

**Presentation to the
RPRC Symposium
Spending the savings: Decumulation and middle-income retirement**

What Would it Take to Have a New Zealand Market for Annuities?

by

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9am – 4.30pm

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The University of Auckland Business School

Case Room 2, Level 0

Owen G Glenn Building,

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Auckland

What are we trying to achieve with Retirement Income Policy?

- **New Zealand Superannuation 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.**

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 descendants 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.**

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:

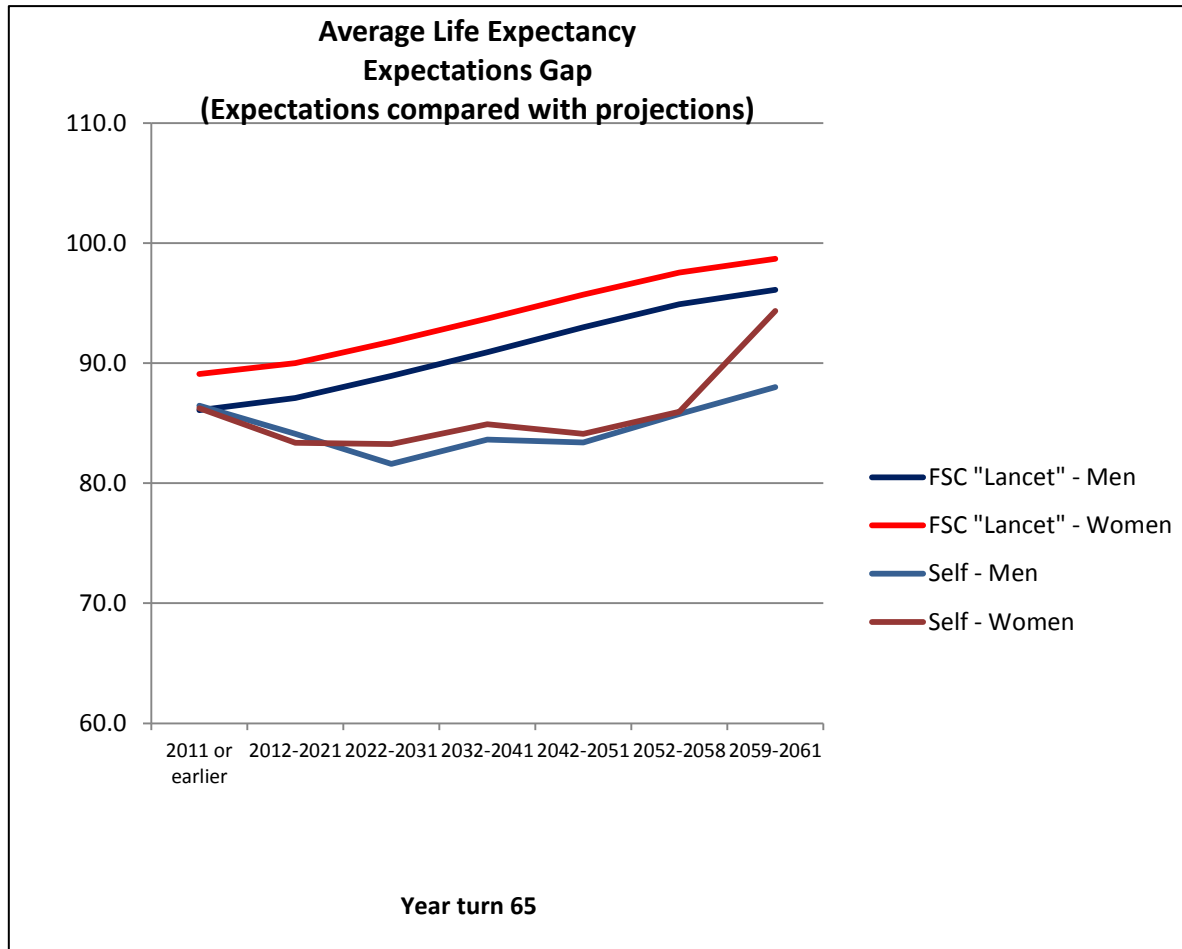
- **Most of the discussion about longevity relates to life expectancy from birth which is not all that useful for accurately estimated longevity in retirement. Why is this?**
- **Many people are referencing their family history for those already died rather than the trend towards increasing longevity 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.**

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. 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.

