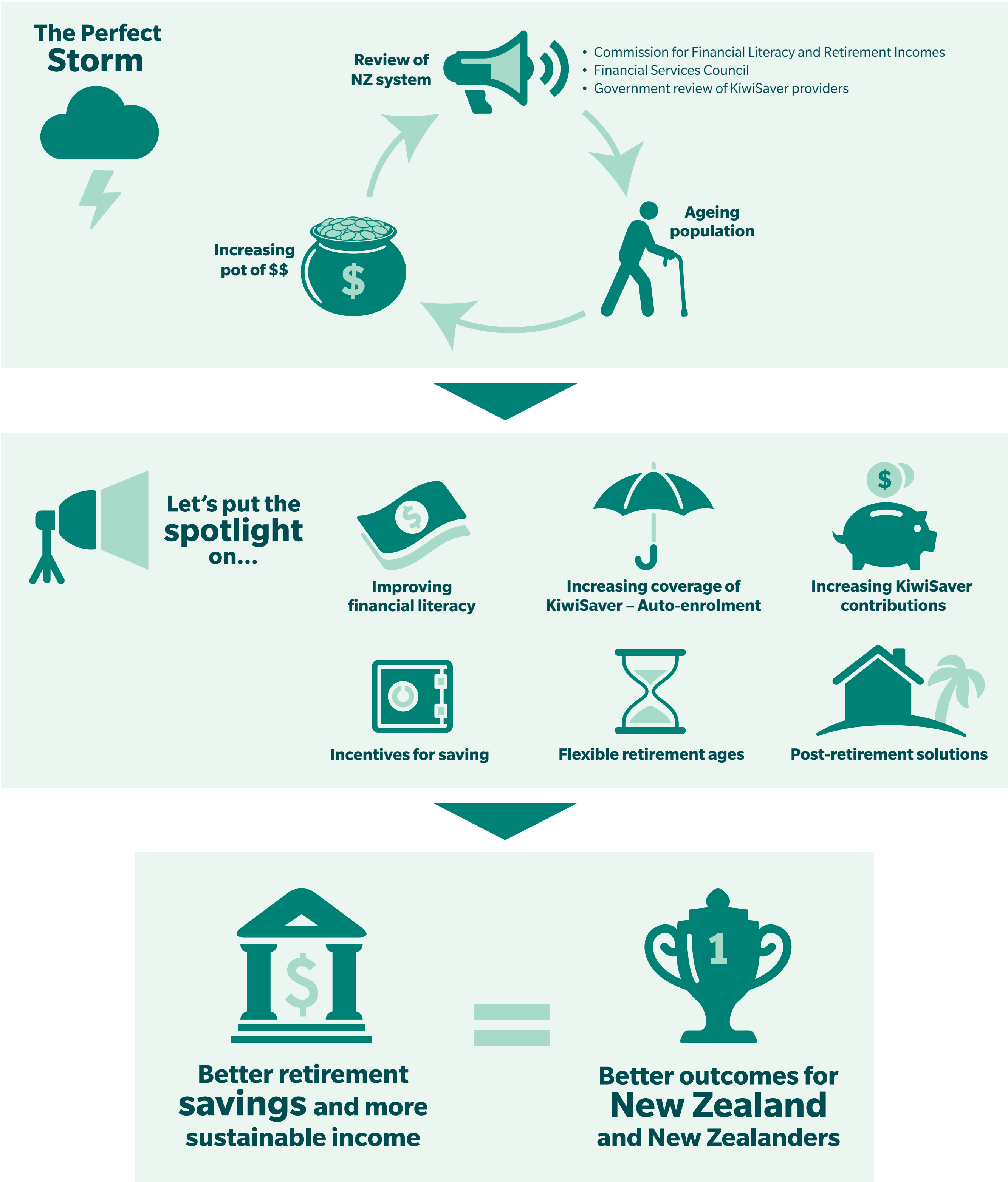
SuperThinking™

CONTENTS

IMPROVING NEW ZEALAND'S RETIREMENT SAVINGS



INTRODUCTION

At Mercer, we've been enhancing the financial security of more than 100,000 New Zealanders via KiwiSaver for more than seven years. Now, as a critical mass of savings within KiwiSaver is emerging and our population is ageing, it is critical that we continue to review our retirement savings system and strengthen New Zealanders' ability to save for a secure and sustainable retirement.

