

INVESTMENT SAVINGS & INSURANCE ASSOCIATION  
OF NZ INC

SUBMISSION

ON

THE  
RETIREMENT COMMISSIONER'S

2010  
RETIREMENT INCOME POLICY REVIEW

30 April 2010



**I·S·I**

# ISI Submission to Retirement Income Policy Review

## 1. Introduction

- 1.1 The Investment Savings and Insurance Association (“ISI”) welcomes the opportunity to submit comments to the Retirement Commissioner’s 2010 Retirement Income Policy Review.
- 1.2 ISI members are the issuers and managers of life insurance, superannuation and managed funds in New Zealand and hence have a keen interest in the development and success of policies to encourage saving for retirement. All six of the default KiwiSaver providers are ISI members.

A list of ISI members is attached.

- 1.3 We note that the terms of reference for the review request analysis of the impact and relevance of policy settings that impact on retirement income specifically in relation to 3 key issues. While we make general comments on all 3 issues, it is the second that is of particular relevance to the financial services industry and that is the focus of this submission.

## 2.0 Summary of Recommendations

We recommend:

- Recognition that people generally have insufficient information/awareness to make rational long-term decisions on provision for retirement income and would benefit from Government intervention
- Higher priority and profile for retirement issues within Government with a Minister having explicit responsibility for co-ordination of and consultation on issues to do with ageing and retirement income
- Amendments to KiwiSaver to re-focus it on saving for retirement income through the workplace
- Consideration of options for limiting the future cost of NZ Superannuation
- Further work on options for income stream products.

## 3.0. Supporting Reports

- 3.1 In November 2009 the ISI Board commissioned a paper from consultancy MartinJenkins on key issues in retirement income and saving policy:
- Demographic projections
  - Household savings and wealth
  - Policy changes to improve sustainability.

We consider the report to be very useful and have attached a copy as Appendix 1.

- 3.2 ISI also endorses the work done by Mercer NZ in its 2009 report *Securing Retirement Incomes: Time to Act*<sup>1</sup>.

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<sup>1</sup> *Securing Retirement Incomes: Time to Act*, Mercer New Zealand, July 2009, <http://www.mercer.co.nz/secureretirement>

- Structural changes needed to manage increased costs of ageing population
- Options to improve NZ Super
- Options to improve KiwiSaver
- Options for development of decumulation products

We have drawn on this report in our policy development and strongly recommend it to the Retirement Commission.

#### 4.0 Demographic Issues

The impact of demographic projections on retirement income policy is well-understood.

*New Zealand's Long-term Fiscal Statement: Challenges and Choices* released by the Secretary to the Treasury in October 2009<sup>2</sup> indicated the likely impact of demographic changes on New Zealand's long-term fiscal outlook:

- Population ageing is important fiscally as 25% of government spending is currently on the 12% of the population aged over 65 and this will grow
- At the same time, the smaller proportion of the population in the workforce is likely to reduce economic growth
- Government debt projections will require spending less, taxing more or borrowing
- Policy changes should be made early and incrementally to give people time to adjust.

New Zealand's population is ageing. From the late 2020s over 20% of the population will be aged over 65, compared with 13% in 2009. Between 2011 and 2037 baby boomers will enter this age group and by the late 2050s the over 65s will constitute 25% of the population.<sup>3</sup>

The key impact of these projections is that, without a significant number of the over 65s remaining in the workforce, there will be an increase in the proportion of the population dependent upon the production of a smaller work force. That is not to say that the retired population will not be contributing through tax payments, but in most cases they will be net consumers rather than net contributors to the economy.

Statistics NZ is projecting an increase in the labour force participation of over 65s. However, the increase from 12% in 2006 to 20% in 2016<sup>4</sup>, will still represent a very small proportion of the labour force.

While it must be recognised that the physical demands of some occupations make it difficult for people to continue in them past the age of 65, and not all will be able to retrain for a less demanding role, the vast majority of people reach the age of 65 well able to continue in their usual employment.

<sup>2</sup> <http://www.treasury.govt.nz/government/longterm/fiscalposition/2009/lfs-09.pdf>

<sup>3</sup> <http://www.stats.govt.nz/Publications/PopulationStatistics/demographic-trends-2009/chapter8.aspx>

<sup>4</sup> [http://www.stats.govt.nz/browse\\_for\\_stats/work\\_income\\_and\\_spending/Employment/NationalLabourForceProjections\\_HOTPO6-61.aspx](http://www.stats.govt.nz/browse_for_stats/work_income_and_spending/Employment/NationalLabourForceProjections_HOTPO6-61.aspx)

Accordingly, any review of retirement policies must consider options for delaying the age of eligibility for NZ Superannuation in order to encourage more workers to continue in their productive roles.

Alternatives are proposed later in this submission.

## 5.0 **The Role of Government**

### *Long-term Policy Framework*

ISI supports the 3 pillar framework represented by the combination of NZS, KiwiSaver/workplace superannuation and additional personal savings by those who are able.

ISI considers there is a need for the provision of and eligibility for NZS to be reviewed in order to ensure that the scheme is affordable as the population ages. As an alternative to lifting the age of eligibility for NZS, the generally increased longevity after age 65 could be recognised by allowing receipt of NZS to be deferred for a number of years and then received at an actuarially determined higher rate to compensate for the deferral.

However, any changes to NZS need to be considered early in order to allow adequate time for people currently in the work force to plan for their desired level of income in retirement.

The savings environment has changed dramatically in NZ since 2007 with the introduction of KiwiSaver and Portfolio Investment Entities (“PIEs”). Both of these initiatives were welcomed by ISI and our members committed a great deal of resource to the development and implementation of the new regimes.

The National Government elected in 2008 made an immediate change to KiwiSaver in the 2009 Budget by lowering the minimum contribution rate to 2%, removing the employer contribution subsidy and member fee subsidy and capping the compulsory employer contribution at 2%. With regard to the impact of these changes, we support the comments in the 2009 Mercer report<sup>5</sup>:

- The removal of the employer tax credit may result in lower employer commitment and contribution to KiwiSaver
- Employers are likely to cap contributions at the compulsory minimum of 2%
- The removal of the administration fee subsidy will have a disproportionate effect on members with small balances.