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



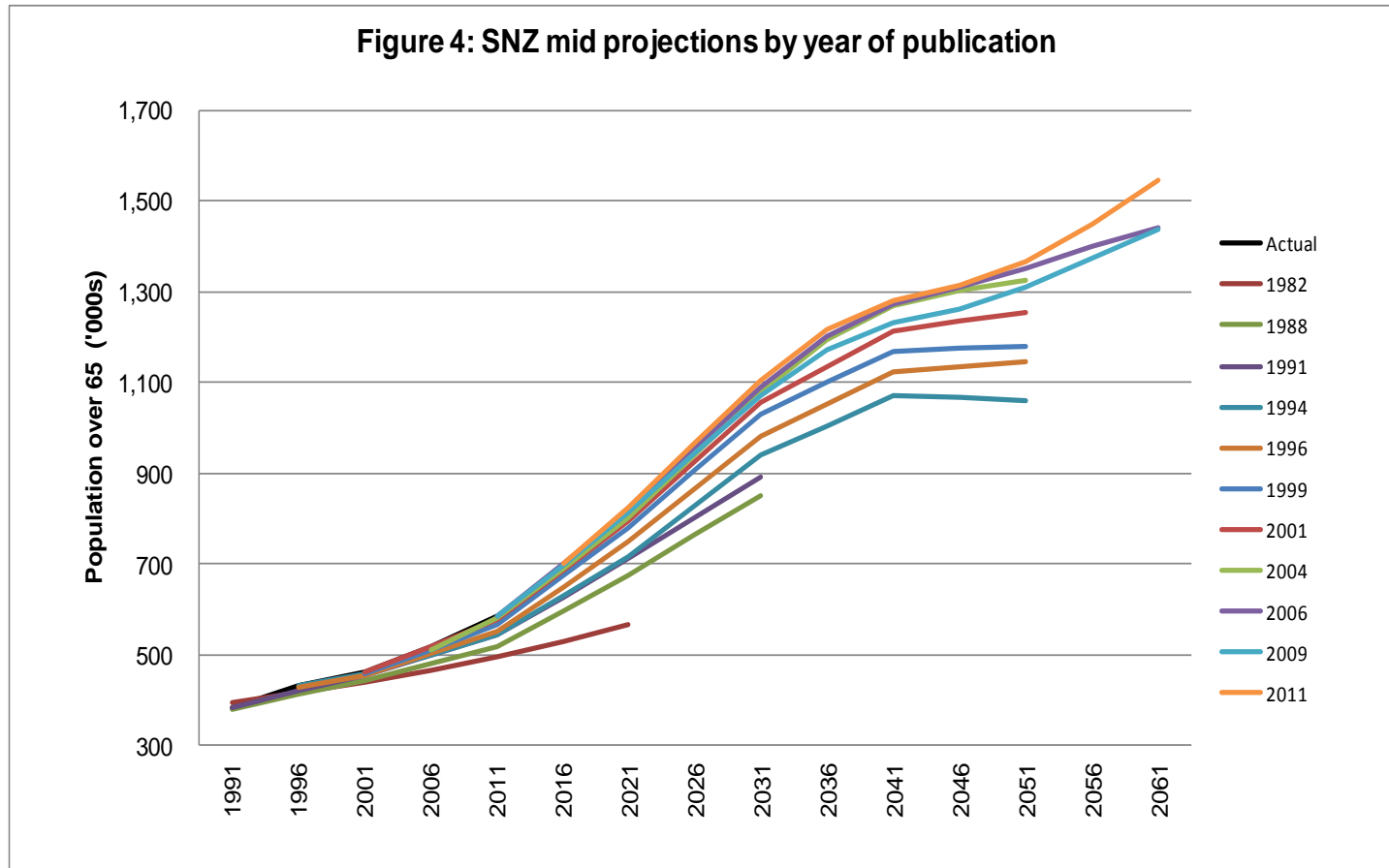
Source: FSC Lancet Projections and Horizon Research Dec 2011

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.