New Zealand's retirement income system has come under renewed scrutiny in recent months. There continue to be some shared and some opposing views about how to improve our retirement savings system and ultimately improve retirement outcomes for New Zealanders.

In this report – *What next for KiwiSaver: Mercer deciphers the debate* – we have summarised some of the key points-of-views being debated and outlined our position on these issues.

We understand what makes a world class retirement savings system; we have analysed, compared and helped design some of the best systems in the world. In New Zealand we have worked with the Government, and clients and KiwiSaver members to improve the adequacy and sustainability of New Zealand's retirement savings and income system.

Based on experience, research, and knowledge we believe New Zealanders face the prospect of a retirement income that meets only basic needs.

At a time of review and possible change and enhancements, we've summarised the key recommendations and views of the following reports and reviews:

- the **Commission for Financial Literacy and Retirement Income's (CFLRI)** discussion document, 'Focussing on the Future', following their triennial review of retirement income policies[1];
- the **Financial Services Council's (FSC)** 'How to Super-Size Retirement Income' conference and paper[2];
- the release of the findings from the **Government's default KiwiSaver provider review**[3].

All three documents recognise the importance KiwiSaver will play in meeting the needs of retirees in the future.

> "It is vital we continue to build on KiwiSaver's contribution to developing a savings culture and lifting New Zealanders' confidence in our financial sector."
>
> BILL ENGLISH

The CFLRI stated, "...maximising the schemes' membership, level of engagement and connection to the overall retirement income framework would be necessary to offset the impact of their recommended changes to New Zealand Superannuation."[4]

The importance of KiwiSaver will become even more apparent as account balances grow through contributions and compounding returns. However, doubts remain as to whether it will be sufficient to maintain the average New Zealander's pre-retirement standard of living without being significantly supplemented by additional savings.

This paper includes Mercer's recommendations to increase the retirement savings of New Zealanders' and ensure we have a system that provides an effective way to draw down on the funds accrued. Our retirement income system should provide more sustainable and protected income streams in retirement. KiwiSaver is not primarily about repayment of debt or estate planning; it is about spreading one's income over a life-time to provide an appropriate living standard in retirement.

As the proportion of tax payers in our population shrinks and the proportion of retirees increase, pressure on the non-means-tested government pension will increase. We need to do everything we can to boost the ability of individuals to self-fund their retirement.

While this report primarily focuses on KiwiSaver, many of the ideas can also be extended to private superannuation savings schemes.

1 http://www.cflri.org.nz/sites/default/files/docs/RI-Review-2013-Focusing-on-the-Future.pdf
2 http://fsc.org.nz/site/fsc/files/SuperSize%20Conference%202013/FSC_How%20to%20supersize%20final.pdf
3 http://www.beehive.govt.nz/release/kiwisaver-default-provider-review-completed
4 http://www.cflri.org.nz/sites/default/files/docs/RI-Review-2013-Focusing-on-the-Future.pdf

IMPROVING KIWISAVER COVERAGE AND MEMBER ENGAGEMENT

FINANCIAL LITERACY

The need or desire to spend today rather than save for tomorrow means, not surprisingly, a large proportion of the population are disengaged with saving for retirement. This is particularly true of individuals with lower levels of financial literacy. The CFLRI reported "people who are more financially literate tend to plan for retirement, regardless of economic characteristics and circumstances."

The Mercer KiwiSaver Sentiment Index Study tells us that only one in five New Zealanders rate their knowledge on retirement savings highly but 55% aspire to increase their understanding. New Zealanders want to learn more about saving for retirement.

Whilst KiwiSaver has become a part of the national consciousness since its inception in 2007 knowledge remains low and New Zealanders are the poorer for it. A large number of KiwiSaver members are either not actively contributing, or not fully benefiting from the incentives on offer. According to the CFLRI, over 75% of members who were eligible for the member tax credit, a Government contribution of 50 cents for every dollar of member contributions, up to a maximum of $521 p.a., had not made sufficient (less than $1,042 p.a.) contributions to gain the full tax credit in the twelve months to June 2012.

Education and member communication should be regularly provided to all members with a focus on the provision of retirement income and not wealth accumulation according to the Melbourne Mercer Global Pension Index.