We comment below specifically on possible improvements to KiwiSaver but our general recommendation is that a high priority should be given to ensuring there is a recognised and well-understood long-term policy framework for the provision of retirement income in New Zealand. We recognise that future governments cannot be bound by decisions made today. However, it is essential that someone entering the paid workforce today can plan with some confidence based on a public commitment to:

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<sup>5</sup> Mercer 2009, page 14

- A basic level of NZ Superannuation
- The age of eligibility for NZS
- The rate and indexation of NZS
- The tax treatment of KiwiSaver

The cessation of contributions to the NZ Superannuation Fund from 2009 is expected to delay the date at which the draw-downs from the Fund will be able to offset the cost of NZS. This adds another element of doubt in the public confidence about NZS.

While we acknowledge the considerable contribution made by the Retirement Commissioner, ISI would support Government demonstrating commitment to long-term planning, by giving a specific Minister explicit responsibility for assigning higher priority to ageing and retirement issues and coordination of the various aspects of ageing that are currently handled by different Government departments or crown related entities. This would also assist with consultation with consumer groups, industry representatives and sector specialists.

#### ***Impact of Savings on the Economy***

The Government also needs to take into account the current impact on the economy of the level of household, business and national savings. A report by Treasury in May 2007<sup>6</sup> included in its conclusions (page 32):

*An intervention that substantially lifts national saving would help over time to lower the structural CAD and equilibrium real exchange rate. We would also expect the large increase in household holdings of financial assets to help develop financial markets which in turn could be positive for firm productivity and growth.*

Another Treasury paper released in October 2007<sup>7</sup> concluded that New Zealand's low national savings rate (and emphasis on investment in residential housing) was one of the contributing factors towards the under-development of the financial system in New Zealand.

The paper noted that the regulatory and tax structures are likely to have influenced the development of household portfolios that are unbalanced in terms of financial investments. While the introduction of KiwiSaver and the PIE regime has removed from the tax regime some of the disincentives weighing against investment in financial assets, the impact of the global financial crisis has highlighted the need for further work on the regulatory structures.

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<sup>6</sup> *A Synopsis of Theory, Evidence and Recent Treasury Analysis on Saving* <http://www.treasury.govt.nz/publications/informationreleases/saving/synopsis/t2007-654v2.pdf>

<sup>7</sup> *NZ Financial Markets, Saving and Investment*, NZ Treasury <http://www.treasury.govt.nz/publications/research-policy/ppp/2007/07-01/tpp07-01.pdf>

### ***Financial Sector Regulation***

ISI welcomed the Review of Financial Products and Providers in 2006 and made submissions on all of the discussion papers. While there has been progress in some aspects of regulation, ISI has moved ahead with the development of industry standards in other areas where the lack of regulation may have contributed to lack of consumer confidence in the financial services market.

This is a key area of interest for the financial services sector and in paragraph 8.2 below we provide an overview of work ISI currently has underway.

We note the announcement by the Minister of Commerce on 28 April of the Government's intention to establish a new securities market regulator (the Financial Markets Authority) and we look forward to the improvement in financial sector regulation that this will potentially achieve.

## **6.0 The Future Well-being of New Zealanders**

ISI endorses the findings of the May 2007 Treasury report<sup>8</sup> which concluded that the general population may not necessarily have sufficient knowledge, information or awareness to make appropriate decisions in respect of saving for retirement.

The report suggests that Government should take into account the literature available in the area of behavioural economics and consider a reform package to supplement KiwiSaver with support and encouragement for private saving:

- Targeted at middle and low income earners
- Designed to reduce the reliance on investment in residential property
- Focussed on long-term locked-in savings schemes
- Accompanied by improved fund regulation and financial education for savers.

ISI endorses all of these features as likely to contribute to the future well-being of New Zealanders.

The Treasury report concluded (at page 33) that there was justification for providing further incentives for investing in financial assets.

*This judgment for further pro-saving action rests on a least-regrets approach in the light of data uncertainties, the economy's tendency to macroeconomic imbalances and the possibility that individuals are basing saving decisions on long-run expectations that could be mistaken... Higher private saving would be a way to mitigate these outcomes should they come to pass, whereas waiting until they become more certain could be leaving it too late.*

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<sup>8</sup>, <http://www.treasury.govt.nz/publications/informationreleases/saving/synopsis/t2007-654v2.pdf>

## 7.0 Impact of Taxation on Saving Choices

Tax policy in New Zealand since the mid-1980s has aimed for a broad-base, low-rate regime with minimal exemptions. The January 2010 report of the Tax Working Group<sup>9</sup> noted, however, that a number of policy changes have resulted in a base that is not as broad as it was. In addition, the tax treatment of capital gains on property continues to provide an incentive to invest in residential property rather than financial assets.

The boom in residential housing prices has been affected by the recent financial crisis and the expectation that the May 2010 Budget will include moves to reduce the tax-favoured status of investment in real property.

Treasury has released a number of reports covering the impact of the boom and the Tax Working Group Report also made reference to it. We do not propose to reproduce those findings here, but merely to note:

- The current tax treatment of investment in residential property results in a substantial fiscal cost
- The ‘wealth effect’ of increasing housing prices has contributed to higher levels of household indebtedness as home-owners effectively ‘eat the house’
- Higher prices for housing make it more difficult for new entrants to break into the housing market
- The increased likelihood that some will never be able to become homeowners has social implications for the future
- Investment in financial assets rather than real property is likely to have a more beneficial impact on the development of the NZ financial system.

The PIE regime has introduced an element of tax incentive for investment in collective investment vehicles, including KiwiSaver. Under the current TTE regime savers are taxed on contributions and investment earnings at their marginal tax rate, although there is a cap of 30% for taxation of investment income in PIEs. Those savers then receive a lump sum which they need to invest to generate income which they are then taxed on.

The KiwiSaver annual tax credit can be regarded as reducing the middle T to give a TtE regime but savers in KiwiSaver schemes will still be left with a lump sum which they must invest and pay more tax on in order to fund their retirement.

While the NZ Superannuation Fund provides an element of pre-funding for NZS, there would be a benefit to the Government in having the tax system structured to produce additional revenues at the time the ageing population will be putting increased demands on the State finances. That could be achieved by a deferred tax regime for long-term locked-in savings.

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<sup>9</sup> *A Tax System for New Zealand's Future*, Report of the VUW Tax Working Group, January 2010

A preferable regime would be for contributing members of KiwiSaver schemes to receive a lump sum rebate to offset the tax paid on their contributions and investment earnings (at a flat rate in order not to provide an extra benefit to high income earners) and for the KiwiSaver benefit to be taken as a taxable income rather than a tax paid lump sum.

## **8.0 Role of the Financial Services Sector**

The key roles of the financial services sector are as product providers and self-regulators of industry practices. The rapid growth of KiwiSaver since its introduction in 2007 has had a major impact on the market and on the demand for improvements in product disclosure and regulation.

