



**Submission on
Retirement Commissioner's
Review of Retirement Income Policy**

**Submission to the Retirement Commissioner
15 May 2007
by Institute for Financial Advisers**

Privacy

The Institute of Financial Advisers (IFA) does not seek to have any part of our submission withheld for privacy reasons. We are happy to have our submission available on the Retirement Commission and other websites.

Continued participation

The Institute is keen to support our submission by participating in any further discussion forums.

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The Professional Body for Needs-Based Financial Advisers

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1. The Institute

The Institute of Financial Advisers (IFA) is the professional body for some 1,450 members, representing needs-based financial advisers in New Zealand. All members are individual members, not corporate members.

Our members provide advice to their clients in the areas of insurance, investments, financial planning, work-based savings and insurance, retirement planning, estate planning and financial services generally. Their professional practices reflect the broad spectrum of New Zealand businesses – they operate as local SME's, are part of large regional or national dealer groups, are associated with strong financial organisations, services companies in banking, funds management, or insurance, work in employee benefits organisations, or sometimes practice as lawyers, accountants and other professional advisers.

The Institute reinforces compliance with a code of ethics and practice standards, runs Dispute Resolution and Disciplinary Committees that are independently chaired, offers education pathways that can lead to tertiary qualifications and the attainment of internationally recognised adviser marks, maintains and ensures compliance with a continuing professional development programme, and provides networking, education, development, and business practice forums at a national and regional level for members. It represents its members with government, government agencies, and other stakeholders.

2. Introduction to the submission

IFA is a professional association and does not have access to significant resources or extensive research facilities. What we can bring to a review such as this is the combined experience of our professional members who work on a daily basis with the “serious savers” and people who are seeking to protect themselves and their families from financial risk and to manage their affairs so they can enjoy life and retirement.

The last review of Retirement Income Policy provided many sound recommendations and it and the associated research papers have provided a very useful background for this review. In broad terms it stated that policy change needed to concentrate on middle NZ, as those in high socioeconomic status were self supporting in retirement and those at the lower spectrum were virtually entirely reliant upon the state for retirement income and risk management through the welfare state.

NZ Superannuation is an essential element of retirement income policy, especially as it underpins retirement income for a substantial portion of the population, including those who seek to save to supplement state-provided benefits. It is important that the NZ Superannuation safety net remains in place and is not subject to uncertainty caused by potential changes in Government through General Elections. Certainty is needed for self-help retirement savers.

It might be thought that IFA members worked largely with those who were financially self sufficient. The reality is that this is a small group in NZ and IFA members provide advice largely to middle NZ. The customer base is mostly 35 plus, with the younger sector being savers and risk managers while older age groups are more concerned with retirement investment income.

The 2003 review included issues around work-based savings, removing tax distortions and disparities, the need for a self-regulatory regime for financial advisers, and the need for education and information. Since then there have been changes affecting each of these areas and this submission will provide a view on the likely impact of the major changes, as viewed by advisers.

3. Work-based savings

3.1 Impact of KiwiSaver

The pending introduction of KiwiSaver is undoubtedly a significant event. However, it needs to be acknowledged that it is likely to take a very long period (decades?) before KiwiSaver will have a significant impact on retirement savings, especially if there is savings substitution such as a shift from mortgage repayment into superannuation.

Increased work-based savings may have the benefit of increasing peoples awareness of the need for increased overall financial planning. However, we have concerns that employers can recommend providers without receiving expert advice. This concern is exacerbated by the requirement that default provider funds for KiwiSaver undertake a low risk approach to investment (presumably to reduce the risk of investment losses) that may in the long run reduce investment returns and hinder uptake.

In addition to superannuation, families need adequate provision for risk through having adequate insurance cover. We envisage potential for work-based group insurance schemes as a cost effective addition to superannuation. If this were to occur, then it would help overcome the underinsurance of working aged families covering life, trauma, income replacement and health insurance. However, this would require the active co-operation of employers supported by financial advisers. In addition, there needs to be product development work by insurers to make such products attractive. Product development means more than good pricing and will need to include enhanced ease of assessment, understandability and conditions for the full range of relevant products covering life, disability, trauma, and health, preferably integrated.