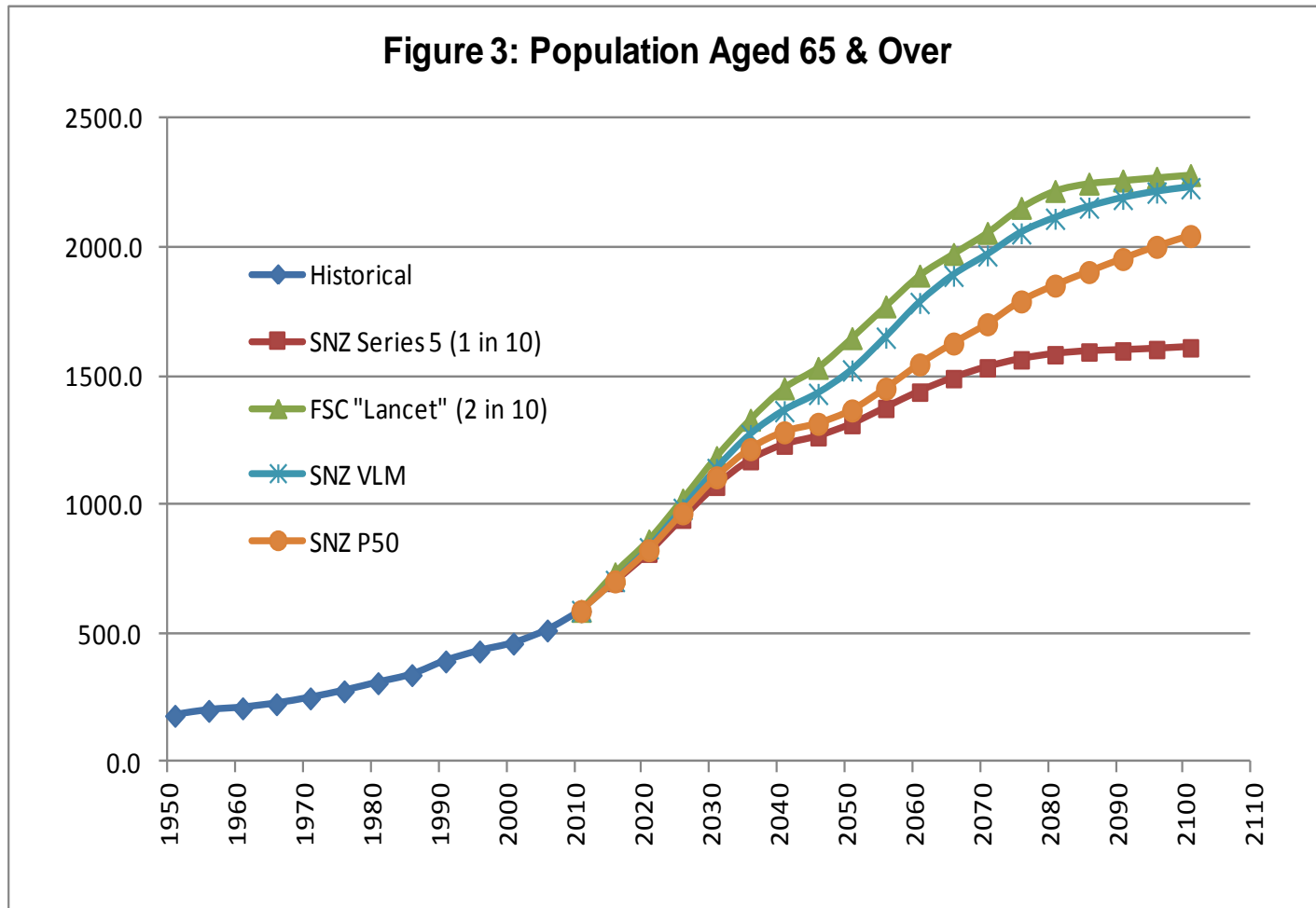
Table 1: Life Expectancy at Birth

		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