As the industry association, ISI has been heavily involved in consultation on government regulation and the development of industry self-regulation.

### **8.1 KiwiSaver**

The process for delivery of KiwiSaver with IRD acting as the central administration hub has been very successful. It obviously fulfils a need for access to a savings product through a simple process linked to the workplace.

Mercer NZ has recently released the results of a survey of KiwiSaver sentiment<sup>10</sup>. The report indicates much more public education about KiwiSaver is needed – particularly around the security of savings. It also shows the impact of policy changes on the level of knowledge about KiwiSaver.

Increasing public education about KiwiSaver might be expected to reduce the number of members in default funds. The Government Actuary's Report for the year ending 30 June 2009<sup>11</sup> shows that 309,718 (32% of all members) were in default schemes and the default investment fund option. Of those default members, 128,958 (42%) of them were aged under 30. Given their investment timeframe, a more growth-oriented investment option would be expected for that age group.

ISI members don't want any dramatic policy changes to KiwiSaver but believe it should be focused on employees saving for retirement.

We would like to see a facility in the legislation to allow for different default investment options for different age groups including "life-stage" investment where KiwiSaver members would be transferred to different investment options as they move closer to the age of eligibility for receiving NZ Superannuation. However, one of the difficulties associated with this facility is the first home withdrawal provision within KiwiSaver which potentially shortens the investment horizon of new entrants to the scheme to 3 years.

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<sup>10</sup> *Securing Retirement Incomes: KiwiSaver Sentiment Study*, Mercer New Zealand, March 2010

<sup>11</sup> Report of the Government Actuary (in respect of the KiwiSaver Act 2006) for the year ended 30 June 2009, [http://www.isu.govt.nz/upload/70505/kiwisaver-annual-report\\_2009.pdf](http://www.isu.govt.nz/upload/70505/kiwisaver-annual-report_2009.pdf)

The Government Actuary's Report for the year ending 30 June 2009 indicates:

- As at 31 March 2009 there were 154,782 opt-in members (23% of the total opt-in members) under the age of 18 and 6628 default members (2% of the total default members) under the age of 18
- As at 31 March 2009 158,062 opt-in members (24% of the total opt-in members) were not contributing but not on a section 104 contribution holiday.

This appears to indicate a large number of children being enrolled in order to take advantage of the \$1,000 kick-start with no further contributions being made to their accounts. At the very least this raises questions about the return to the Government from providing this incentive for the under-18 age group.

In our view, incentives could be more effectively targeted by providing a lower tax rate on actual contributions or a 5 yearly rebate as mentioned above.

ISI recommends that the structure of incentives for KiwiSaver should be re-examined and consideration given to options such as:

- removing withdrawal facilities
- limiting the \$1,000 kick start to new entrants 18 years or older
- possible flat-rate bonus addition at 5-yearly intervals if contributions continuing
- Consider making KiwiSaver membership compulsory

We endorse the recommendations to improve KiwiSaver that are set out in chapter 4 of the 2009 Mercer report.

## **8.2 Improving Standards**

As noted above, the Review of Financial Products and Providers ("RFPP") in 2006 was a comprehensive review of the regulation of the financial services industry. While the RFPP identified many areas for reform the actual development of regulation has been relatively slow. Recent regulatory development has focussed on adviser regulation which will come into effect in December 2010. The next step in the long-deferred review of the Securities Act is expected to be the imminent release of a consultation paper, followed by legislation in 2011.

The global financial crisis and the collapse of numerous finance companies in New Zealand have together had a disastrous effect on the savings of many people who are retired or close to retirement. Publicity of these issues has heightened public concern regarding the security of their savings and the quandary about who they can trust.

This has occurred at the same time as increasing numbers of New Zealanders have committed to saving in KiwiSaver schemes, giving them a vested interest in the standard of regulation of the industry.

While ISI does not represent the finance company sector of the market, the public does not always make that distinction and we have an interest in

improving consumer confidence in the general financial services industry. To achieve that ISI has made a commitment to improved industry standards in several areas, as well as contributing to the development of the new regime for the regulation of financial advice which will be effective from December 2010.

The combination of a Financial Markets Authority, whose establishment was also announced this week, and the work outlined below which is already underway within ISI is likely to produce a significant improvement in public confidence in the financial sector in the next few years.

### ***Regulation of Financial Service Providers***

From December 2010 all financial service providers (product providers as well as advisers) will need to be registered. Financial service providers may choose to apply for approval as Qualifying Financial Entities which will enable them to take responsibility for the actions of their employees and any other advisers they nominate.

However, most advisers will also need to be “authorised” which will require achievement of set competence standards and compliance with a code of conduct approved by the Minister.

ISI members support the introduction of professional standards for advisers and they are committing a considerable amount of resource towards ensuring that their employees, and any other advisers involved in the distribution of their products, will be fully compliant with the new regime in December. One ISI member has estimated that it will incur costs of \$2 million to \$3 million this year as a result of regulation changes.

We welcome the announcement by the Minister of Commerce this week that full implementation of the financial advisers regime will be delayed to 30 June 2011 to take account of amendments to the legislation that are still being considered by Parliament.

### ***Calculation and Disclosure of Fees and Expenses***

While the level of fees and expenses for KiwiSaver schemes is scrutinised by the Government Actuary the growth in KiwiSaver membership has raised the level of interest in the fees and expenses associated with all financial services products.

ISI has replaced the previous Standard for Management Expenses Ratios with a new Standard for the Calculation and Disclosure of Fees and Expenses which will be effective from 1 April 2011. The new Standard requires the calculation of a Total Expense Ratio and sets a template for disclosure of fees and expenses in the prospectus as well as an example of the impact of fees and expenses in the investment statement.

The objective is to assist consumers with comparisons between products.

### ***Calculation and Disclosure of Investment Performance***

ISI has also recognised that the growth of KiwiSaver and the facility for members to transfer between schemes has stimulated interest in comparing the performance of different products.

In order to update our current Standard for the Measurement of Investment Performance we have commissioned a global review of best practice in the area of investment performance standards. We expect to have a new standard drafted for consultation before the end of June.

### ***Unit Pricing Standard***

The financial services industry has come in for criticism from some quarters for the use of unit pricing. We do not agree that the use of unit pricing represents any disadvantage to savers. However, we recognise that having a specific standard that product providers must comply with is likely to improve consumer confidence. Accordingly, we have commissioned the drafting of a Standard for Unit Pricing in New Zealand which will be based on the Australian APRA Unit Pricing Guide to Good Practice.