3.2 Financial Literacy for Employees

Until work-based superannuation accounts accumulate significant balances, individual employees are unlikely to be prepared to pay even modest sums for the financial advice they need to make wise investment and risk decisions. Anecdotal evidence from Australia is that it was only once the average superannuation account balance had built up, that employees are taking active interest in receiving financial advice on investment of their superannuation. Reportedly, this become a common morning tea discussion topic, which seems to be a practical test of awareness.

We suggest that provision of adequate financial advice will initially only occur if it is led by government agencies such as the Retirement Commissioner but as a joint venture with others. Consideration should be given to changing the title of the Retirement Commissioner to something like the Office for Financial Literacy, which would match the breadth of their current work supported by their excellent sorted web site.

Relevant other groups include financial services product companies, employers and their associations, unions (who reportedly played a major role in Australia when their compulsory superannuation scheme commenced), employee associations, adviser associations such as IFA, and groups such as iwi and other ethnic groups (e.g. Ngai Tahu supports financial literacy for its members). Incidentally, IFA has raising the financial literacy of the NZ public as one of its goals.

Initially, this literacy training will need to be subsidised (by employers or government) or sponsored by product providers.

3.3 Need for equity in work-based savings schemes

Another change since the 2003 report has been that there have been new public sector work-based superannuation schemes. We note that some of these with employer subsidies (e.g. teachers) have been restricted to members of unions. We regard this as inherently unfair and detrimental to overall retirement income policy.

Finally, we would be concerned if KiwiSaver received special treatments, such as tax advantages, that were not available to everyone. It is important that existing disciplined savers should not be disadvantaged as active savers relative to Kiwi Saver.

4. Taxation of savings, investment and insurance products

The 2003 report identified distortions and disparities in taxation of savings, investment and insurance products. Again, there have been significant changes in legislation, some of which has yet to take effect, as well as ongoing reviews, but in IFA's view there remain some areas of distortion.

4.1 Annuities

There was an excellent research paper on this topic in 2003. Little has changed since then. While the taxation of life insurance products is being reviewed by IRD, their study specifically excludes annuities, perhaps considering this "too hard".

IFA considers that annuities remain non-viable in NZ and not favoured by many people for several reasons.

- They are tax-disadvantaged as that they are taxed at a 33% rate while those drawing the annuity will typically have a tax rate of 21%.
- In the past some companies providing annuities went into liquidation, meaning that annuitants lost their income.
- Past practices for income testing for social welfare benefits were perceived as unfair in relation to annuities, since they are partly a return of capital rather than "income". While the surcharge on NZ Superannuation was withdrawn around a decade ago, people remain wary of potential future policy changes and an annuity contract is inflexible once entered into.
- While pricing of annuities is based upon life expectancy, where an annuitant dies early, the family may feel unfairly treated unless the product provides for a lump sum payment for early death.

With the introduction of KiwiSaver combined with longer life expectancy, there will in future be more people with lump sums at age 65. Having viable annuities would provide people with the ability to reduce the risk that they will outlive their retirement savings since some of the risk would be absorbed by pooling through the insurer. A viable annuity market requires changes to tax laws, good product design (e.g. to avoid the impact of early death), perceived stability in government policy relating to income tested benefits/rest home subsidies and may also need greater availability of long term fixed rate bonds so that insurers can themselves reduce their investment risk.

4.2 Taxation of life insurance

As mentioned, taxation of life insurance is under review. While our members are not expert in taxation of life insurance companies, they are very concerned at any changes in taxation that will affect the cost of insurance. Some points follow, which we have also made in a submission to IRD.