Source: Infometrics from Statistics New Zealand Data



Source: Infometrics

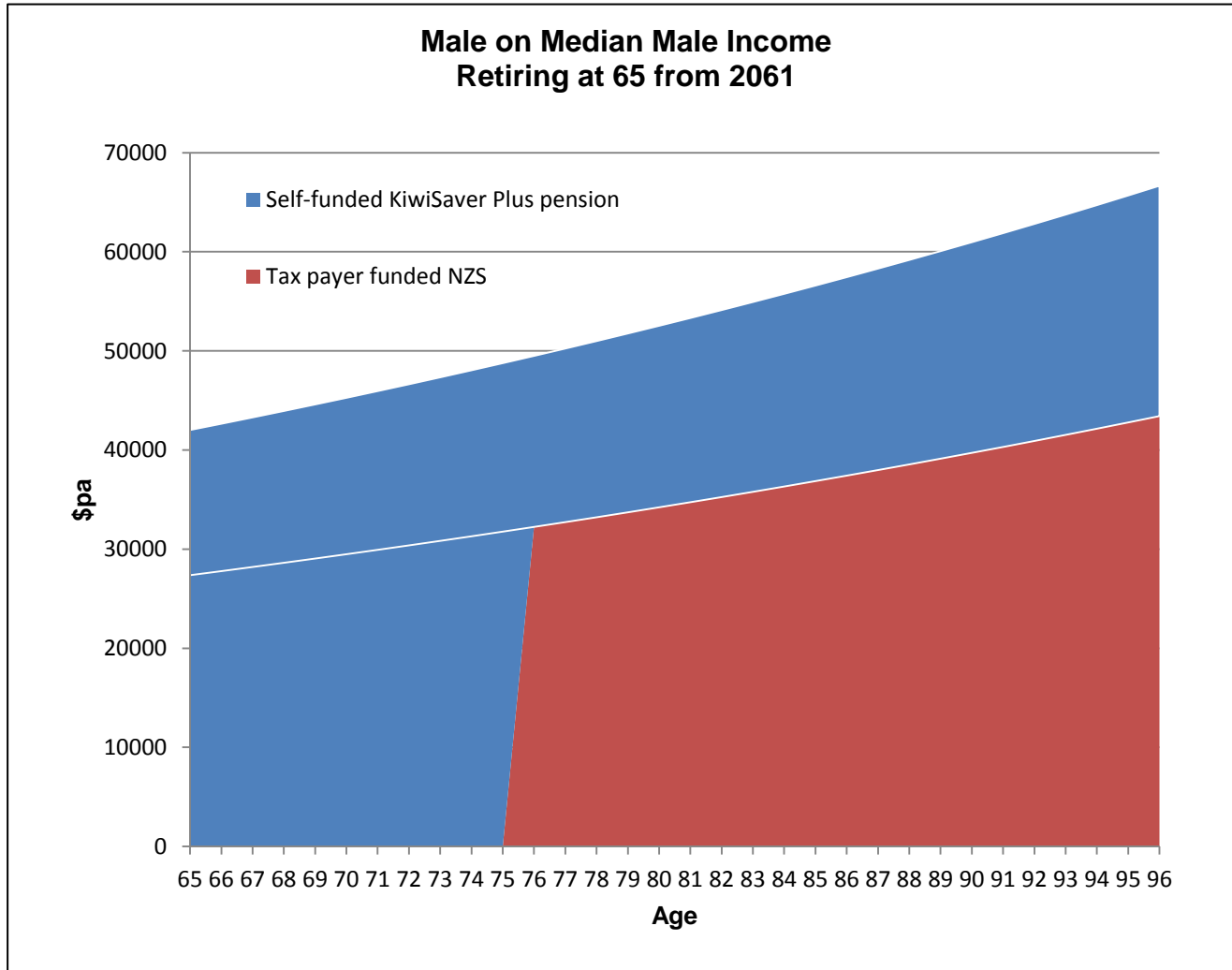
Why do we have problems on the supply side?