## **8.3 Provision of Income Stream Products**

Under paragraph 7.0 above we noted that savers in KiwiSaver schemes will reach retirement with a lump sum benefit which they will then need to invest in order to generate income to supplement NZS. Currently there are very few products available that will enable those savers to purchase an income stream.

In our submission on the 2007 Retirement Incomes review we noted the work done by Susan St John<sup>12</sup> on the provision of income stream products. We endorse the options identified in the 2009 report by Mercer NZ which included:

- Life annuities
- NZ Super Plus
- Variable annuities/allocated pensions
- Deferred annuities
- Pooled survival payments
- Long term/index linked bonds.

We believe all of these merit further work, including the proposal for ‘NZ Super Plus’ which would effectively be a facility for recipients of a lump sum to use it to increase the amount of NZS they receive.

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<sup>12</sup> *The Policy Implications of Decumulation in Retirement in New Zealand*, Susan St John, University of Auckland, July 2006.

## List of ISI Members

### **ISI MEMBERS**

AIA New Zealand  
AMP Financial Services  
Asteron Life Ltd  
AXA New Zealand  
BNZ Investments and Insurance  
CIGNA Life Insurance NZ Ltd  
Dorchester Life  
Equitable Group  
Fidelity Life Assurance Co Ltd  
Gen Re LifeHealth  
Hannover Life Re of Australasia Ltd  
ING New Zealand Ltd  
Kiwibank Ltd  
Medical Assurance Society NZ Ltd  
Mercer  
Munich Reinsurance Co of Australasia Ltd  
Public Trust  
RGA Reinsurance Co. of Australia Ltd  
Sovereign Ltd  
Southsure Assurance  
Swiss Re Life & Health Australia Ltd  
TOWER Limited  
Westpac/ BT Funds Management Ltd

### **Associate Members**

Bell Gully  
BNP Paribas  
Bravura Solutions  
Burrowes & Co  
Chapman Tripp  
Davies Financial & Actuarial Ltd  
Deloitte  
DLA Phillips Fox  
Ernst & Young  
InvestmentLink (New Zealand) Ltd  
KPMG  
Kensington Swan  
Melville Jessup Weaver  
Minter Ellison Rudd Watts  
Morningstar Research Ltd  
PricewaterhouseCoopers  
Russell McVeagh  
Simpson Grierson



# **Retirement Income and Saving Policy**

November 2009

**Report for the Investment Savings and  
Insurance Association**

MARTIN<sup>I</sup>JENKINS

## Preface

This report has been prepared for the Investment Savings and Insurance Association by Nick Davis from MartinJenkins (Martin, Jenkins & Associates Limited).

MartinJenkins is a New Zealand-based consulting firm providing strategic management support to clients in the public, private and not-for-profit sectors.

Our over-riding goal is to build the effectiveness of the organisations we work with. We do this by providing strategic advice and practical support for implementation in the areas of:

- organisational strategy, design and change
- public policy and issues management
- evaluation and research
- financial and economic analysis
- human resource management.

MartinJenkins was established in 1993, and is privately owned and directed by Doug Martin, Kevin Jenkins, Michael Mills and Nick Davis.

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## Purpose

MartinJenkins was engaged by the Investment Savings and Insurance Association (ISI) to develop a short discussion paper that:

- provides a 'high-level' overview of the key issues in retirement income and saving policy
- makes an initial assessment of the implications of policy settings for the investment, life insurance, superannuation, savings and managed funds industries
- identifies the issues that the Board may wish to take a view on and communicate as part of its stakeholder engagement strategy
- helps the Board to identify areas where it needs to do further work.

## Background

### Demographic context

New Zealand is going through a major long-term demographic shift from a younger to an older population as people live longer and have smaller families. Based on projections, by 2050:

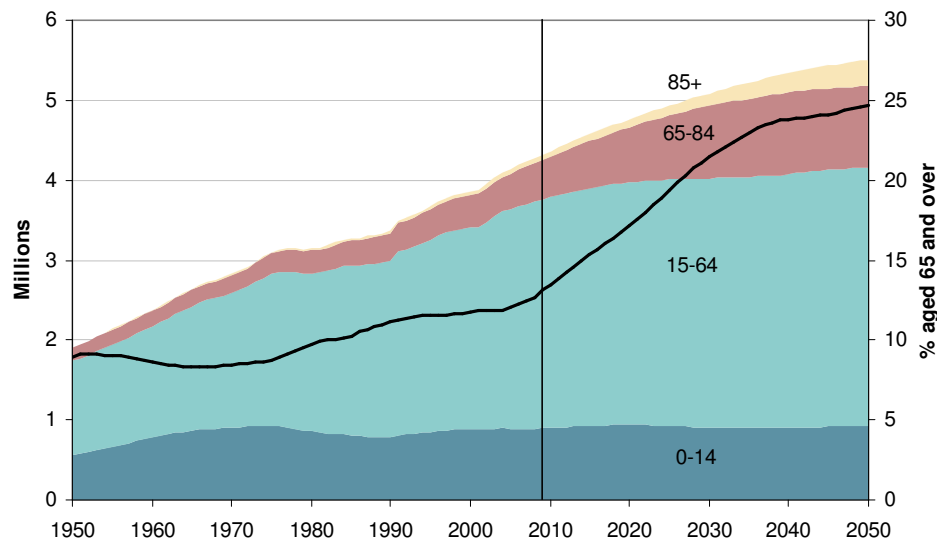
- the total population will have grown by a quarter
- the proportion of people aged 65 years and over will have more than doubled (see figure 1)
- the number of people 85 and older will have grown by four times, from 67,000 to 330,000
- the old-age dependency ratio<sup>1</sup> will increase from 19% today to 42% by 2050.

These changes will accelerate over the next few years.

Population ageing is fiscally significant. Already, 25% of government spending is spent on the 12% of the population aged over 65. The number of people receiving NZS is expected to grow from 522,000 people today to 1.3 million in 2050, causing the cost to rise from 4.3% of GDP in 2009 to 8% in 2050. Much of this shift occurs in the next 20 years.

Ageing also has significant economic implications as the shifting balance between dependents and working-age people is also likely to contribute to a slowdown in economic growth.

**Figure 1: Changes in population structure and ratio of people aged 65 years and over**



Source: Statistics New Zealand, Series 5 projection

<sup>1</sup> The ratio of people aged 65 and older relative to the working age population aged 15 – 64

## International trends

At present, New Zealand has fewer citizens aged over 65 in comparison with other OECD countries and spends a relatively low proportion of GDP on its public pension system.