5 2012 Mercer KiwiSaver Sentiment Index study

6 https://secure.superfacts.com/public/kickstart/content.tpz?TP=PL_Cocontributions&QL=QL_Cocontributions

MERCER'S VIEW

We are pleased to see the Government's revised criteria for KiwiSaver default providers include the requirement that such providers must offer investor education to default members. By definition, these members are much less likely to have been proactive in considering their savings options and it is important they are aware of all of their options. The continued use of a conservative option, with 75% – 85% of assets invested defensively, as the default was confirmed in the recent review of the default provider arrangements. This meets the Government's desire for capital protection, but is expected to result in lower long-term returns than using a lifecycle approach, particularly for younger KiwiSaver members. The requirement to educate these members should lead to improved results for them.

Our Mercer KiwiSaver Sentiment Index revealed the majority of New Zealanders are aware they will not enjoy the same level of comfort in their retirement as they currently do. However, many are unaware of the amount needed at retirement to meet their goals, or a suitable savings pattern to reach such an amount. They know they won't have enough but have no idea what is enough or how to get there.

Educating people about the projected level of retirement savings and lifetime income they will need to live their desired lifestyle through their retirement years, would help ensure they are contributing a suitable amount during their working lifetime. KiwiSaver providers and retirement savings schemes' sponsors could provide more guidance in this area and include relevant information into annual benefit statements, including an illustration of the estimated income afforded from balances.

Knowledge is power and helping KiwiSaver members boost their retirement savings by improving their knowledge can be simple. Mercer's award-winning 'Money for Jam' campaign[6] was an educational campaign and timely reminder for members of the contributions needed to maximise the tax credit part of their savings. Regular information is critical in educating KiwiSaver members with a 'set and forget' mentality.

AUTO-ENROLMENT

Increasing the coverage of employees and/or the self-employed in the private pension system, without an element of compulsion or automatic enrolment, is a significant challenge for pension systems around the world according to the 2013 Melbourne Mercer Global Pension Index.

An auto-enrolment exercise, whereby all employees who are not currently members of KiwiSaver are signed up to the scheme has long been mooted, but the Government has stated this would not occur until it was affordable, which based on the projections released in the 2013 Budget, is not expected to be before 2016. The costs of an auto enrolment exercise to the Government are predominantly in respect of the $1,000 kick-start provided to each new member who remains signed up, plus the regular member tax credit of up to $521 per annum. The 2012 Budget estimated the cost of auto enrolment to the Government as approximately $500m over four years, with most of the cost in the first year. Assuming there are no increases in the kick-start payment or member tax credits, this additional cost is likely to fall over time as more New Zealanders enter the scheme through other means.

The CFLRI has recommended an auto-enrolment day be held "as soon as fiscally prudent", but rejected compulsory membership, noting a "proportionally greater burden would probably fall on those with low incomes". The FSC presented two recommended systems, one compulsory and one voluntary, but with recommended auto-enrolment days once every three years under their proposed 'Voluntary KiwiSaver Pathway'. Independent research conducted in December 2012 on behalf of the FSC shows at least 60% of Kiwi adults are behind a universal (compulsory) KiwiSaver scheme for employees.

7 Inland Revenue KiwiSaver annual report 2013

MERCER'S VIEW

We believe the current auto-enrolment mechanism, whereby new employees are signed up to KiwiSaver is a positive feature of KiwiSaver and has led to proportionally greater coverage amongst younger people, 72% of 18-24 year olds are enrolled compared to about 60% of older working age groups[7]. Mercer strongly supports extending this to all employees. We believe it will bring New Zealanders a step closer to having a world-class retirement savings system.

New Zealand is unique in having the world's only non-means tested universal pension system and we need to ensure the introduction of a compulsory system will not be to the detriment of this.

Our modelling shows a 40 year old joining KiwiSaver today could expect a retirement savings balance at 65 up to 20% higher than if entry were delayed for three years. Holding an enrolment event as soon as possible would provide a significant boost to long-term savings.

Greater coverage will lead to increased financial security for retirees, growth of the funds management industry and a subsequent injection of funds into the wider economy. It is also an important step forward in terms of reducing reliance on NZ Super. NZ Super is unlikely to continue to fund an acceptable quality of living for most people (it's equivalent to about 66% of the average wage) so it is essential that individuals are encouraged to save for their retirement.