Continued tax at 33%

From the IRD discussion document, we note the intention to continue to tax life insurance products at the 33% tax rate. This means that many consumers who purchased traditional life insurance investment products – such as whole of life and endowment policies – will continue to pay tax at 33% when their marginal tax rate will often be lower. Since many of the consumers holding these investment products will have done so for many years (since there has been a move to use unit trusts once the imputation credit regime removed double taxation) a high proportion will now be retired and have lower marginal tax rates. In our view this is unfair.

Assumption relating to overhead costs

The draft proposals by IRD would lead to changes in the assumption relating to the proportion of insurance premiums relating to overhead costs and that this will substantially increase the amount of tax payable by life companies. The figure of \$100 million pa has been mentioned.

While we do not have the basis to judge whether this is correct, our members are alarmed at the potential impact this would have on premiums, especially for term insurance cover. There is general agreement amongst advisers and insurers that the level of life insurance cover held by NZ families is lower than desirable in terms of provision of protection of families from early death of a parent. Any increase in premiums would be undesirable from a social perspective.

The need for equity between life company products and Portfolio Investment Entities

A basic principle of good tax policy is equity between taxpayers in similar situations. We note that IRD policy proposals seek to treat unit-linked insurance products in a manner similar to PIEs. We support this aim as otherwise consumers who hold these products may pay more tax than those who have invested through other structures.

4.3 Taxation of international shares

The introduction of the Portfolio Investment Entity (PIE) tax regime will reduce some aspects of disparity in the tax system, but new distortions have been created for international shares. This distortion will be a disincentive for sensible investment diversification as it will encourage savers to over-weight investment in NZ and (some Australian shares) relative to broad investment in all international shares.

While supporting the changes to managed fund tax on capital gains of NZ and (some) Australian shares under the PIE regime, the so called Fair Dividend Rate (FDR) regime introduces new distortions.

The taxation of individuals directly holding international shares is lower than when they are part of a managed investment fund. Basically, managed funds holding international shares will pay tax on 5% of the value of investments (irrespective of whether they make a gain or a loss during the tax year) while individuals pay lower tax if their international shares fall in value or have modest growth. Reports of modelling by a stockbroker suggested that for individuals the FDR over a 20 year period would average out at tax on 3.5% of value versus 5% for a managed fund.

Since individuals rarely have sufficient funds to create a widely diversified portfolio of directly held international shares, this will encourage a higher risk profile by encouraging direct investment rather than the advantages of a diversified managed fund. This is the same as the old distortion encouraging direct investment in all shares but now relates to international shares.

5. Home Equity Release Products

At the time of the 2003 review, home equity release products were just beginning to come into the market. Since around 80% of household assets are in residential real estate, being able to convert some of this into cash or retirement income is likely to become important. Home equity release products have potential to enable retired people to “eat their house”, though are more likely to be used for funding home maintenance, medical treatment or other major expenditure.

A recent study¹ reported that 4,500 loans totalling \$227 million book value existed in December 2006. The industry association, SHERPA predicted the loans would total \$500 million by the end of 2007. Putting this in perspective, the average loan was under \$50,000 and the average age of the borrower 73. Younger borrowers (those in their 60s) had much smaller amounts outstanding. Virtually all borrowing was lump sum rather than an annuity and virtually all loans had floating interest rates.

The overall housing stock in December 2006 was estimated to be \$558 billion.² A rough estimate of the value of houses owned by those 65 plus is \$130 billion.³ So, the amount borrowed under Home Equity Release products is currently modest relative to the value of housing ownership by retired people. This also means that there is considerable potential for this to become a significant source of retirement income.

However, IFA considers that NZ Superannuation should remain the major source of retirement income for most people and the development of home equity release products should not be seen by government as a substitute for NZ superannuation. In particular, it would be unfair to treat sums drawn from home equity release products as income for social welfare benefit testing or rest home care subsidies since the amount borrowed is capital not income. We regard the availability of home equity release as a useful product that would normally be used as a last resort, rather than as the prime source of cash for retirement spending.