**Table 1: Key Indicators for New Zealand compared with Australia and all OECD countries**

		New Zealand	Australia	OECD
Average earnings	USD	27,900	41,600	35,800
Public pension spending	% of GDP	4.4	3.5	7.2
Life expectancy	At birth	80.2	81.1	78.9
	At age 65	84.4	84.9	83.4
Population over age 65	% of working age population	20.7	21.5	23.8

Source: OECD (2009). Pensions at a glance 2009. Retirement Income Systems in OECD Countries

Most OECD countries are facing the same demographic challenges associated with an ageing population and shrinking working age population. In coming years, the old-age dependency ratio of New Zealand is predicted to remain lower than many OECD countries but will grow sharply in comparison with Australia. The OECD projects that by 2050, Australia will have an old-age dependency ratio of 39.9%, compared with 46.4% for New Zealand and an average of 47.6% for all OECD countries.

## Fiscal context

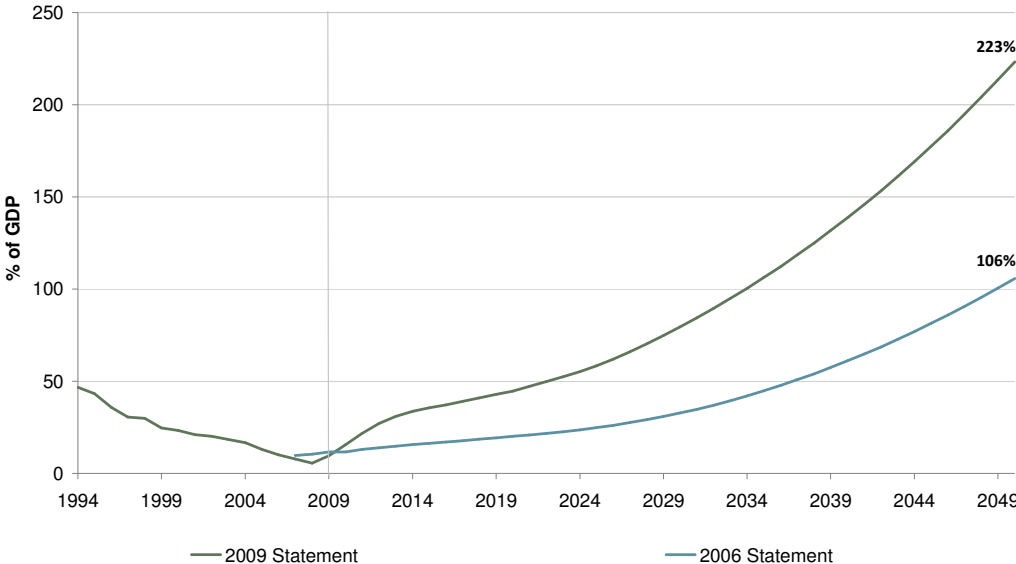
The New Zealand economy has been badly affected by the world financial crisis, which has compounded long-standing macroeconomic imbalances, persistent current account deficits and high net foreign indebtedness.

The world financial crisis combined with five quarters of domestic recession makes the longer-term fiscal task more difficult and more urgent. Fourteen years of continuous surpluses have come to an abrupt end, and deficits are now projected until at least 2014. Just three years ago Treasury projections were for another 25 years of surplus.

The recession has highlighted a structural imbalance between spending and tax. Nowhere is this demonstrated more clearly than in the alarming projections of government net debt recently released by the Treasury (see figure 2).

Addressing budget imbalances means spending less, taxing more or borrowing. Government deficits require borrowing and increased debt to finance them – debt builds debt.

Figure 2: Government net debt



Source: Treasury Long-Term Fiscal Statement, 2009

## Retirement income policy

New Zealand's retirement income policy framework is built around:

- New Zealand Superannuation (NZS)
- New Zealand Superannuation Fund
- KiwiSaver.

### New Zealand Superannuation

NZS is a universal state pension funded out of General Revenue. Key features include:

- Paid to all residents 65 years and over (subject to a relatively short residency test)
- Married couple receives 66% of the national average wage (33% each = NZD \$14,229 each before tax), with variations that depend on a person's circumstances
- Indexed annually
- Taxed along with all other income
- No income or asset tests
- No requirement to retire from paid work
- Unrelated to past earnings history
- Non-contributory.

The scheme is simple and easy to understand and efficient to administer. The flat rate aspect of NZS means that lower-income earners are assured of post-retirement incomes comparable to their pre-retirement earnings. For higher-income earners it provides a baseline from which they can plan further saving. It is a protection against lack of income in the event that someone outlives their saving.

NZS is unique in the OECD, particularly in its universality. Its present structure has focused on preventing poverty in old-age.

The main issue with it is its long-term affordability. Shortly after the public pension system was introduced in 1977 (accompanied by a lowering of the eligibility age from 65 years to 60 years, and a rise in the payment from 65% of the average wage to 80%), the fiscal cost rose to around 8% of GDP. The subsequent lowering of the relativity with wages and raising of the age of eligibility through the 1990s, fewer retirees and a growing economy have brought the ratio of total payments of NZS to GDP closer to 4%. But the accelerating ageing of the population suggests that by mid-century the ratio will return to 8%, or more. Unless there is a policy change or an acceptance that this would mean increasing public debt, funding this would require cutting other expenditure, or lifting tax rates.

Many countries have reacted to the fiscal effect of ageing on public pension systems by making changes to the age of eligibility and indexation rules of their pensions. These changes reflect debt, spending and demographic pressures similar to those faced by New Zealand.

## New Zealand Superannuation Fund

In 2001 the government created the New Zealand Superannuation Fund (NZSF) and until this year had added to it at a rate of around \$2 billion per annum.

The Fund was designed to help smooth the future cost of NZS over time. Essentially, current tax dollars have been placed in the Fund, where they earn investment returns. From 2020, the Fund will be used to help cover the cost of paying NZS.

The NZSF does not solve the fiscal sustainability issues associated with NZS. Rather, it was intended to provide additional fiscal headroom as budget adjustments need to be made over time.

As at 30 September 2009, the total assets of the NZSF stood at \$15.2 billion. These assets are primarily managed by external investment managers. The Fund has earned a rate of return since inception of 5.7% pa against a risk free rate of 6.5% pa.