BOOSTING SAVINGS BALANCES & RETIREMENT OUTCOMES

INCREASE KIWISAVER CONTRIBUTIONS

For a KiwiSaver member earning the national average wage of approximately $56,000, the total of their minimum employee contributions, employer contributions and member tax credits amounts to 6% - 6.5% of their gross salary (after the deduction of contribution tax from their employer funded portion). The argument of whether this is enough to provide New Zealanders with their desired lifestyle in retirement is ongoing.

As a comparison, the level provided by the Australian Superannuation Guarantee is currently due to rise to 12% of salary (10.2% after deduction for tax) by 2021. The Australian system also offers tax incentives for individuals to contribute more.

A suitable contribution rate to meet an individual's retirement needs depends on many factors including: age, existing savings and the level of tax subsidies. The CFLRI and FSC have differing viewpoints on the suitable level.

The CFLRI believes a continuous working lifetime making the minimum contributions would provide a higher standard of living than NZ Super alone, fulfilling the requirements of KiwiSaver. It did however, recognise that were NZ Super to change in line with its recommendations, the ability of KiwiSaver in its current form to supplement retirement incomes would be reduced as it could be needed to fund the resultant income gap left from reduced indexation and later retirement ages.

The FSC has previously stated a total rate of 10% of salary was needed to secure a comfortable retirement income (considered to be double the rate of NZ Super) over a working lifetime. However, it has more recently recognised a starting rate of 10% would be difficult and concluded in their recent review a lower rate of 7% (with a potential starting rate of just 1%) could be feasible, but only with other reforms to the KiwiSaver system, including improving net returns from investments.

MERCER'S VIEW

We believe a higher contribution rate than the current minimum is necessary to secure a more sustainable retirement outcome for New Zealanders. It is also necessary to reduce the pressure on future generations and governments to fund an increasing superannuation bill from NZ Super. Mercer believes a contribution rate of 8-10%, shared between employees and employers, would allow a KiwiSaver member to enjoy a comfortable retirement and make New Zealand's superannuation system competitive with those in other countries.

Any increase in minimum contributions should be phased in. Forcing the minimum contribution rate up too high, too quickly could discourage membership, particularly for lower-income earners, but foreshadowing a future change early would allow individuals and businesses to make the necessary preparations and even encourage an early adoption. The increase in the minimum contribution rate could be applied to the employer's contribution rate only. Whilst this would be expected to be ultimately passed on to employees through a reduction in benefits elsewhere, it may appear to be more palatable.

One way to introduce policy change would be to allow an employee contribution rate of 6%, filling the large jump between the current 4% and 8% rates. Whilst this would remain optional, and so perhaps fairly limited in its outcome, the introduction of an intermediate rate, together with a concerted education exercise, could encourage higher savings rates.

BOOSTING BALANCES AND RETIREMENT OUTCOMES (CONT)

INCENTIVES FOR SAVING

There are currently no incentives for New Zealanders to contribute more into KiwiSaver than the compulsory rate (or $1,042 p.a. if lower), beyond any discretionary benefits offered by their employer. In fact, long-term retirement savings through KiwiSaver and other schemes is dis-incentivised, as noted by the FSC:

"The current tax system strongly discourages longer term saving using the preferred vehicles of KiwiSaver and bank term deposits, which feature compounding returns, while strongly encouraging investment in rental property."

To amend this discrepancy and level the playing field the FSC recommended restructuring the Portfolio Investment Entity (PIE) tax rates on retirement savings to be approximately half their current rate.

Taxation matters are beyond the scope of the CFLRI's review of retirement income policy, however it did note previous tax policy reviews and many of the submissions they received highlighted the tax discrepancies between different investments. The Commission did recommend removing the payment of tax on the inflation component of simple investment instruments such as bank deposits and bonds.

MERCER'S VIEW

A review of the taxation of contributions and investment returns could encourage individuals to increase the amounts deposited in KiwiSaver or other superannuation schemes. A preferential tax treatment on contributions made to retirement savings schemes, rather than taken as salary could be implemented by amending the contribution tax scale to lift the thresholds or reduce the rates applied. The Australian system, for example, allows for individuals to sacrifice some of their salary into their superannuation, where it is taxed at a flat rate of 15%, rather than at their marginal tax rate. To avoid overly subsidising the already wealthy, appropriate limits on the level of contributions made should be put in place.

Increasing the compounding returns on savings through the use of a lower tax rate within KiwiSaver and other superannuation schemes would also provide an incentive to lock more funds away to ensure a sustainable retirement. We would, however, be concerned about effectively subsidising defensive asset classes over others, as recommended by the CFLRI. This could actually lead to lower long-term outcomes as individuals eschew riskier, but higher returning assets in favour of tax efficient ones.