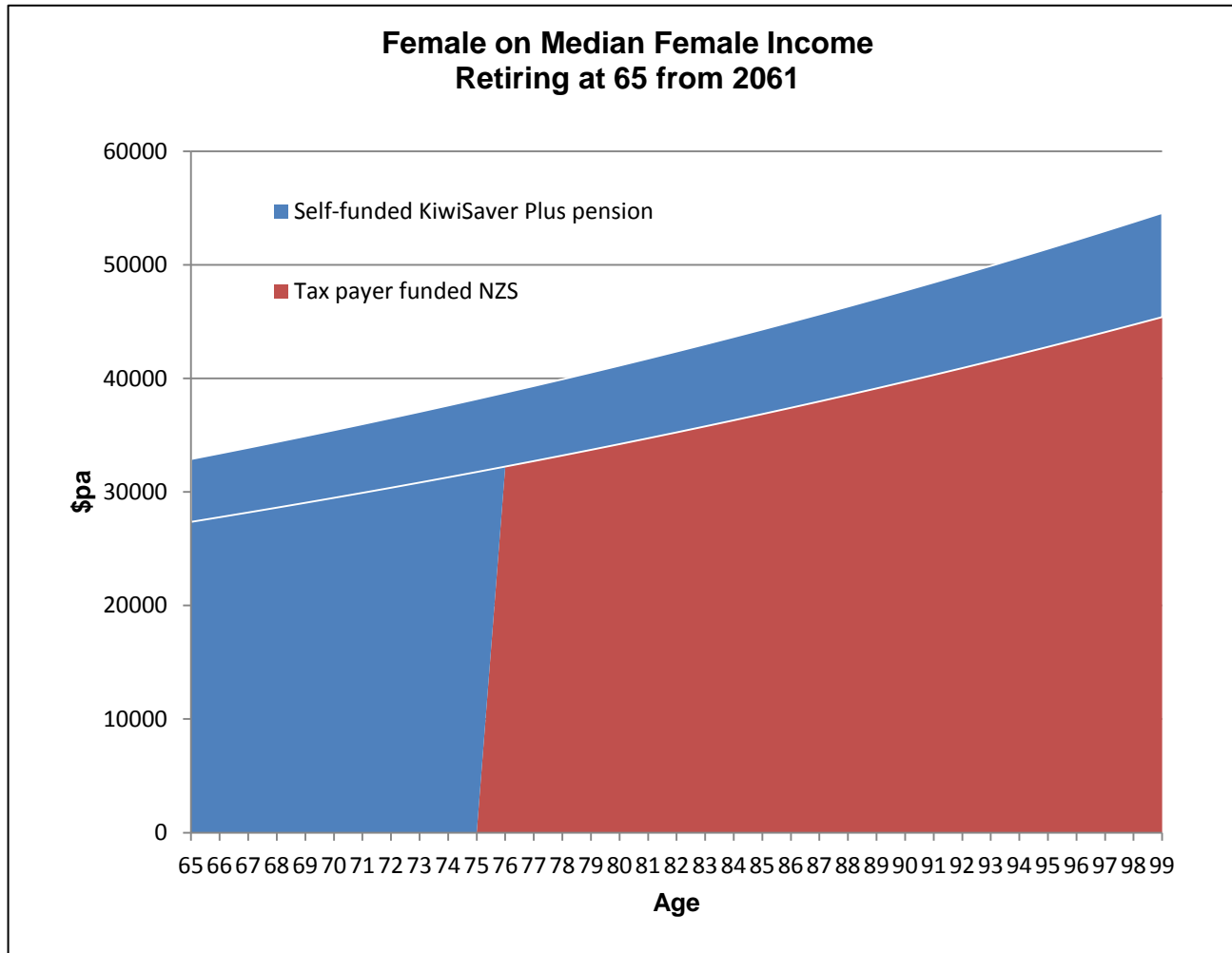
- **Currently there is insufficient demand but that will change with time.**
- **There is an unwillingness to carry the inflation, investment, interest rate and longevity risk for what is likely to be a very long period. Evergreen contracts that last 20 to 40 years are extremely rare and usually contain 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.**

- **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 whereas those who have reason to expect a shorter than average retirement will not.**
- **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:

- **All New Zealand 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 New Zealand Superannuation.**
- **The Crown would tender for those fixed term pensions each year for that years 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.**





References

- The Financial Services Council of New Zealand *“Pensions for the Twenty First Century: Retirement Income Security for Younger New Zealanders”* 2012
http://fsc.org.nz/site/fsc/files/reports//FSC_Pensions%20report%20%20FINAL%20Publication%2017%20June%202012%20copy.pdf
- *The Institute of Actuaries of Australia “Australia’s Longevity Tsunami What Should We Do?”* 2012 <http://www.actuaries.asn.au/Library/WhitePapers/2012/AI-WP-Longevity-FINALWEB.pdf>