We consider there are a number of policy issues to make home equity release a viable and fair source of retirement income.

If reverse annuity products (i.e. an annual annuity rather than a lump sum) are to be viable, there may need to be changes to tax (similar to annuities) so the tax rate is the marginal tax rate for retired people, probably 19.5% or 21% rather than the current 33%.

To be fair to the borrower, home equity products need reasonable terms. These need to include protecting the long-lived, by allowing them to retain occupancy, and limiting the loan maximum to the value of the house. There is also a need for “balance” in the rules imposed by lenders, e.g. limiting the costs imposed on the borrower for frequent valuations and maintenance. Maintenance provisions could perhaps mirror the fair wear and tear rules recommended in the guidelines for Retirement Villages.

It is also important that people entering into home equity release contracts are fully aware of the financial consequences and have access to independent, informed, financial advice. The impact of compound interest on the loan balance relative to realistic projections of the value of the house, needs to be modelled so that the impact is made clear.

IFA made a submission to the Office for Senior Citizens review and more detailed comments are available in that document.

¹ Trowbridge Deloitte NZ

² Spicers Household Savings Indicators, March Quarter 2007

³ Using census data on the proportion of home ownership for this group and Spicer’s data on current values.

6. Health costs, rest home care and insurance

The 2003 report highlighted concerns about the rising cost of health and availability for retired people, especially some disadvantaged groups such as Maori. While acknowledging that this is a worldwide problem, health insurance could potentially play a role in risk spreading for retired people, provided the insurance policies were suitable in design for older age groups. While health insurance may be unsuitable for catastrophic illnesses, they may cover the most common procedures likely to have an impact on quality of life – cataracts, joint replacement, angiotherapy.

Catastrophic health issues are able to be covered to a limited extent by modern trauma insurance policies. However, for these to be viable for older age groups, people need to take out policies at younger ages so that the insurer is able to build up funds to cover claims.

The same applies to insurance policies for rest home care, which have been developed in markets such as the US. These are also cost-effective only if started at younger ages.

From a policy perspective, government needs to consider whether it wishes to encourage private provision for health and rest home care, or whether it considers the taxpayer should fund the bulk of the costs, as it does at present.

There may be the possibility of some form of government supported, pooled long term insurance option to partially privatise rest home care and funding for health. The key would be product design as well as the ability to form a large enough pool to spread the risks, for the funding to begin early enough for the power of compound income accumulation to build up funds and for features such as level premiums (rather than premiums that rise with age⁴).

For all these products, the issues raised under taxation of life insurance at the 33% rate while the insured have a lower marginal tax rate is a significant factor in cost.

7. Trusted advisers

The 2003 report makes the point about there needing to be “trusted advisers”. We agree that having access to trusted financial advisers is very important.

Since the report, the Ministry for Economic Development has conducted a major review, issued discussion documents and is about to announce the details of a co-regulatory regime requiring all financial advisers to be members of a professional body. IFA supports this move.

IFA receives few complaints about its members, but has an independently chaired committee and discipline processes to handle these. At present we receive complaints about advisers who are not members, but are unable to take action. Also, if IFA were to eject a member for discipline reasons, they can continue to act as an adviser. The new requirements would be able to prevent this happening.

An essential element in having consumers able to use good advice is the need for increased education in financial literacy so there is awareness amongst consumers of the need for advice. Well informed consumers are a prerequisite for acceptance and implementation of financial planning for retirement and risk management for family protection.

⁴ Health insurance premiums currently seem to be set based upon short time periods (a year).

8. Conclusion

With an ageing population New Zealand needs sound retirement policies. IFA members deal with those who choose to help themselves and their families prepare for retirement. We believe that retirement policies need to support a combination of government and privately funded provision. Our comments in this submission have been directed towards enhancing private provision through self help. Many New Zealanders are prepared to help themselves, but need good advice from trusted financial advisers and the removal of barriers to saving and risk management, such as the ongoing distortions in the tax system, especially of insurance.