TAX ON INVESTMENT EARNINGS

Mercer believes that the tax rate on investment earnings should be a single, preferential rate applying to all investments – shares, bonds, property and other investment assets. This will:

- Ensure that there is no future need to keep trying to manually re-align the PIE tax rates with personal tax rates in New Zealand (note that when the PIE tax regime was introduced in New Zealand personal tax rates had not changed for about 9 years). At present lower income earners are taxed more heavily within KiwiSaver on their investment earnings than the marginal tax rates applying from 1 October 2008 – and each and every time personal tax rates change the issue of misalignment between the tax on investment earnings and an individual's own tax rate will rear its ugly head;
- Encourage people to transfer savings from non-superannuation assets and traditional superannuation to KiwiSaver;
- Simplify investment reporting for fund managers (and the cost of the whole system which will ultimately benefit members);
- Ensure members more easily understand their KiwiSaver returns – since all members are taxed at one rate and the key message which will stand out in their minds is that the rate will be "preferential" i.e. better than other opportunities available; and
- Encourage individuals to possibly transfer their superannuation savings which are presently abroad (such as in Australia) back to New Zealand. Mercer is on record as saying that under the current tax regime, there is no incentive for anyone in New Zealand to repatriate any superannuation back from Australia.

LIFE-CYCLE INVESTMENT

A lifecycle investment option automatically changes the mix of assets your retirement savings are invested in to match your life stage and ability to take on risk.

Typically, a member's assets are gradually switched from a growth investment strategy to a more defensive one as they get closer to retirement age, and beyond. Mercer research[8] shows by changing from a static conservative strategy to a dynamic life-cycle approach, members are better positioned to generate more retirement savings while not increasing the chances of a negative outcome during the critical 5-10 years leading up to retirement.

Mercer expressed its support for life-cycle default investment options over a conservative fund approach in the call by the Ministry of Business, Innovation and Employment for submissions on the KiwiSaver default provider arrangements. Conservative funds adopt a relatively static asset allocation of approximately 20% in growth assets and 80% in defensive assets throughout their duration. While this may be appropriate for an older member, it may not be an optimal strategy for a younger member, who has time to recover from any risk events (although it is accepted that this strategy may have limited utility in the case of younger members looking to purchase their first home). This approach has also been supported by the FSC and the ability to automatically transition investments over the years before and after retirement was suggested in the recent MMGPI report as one of the key features of an adequate, sustainable defined contribution scheme.

The Government decided to maintain the conservative option as the default, stating that "the aim of default funds is to provide stable returns and build confidence in KiwiSaver while members actively consider the best fund for their individual circumstances."

While the CFLRI had the same view as the Government with respect to keeping the default funds invested conservatively, they did recognise the merit of a life-cycle approach. They stated:

"While it may be true that a less conservative option or a life-cycle fund is more appropriate in many cases, this is for members themselves to determine."

MERCER'S VIEW

We believe age-based investment strategies are a significant and necessary improvement to the design of KiwiSaver which would result in better outcomes for members over the long term. However, we also believe a life-cycle approach is not a substitute for one-on-one financial advice. According to Mercer's investment experts and our research, age 45-55 is an opportune time to re-evaluate a member's investment strategy and for the member to consider converting to a personalised, advice driven strategy. The call from the Government for default providers to deliver investor education will hopefully encourage individuals to review their strategies at regular stages of their life.

THE POST-RETIREMENT CHALLENGE

FLEXIBLE RETIREMENT AGES

The recommendation from the CFLRI to introduce a mechanism to link the pension age to life expectancies to maintain the sustainability of NZ Super, has garnered significant public debate. It also dismissed the recent proposal by United Future for the age of eligibility to be made flexible, with individuals choosing whether to commence receiving the state pension earlier or later than the current fixed age. This was on the basis that it could lead to increases in administrative complexities and worse long-term outcomes for many who would spend their full retirement on a lower income. To allow individuals to bridge the gap between age 65 and a later age of eligibility, the Commission recommended maintaining the age at which KiwiSaver can be accessed at age 65.