## KiwiSaver

KiwiSaver came into operation on 1 July 2007 as a voluntary, private contributory scheme with Crown and employer-funded incentives for membership. The scheme has proven very popular, with 1.2 million members as at 30 September 2009, far exceeding official projections for the scheme. Since the scheme began \$4.25 billion in contributions from members, employers and the Crown have been passed to providers for investment.

Key features of KiwiSaver include:

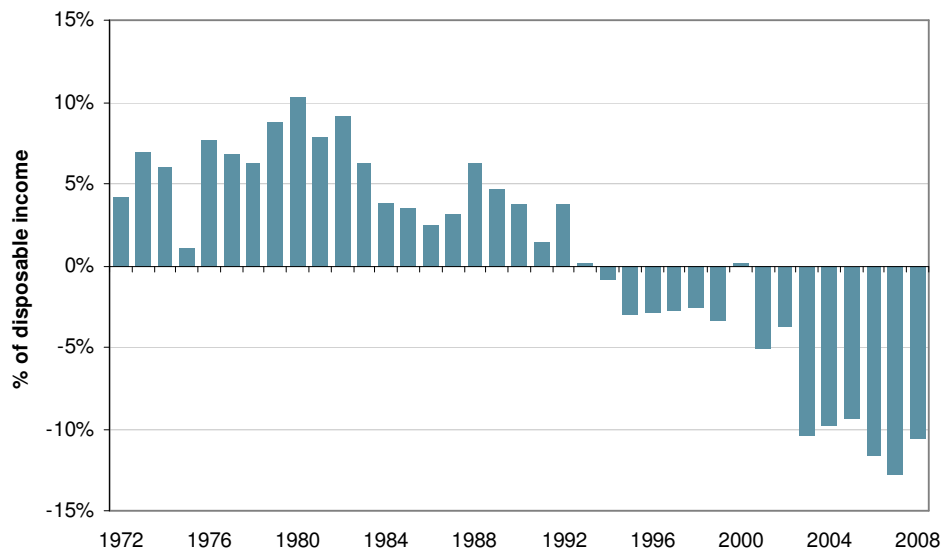
- Work-based scheme for most people, with provision for membership by self-employed
- Automatic enrolment (new job, new employer), with provision for opt-out
- Members contribute at 2%, 4% or 8%, with ability to take contribution holiday
- Compulsory employer contributions of 2% provided member is contributing
- \$1,000 government kick-start plus member tax credits
- Provision for first home deposit withdrawal and deposit subsidy, subject to eligibility.

## The broader household savings picture

### New Zealand trends in saving and wealth

Over the last decade household saving out of current income has been low and declining – in fact, we've seen expenditure exceed income in recent years (see figure 3), as many people have increased their debt.

**Figure 3: Household Net Saving Rate**



Source: Reserve Bank of New Zealand

Table 2 shows the household sector balance sheet at the end of 2008. The balance sheet is dominated by the housing stock on the asset side and by loans for housing on the liability side. Total financial assets amounted to \$194 billion, or around a quarter of total household assets, with more than half of these invested in deposit accounts with financial institutions, and under one third in insurance, superannuation and managed funds.

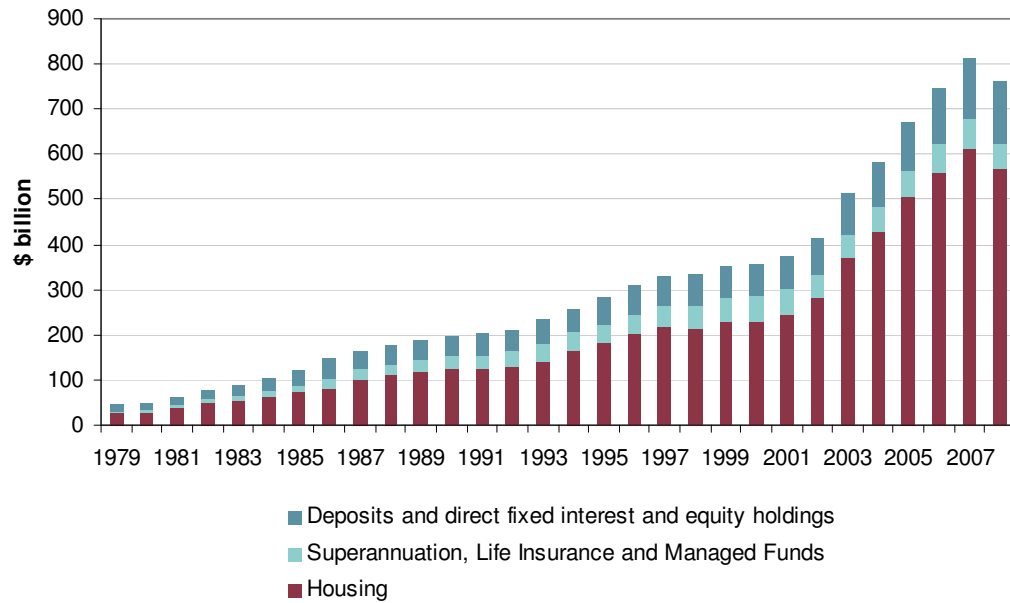
**Table 2: The Household Balance Sheet - 2008**

	<b>\$ billion</b>	<b>% Total Assets/Liabilities</b>	<b>% of Net Wealth</b>
Deposits with financial institutions	99	13%	17%
Direct holdings of fixed interest securities	23	3%	4%
Direct holdings of equities	16	2%	3%
Life, superannuation and managed funds	56	7%	10%
<i>Total Financial Assets</i>	<i>194</i>	<i>25%</i>	<i>34%</i>
Housing stock	568	75%	99%
<b>Total Assets</b>	<b>762</b>	<b>100%</b>	<b>133%</b>
Housing loans	163	87%	(28%)
Consumer loans	14	7%	(2%)
Student loans	10	5%	(2%)
<b>Total Liabilities</b>	<b>187</b>	<b>100%</b>	<b>(33%)</b>
<b>Net Wealth</b>	<b>575</b>	n/a	<b>100%</b>

