pensioncommentary

An article from the Retirement Policy and Research Centre

Divestment and Decumulation – Planning for Post-Retirement

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Are catalysts required?

Not all agree, but my beginning premise is that we have a serious hole in our otherwise very good retirement income policies. We lack a simple secure income insurance for middle income New Zealanders over and above the base annuity NZ Super. The problem is that under defined Contribution (DC) schemes like KiwiSaver, costly risks of ageing, especially outliving one's savings, are shifted onto the individual. This worrying neglect is happening in the context of rapid ageing. We are already in the 8th year of the 20 year baby-boom retirement. Once the tsunami starts turning 85 from 2030 we will see the true folly of today's inaction.

Older people are living longer on average but the real problem is the size of the tail of those who live longer, sometimes much longer, than the average and who need extensive and expensive long term care. As well, rapidly increasing numbers of those over 65 are suffering dementia. Many may be exposed to being exploited financially if they have only a 'Do it Yourself' (DiY) decumulation plan.

In the international pensions world, The New Zealand experience clearly shows that with no state action whatever, the annuities market just disappears. It is not an easy problem to remedy and as Ralph Stewart's experience with the NZ Income Guarantee has shown it is a costly and time consuming path for individual private providers to develop profitable products. I do not see any consistent, stable outcome that is capable of providing cover for most middle income people without a substantial state involvement.

Seeing a serious market failure in the voluntary annuities space most pension experts and economists would argue for state intervention. State provision of longevity bonds to allow providers to take on the risk of increasing longevity, and long-dated indexed government bonds to protect against inflation are the stock in trade recommendations for correcting market failure. Typically too, the discussion stops at this point. I think the New Zealand experience shows that the state needs to grasp a much bigger vision for there to be meaningful annuity options. I want to suggest that the state can act as a catalyst in three important ways:

1. First, the state must provide more resourcing to retirement policy development with much more attention to overseas experience. How much do we know about the benefits people have from the certainty annuities provide? The annuitant population is fast diminishing in New Zealand and time is running out to explore this. Anecdotally, access to an inflation-linked pension enhances the retirement experience for those fortunate to still have one and is very good for their families too.

   And debate must be more inclusive. We rely on poor surveys and one-sided opinions too much. My own view is that the voices of women are sidelined. For many women managing money after retirement, often when they are on their own is daunting. Knowing how much they can spend each year and not run out of money is critical. New Zealand is unusual in taking a very a hands off approach to decumulation. It is also unusual in its seeming acceptance of a DiY or rule of thumb approach. Another gap in the debate is the financing of long-term care. Annuities can play a very significant part in paying for long-term care: many other countries are more aware of the looming costs of long-term care than is New Zealand.

2. Second, we need to recognise that the bias towards using property as a retirement asset requires radical reform. Under current tax rules property wins every time- returns are hedged against inflation and the asset generally grows in real terms. But there are so many downsides to middle income people using this vehicle as a defacto annuity, especially as they age and the management of rentals becomes problematic. For society it is really undesirable as well. We don't need to remind ourselves of what is happening to home ownership and affordability of housing because of investor demand. The catalyst is to remove this advantage with wide housing tax reform. I favour the suggestions of the McLeod Review in 2001 to tax total equity over a base amount held in housing.

3. Third, the state could grasp the huge opportunity is has to build on the success of KiwiSaver and the KiwiSaver provider infrastructure. What is needed is limited-value generic annuity product with generic branding, with oversight by FMA, and default provisions. We could call such a product Kiwi something, eg KiwiSpend and in time it could be an accepted part of the retirement incomes mix. Using the opt out experience of KiwiSaver, members could be defaulted into an annuity option with an opt-out provision for a limited time.

   KiwiSpend could have the following characteristics: The same annuity for the same lump-sum for men and women (Gender neutrality), low cost administration, and protection from inflation. The annuity could be linked to average wages/ investment returns and have an add-on insurance for long-term care. For example, retirees with modest KiwiSaver accumulations and other capital on retirement would have the option to purchase annuity of $10,000-20,000 pa with a provision for augmentation once the need for long-term care established.

   Currently middle income people who need care have to run down their assets to very low levels before they qualify for a state subsidy. Care costs alone are currently around $50,000 with the need for another $5-20,000 for additional costs such specialists appointments, hearing and dental care. Only a small amount of this cost is met from a person's New Zealand Superannuation. A top-up annuity with a long-term care rider would spread the risk more fairly away from families who see the parental assets rapidly eroded away, to the older population more broadly.

   KiwiSaver providers would have a role with the possible use of the NZ Superannuation Fund to underpin the longevity and investment risk. The state would also have opportunity to make the purchase of such annuities attractive. In contrast to tax incentives for accumulation common in most OECD countries, subsidies for decumulation for a limited annuity can be well-designed with clear social benefits in sight. The costs of subsidies would be limited by a cap on the size of annuity that could be bought.

To conclude: nothing will happen until the social and personal value of annuities to middle income people is more widely appreciated. There is much work to do.

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