MERCER'S VIEW

Mercer would like to see increased flexibility in the age at which KiwiSaver savings can be accessed, and the age at which the current benefits are able to be earned. The pace at which funds are removed should be controlled to protect against longevity risk whilst facilitating an earlier access age. Possible features to achieve this are discussed in the next section. A lower age of accessibility would increase the appeal for individuals who may struggle to continue working to 65.

To recognise increasing life expectancies and the desire (and need) for some people to work beyond age 65, compulsory employer subsidies should not cease and member tax credits could continue, at least until NZ Super became payable.

POST-RETIREMENT OPTIONS

The major concern for most retirees is that they will run out of money. This can occur through excessive consumption, poor investment returns, high inflation, living longer than expected or being faced with a major unexpected expense. A focus on providing retirement income necessitates a significant change in everyone's mindset about the core purpose of KiwiSaver. We must focus on the outcomes during retirement not just accumulating a lump sum for retirement.

KiwiSaver has focussed on the accumulation of retirement savings with very few targeted options for managing balances during retirement. With no significant market for post-retirement products currently available in New Zealand, retirees with account based benefits are left on their own to manage the spending of their savings through retirement. Managing the longevity and investment risks of retirement savings is complex and beyond the capabilities of most of the population. New Zealand needs taxation and regulatory legislation that encourages products that manage the utilisation of accumulated balances – or, in other words, provide a sustainable income in retirement rather than a lump sum. Such a structure would allow individuals to make the necessary preparations to fund their desired lifestyle and increase confidence in the whole retirement income system.

Annuities have traditionally been a primary solution and while they provide a suitable hedge against the risk of an individual outliving their capital, they have proven to be unpopular in recent years in New Zealand. Issuers have been reluctant to offer them without suitable investments to back them and there has been only a small potential market and high capital requirements. Potential purchasers have been scarce due to fears over the security of issuers, the safety net already provided by NZ Super and perceived low returns.

When pricing annuities providers must account for the risk of anti-selection, whereby the healthiest individuals are most likely to purchase, low future returns due to the capital requirements and the taxation of returns at the corporate tax rate, rather than an annuitant's own rate (or likely their Prescribed Investor Rate). All these factors combine to make annuities relatively expensive and so more flexible post retirement options are required.

The concept of requiring retirement savings to be used to provide a post-retirement income was covered by the CFLRI, the FSC and the Melbourne Mercer Global Pension Index:

- The CFLRI reported that "priority be given to encouraging market response" rather than compulsory annuitisation, and included the recommendation that the Retirement Commissioner undertake a review to determine the viability of voluntary annuitisation.
- The FSC suggested it should be a requirement that savings be used to buy a second pension at the level of NZ Super. After funding this pension, any surplus funds could then be accessed as a lump sum.
- The 2013 Melbourne Mercer Global Pension Index provided an extensive review of how defined contribution schemes should be utilised post-retirement to contribute to a sound retirement income system. This review recognised the need for some access to capital throughout retirement, plus secure income products which offered longevity protection whilst providing good returns. Furthermore, in comparing the retirement systems of 20 countries, the Index considered it ideal for systems to require 60%-80% of savings to be taken as an income stream. Failing this compulsion, incentives to encourage income streams were favoured.

In retirement people seek many outcomes from their superannuation benefit. They want:

- good investment returns with some investment choice;
- preservation of their hard earned capital;
- some protection from longevity and market risks; and
- access to some capital to cover unexpected expenses and/or the ability to pass their unused benefit on to family members.

MERCER'S VIEW

We believe an ideal portfolio should include limited access to a lump sum benefit for benefits above a prescribed minimum level; a relatively flexible income product in the first period of retirement (say 20 years) that could be an annuity or drawdown product with some constraints and/or guarantees; and a pooled insurance-type product to provide longevity protection for the later years that could be a deferred annuity or pooled product provided by the superannuation plan or insurer. This overall design would also enable members to seek good investment returns in the earlier years of retirement, to have access to some capital and have some protection from risks.

THE POST-RETIREMENT CHALLENGE (CONT)

AN ALTERNATIVE POST-RETIREMENT APPROACH

The conversion of retirement savings into adequate and sustainable retirement incomes remains a largely unresolved problem in many countries and New Zealand is definitely in this boat.

We believe two fundamental steps in developing the best post-retirement solutions are:

1. Separating accumulated savings into income and discretionary accounts; and
2. Adopting a new approach to the provision and timing of annuity benefits.