Source: Reserve Bank

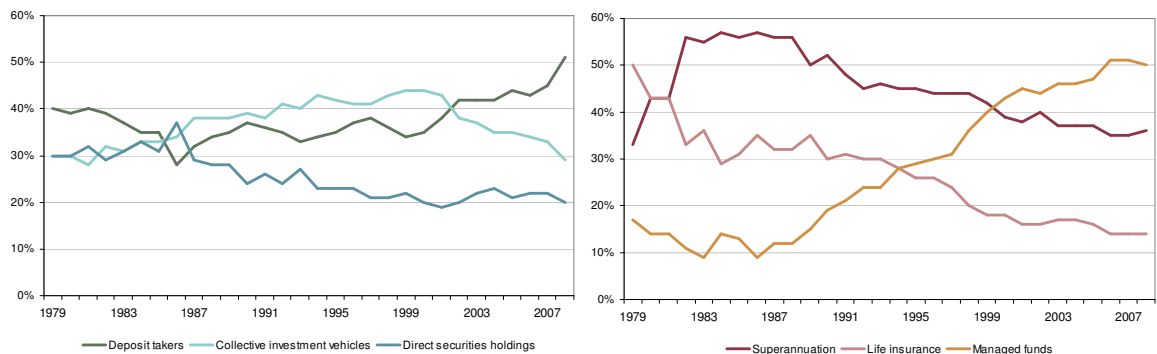
Figures 4 and 5 show how household assets have changed over time. Since 1986, the share of assets held with deposit takers has increased from less than one third to more than one half. Deposits with financial institutions overtook collective investment schemes as the single largest institutional savings category in 2002. Funds under management by the life, superannuation and managed funds sectors increased steadily between 1978 and 2000 before declining sharply from 2002. Within this category, the share of assets in managed funds (eg, unit trusts, group investment funds etc) increased significantly between 1986 and 2008, mirrored by a persistent decline in the share of assets invested in life insurance and superannuation schemes.

**Figure 4: Changes in household financial assets over time**



Source: Reserve Bank of New Zealand

**Figure 5: Changes in household financial assets over time**



Source: Reserve Bank of New Zealand

Other key points regarding the household asset portfolio include:

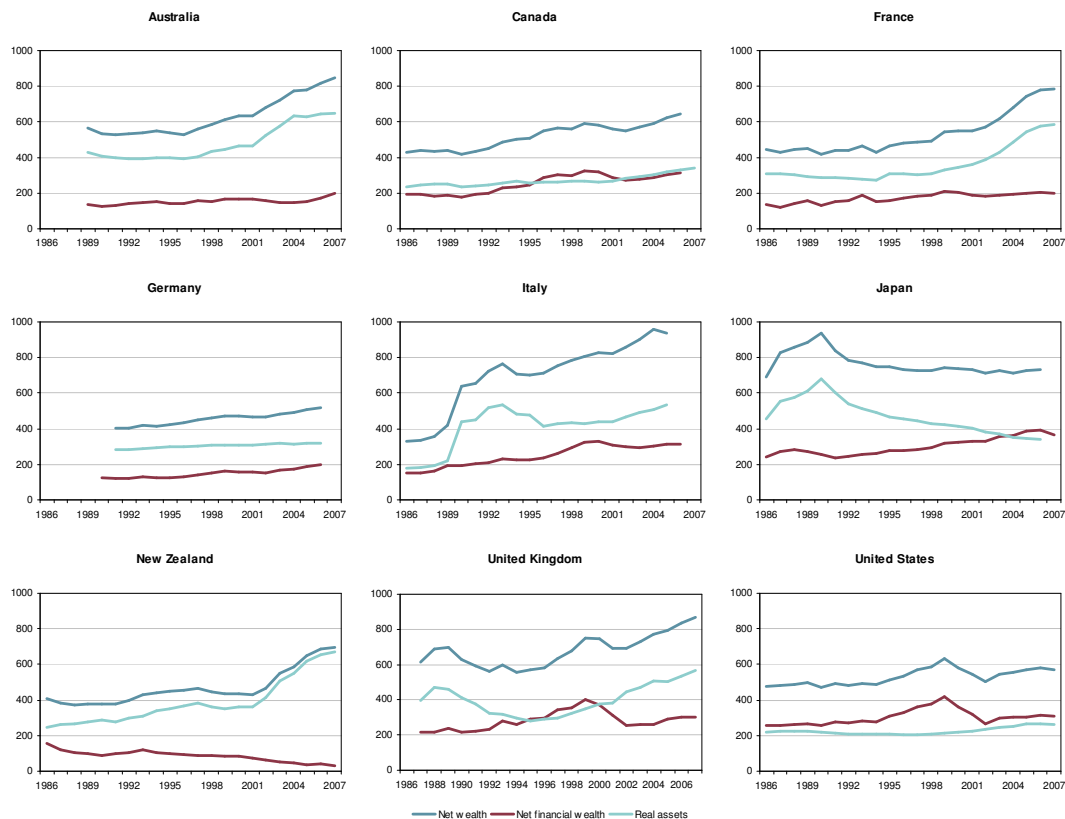
- It is undiversified and overwhelmingly dominated by property, and the concentration in property has increased over time
- There is a very strong domestic bias, with only 6% of total assets held overseas
- There is a relatively low allocation to productive growth assets
- Amongst financial assets, there is a significant tilt towards low risk, high liquidity assets.

## Comparison with OECD countries

A fall in the household saving rate is a common trend among OECD countries. Flows-based measures of saving have declined in Australia, Canada, Italy, Japan, the UK and the United States to varying extents. However, New Zealand stands out as the only country to record large negative saving rates. New Zealanders have to a greater extent borrowed against rapidly rising household wealth, driven mainly by house prices, so that our household sector is now the most indebted.

While New Zealand household wealth is moderate by international standards, the portfolio composition of New Zealand households is quite different to that of other countries. New Zealand household portfolios are more heavily weighted towards housing and our households have the lowest share of financial assets invested in equities. New Zealand is the only country to have experienced a decline in household net financial wealth over the last decade, and has one of the lowest per capita holdings of financial assets in the OECD.

**Figure 6: Changes in household financial assets over time**



Source: OECD

## Do household savings patterns matter?

At an individual household level, saving serves several purposes including:

- funding planned expenditure, such as a car, house or living costs in retirement
- as a precautionary buffer against unexpected future expenses
- to accumulate an estate to bequeath upon death.

Of these motives, the first generates the greatest demand for managed funds and superannuation products. In addition, the precautionary and bequest motives generate demand for life and income protection-type insurance products.

At the household level, the main concern for policymakers is to prevent poverty amongst the elderly and to ensure people have adequate income in retirement. The former is a key function of NZS, whereas the latter is achieved by a combination of NZS, KiwiSaver and private provision.

Household savings also matters in the aggregate because of its macroeconomic impacts and its role in reducing the vulnerability of the economy to economic shocks.