The chart below demonstrates how potential retirement spending needs and patterns will vary through time. It shows a need for regular income in excess of the base level provided by NZ Super, with additional funding at infrequent times to fund irregular spending such as overseas holidays or a new car.

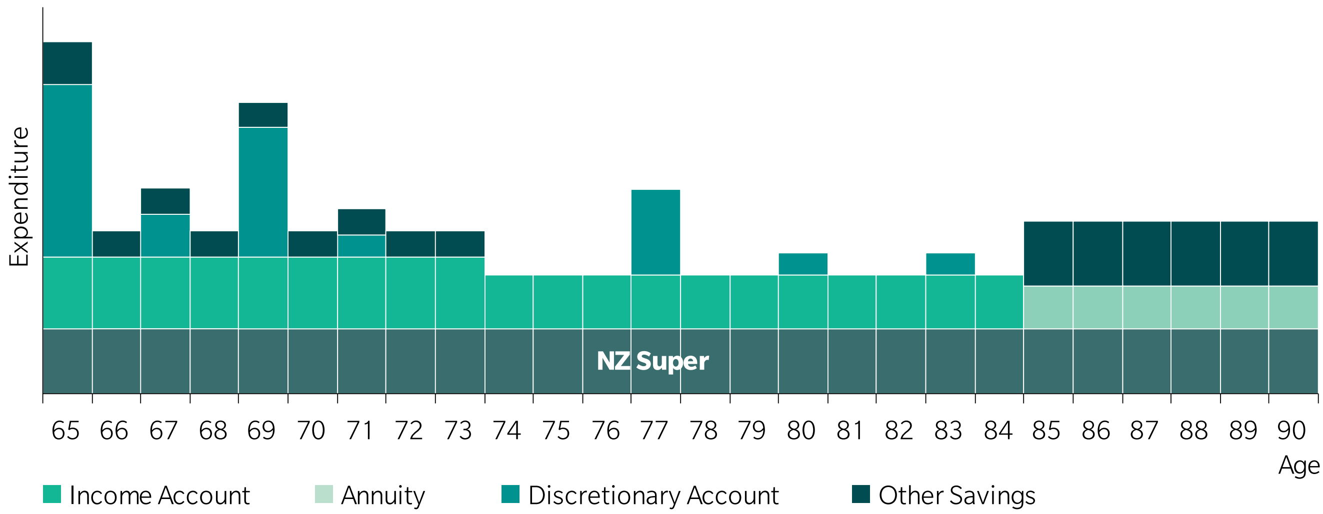


Chart: *Mercer's illustration of an expenditure pattern and sources of income for a retiree*

Dividing retirement savings into two parts: income and discretionary accounts, allows for a regular and sustainable income as well as the protection of a 'safety net' for unexpected costs. The *income account* provides 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* can be used to meet the irregular 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.

To compensate individuals for the restrictions imposed by income accounts there would need to be savings incentives, which are already used to some extent through the kick-start and tax credits offered in KiwiSaver. These would possibly need to be extended, most effectively through the use of tax efficient returns, to increase the level of savings and offset the unpopularity of introducing restrictions. A less popular, but potentially cheaper, policy change would be to impose compulsory savings.

As well as the option to manage their own investments in line with their risk tolerances, individuals should have the (simpler) option of using their income account (and any other savings) to purchase an annuity at any time. However, it should be noted that by deferring an annuity purchase for 20 years post retirement an individual could realistically 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 the flexibility to manage their own savings during the early years of retirement. In this illustration the purchase of the annuity at age 85 can be funded from the unspent balance from both accounts, but could also be achieved by setting aside designated funds at retirement or through the payment of on-going premiums from regular income in earlier retirement years.

Global experiences show that Government interventions are likely to be needed to produce a viable private sector annuity market. One solution for New Zealand 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 until it matures and also for individuals well into their retirement.

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. A more generic retirement income design, that is non-country specific, can be found in the MMGPI's most recent report.

ABOUT MERCER

Mercer is a global consulting leader in talent, health, retirement, and investments. Mercer helps clients around the world advance the health, wealth, and performance of their most vital asset – their people. Mercer's 20,500+ employees are based in more than 40 countries, and we operate in more than 140 countries. Mercer is a wholly owned subsidiary of Marsh & McLennan Companies (NYSE: MMC), a global team of professional services companies offering clients advice and solutions in the areas of risk, strategy, and human capital.

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