Aggregate savings makes an important contribution to the development of the financial system. Persistently low household and national saving has contributed to shallowness of New Zealand's capital markets, particularly in parts of the capital market less likely to be funded with foreign saving (eg, new share issuance, venture capital). Through these channels, low rates of saving may adversely affect the quantity and quality of investment and the overall rate of economic growth.<sup>2</sup>

An implication of New Zealand's low saving rates has been persistent current account deficits and rising levels of external indebtedness. High debt means the country is more exposed to external shocks, and volatility in the exchange rate. Further, high debt raises the cost of capital for New Zealand businesses. The OECD recently reported that low saving and high indebtedness are the cause of macroeconomic imbalances in the economy<sup>3</sup>.

The composition of saving may also matter for economic performance. The low rate of household saving is exacerbated by the strong preference of New Zealand households for housing investment and, within the classes of financial assets, a preference for high liquidity, income generating assets rather than growth assets. Equities make up a very small portion of the household financial portfolio in both absolute and relative terms. This restricts available funding for new issues and also likely contributes to a relative lack of breadth, depth and

<sup>2</sup> For further discussion, see New Zealand Treasury Policy Perspectives Paper 07/01.

<sup>3</sup> OECD. (2009). Economic Survey of New Zealand, 2009: Policy Brief, April 2009.  
<http://www.oecd.org/dataoecd/62/41/42564695.pdf>

liquidity on the share market. This may have adverse impacts on firms starting up or trying to expand.

The low level of saving and declining share of assets under institutional management has resulted in a relatively small institutional investment sector, although KiwiSaver is beginning to help reverse this trend. This potentially has significant implications for the overall functioning of the financial system since the development of contractual saving institutions are believed by some to bring a range of benefits to the financial system, including deepening the stock and bond markets. For example, Vitas (2000) argues that:

Institutional investors can potentially act as a countervailing force to the dominant position of commercial banks and thus promote competition and efficiency in the financial system. Specifically, institutional investors:

- provide an institutional framework that favours the accumulation of long term capital
- foster competition for savings thereby lowering management fees
- foster competition for investments thereby lowering the cost of capital
- promote financial innovation by demanding new securities and products to diversify risks
- promote market discipline by demanding greater corporate transparency and accountability.

The above discussion raises a question as to why New Zealand households have such a low level of financial asset holdings. A recent Reserve Bank paper<sup>4</sup> listed the following possible reasons:

- Valuation effect from house prices.
- A strong preference for larger houses, second homes, bachs and investment properties, reinforced by strong returns and favourable tax treatment.
- Weak demand for financial assets, linked with a perception that the equity market in particular, and financial assets more generally, are a risky and unrewarding investment.
- Weak supply-side support for saving over the last 20 years, e.g. reduction in employer based superannuation schemes, historical lack of a compulsory retirement saving scheme.
- Relatively generous state pension, which reduces incentives for private provision.

<sup>4</sup> Burns and Dwyer (2007) Households' attitudes to saving, investment and wealth, RBNZ Bulletin 70 (4) pp 25-38.

## Issues for industry

The previous discussion indicates that, while important changes have been made to improve retirement income and saving policy in recent years, the overall savings picture remains weak.

This section briefly highlights issues that the industry could consider forming a view on and communicating to government as part of its stakeholder engagement strategy.

### New Zealand Superannuation

While simple and easy to understand, issues exist with the long-term affordability of NZS. Under current policy settings, the ageing of the population will drive a doubling in the total annual payments for NZS, to around 8% of GDP by 2050.

There are a number of parameters that could be changed to reduce the future cost of NZS, including age of eligibility, benefit determination, and the introduction of means testing.

Policy changes to reduce the costs of NZS would benefit ISI membership by increasing incentives on individuals and couples to save more for their retirement.

### Age of eligibility

Many OECD countries are currently lifting their pension age beyond 65 years, on the premise of the increasing gap between pension age and life expectancy. In addition to Norway, Iceland and the United States, other countries proposing to do so include Australia, Germany, United Kingdom, and Denmark.

In Denmark legislation has been enacted that indexes the eligibility age to increases in life expectancy<sup>5</sup>. Australia has announced that from 2017 the qualifying age for the age pension will increase by six months every two years until it reaches 67 years of age on 1 January 2024.

The Treasury recently modelled the effects of increasing the eligibility age each time life expectancy at 65 years-of-age rises by six months. Under this scenario, the eligibility age would reach 69 years-of-age by 2050, the ratio of spending on NZS to GDP would be 1.5 percentage points lower in 2050, and there would be small positive impacts on labour participation and GDP.

<sup>5</sup> Taking effect with a long delay, the eligibility for the Danish old-age pension will rise by six months each year from 2024 to 2027, so that the pension age increases from 65 to 67 years. After this transitional period, any increases in the eligibility age would be tied to increases in life expectancy, with any increase announced five years in advance.

Arguments against proposals for lifting the pension age place an emphasis on the disadvantage for people with lower life expectancy.

### Benefit determination

Currently NZS payments are indexed to the average wage. By contrast, most working-age benefits are adjusted against inflation. As wage growth is projected to be around 1.5% above inflation, those receiving superannuation will get an increase in their spending power over time. If NZS was instead indexed to inflation, recipients would maintain their spending power in real terms.

In Australia, government superannuation pensions are adjusted against the Consumer Price Index (CPI) or by a new prices measure specific to pensioners and beneficiaries. From September 2009, the Pensioner and Beneficiary Living Cost Index (PBLCI) will be used where the increase in the PBLCI is greater than the CPI.

Treasury has modelled the impact of adjusting NZS to inflation indexation from 2017. Based on this scenario, this would reduce the cost of NZS to 5% of GDP in 2050.

In other words, determining benefit entitlements on the basis of inflation offers significant gains in affordability of NZS.

### Means testing

Most OECD countries, including Australia, Canada and the UK, have some form of targeting in their pension systems. It is only in the past 30 years that New Zealand have not had some form of income or asset testing of superannuation, and even then the surcharge from the mid-1980s to the late 1990s was a form of income testing.

There are a variety of ways in which the NZS could be targeted, with the most sensible being income and/or asset testing, combined with an abatement regime. The objective would be to target payments towards people with more limited resources, or to direct money elsewhere.

Treasury recently modelled several scenarios for abating NZS for superannuitants in the top income quartile, however the fiscal savings are relatively modest by comparison with the inflation-indexing scenario.

There are also problems with means testing in that it would encourage people to shelter income to avoid its inclusion in the pension calculation.

The Retirement Commission views the absence of means testing as one of the merits of the NZS, as it does not discourage saving or employment activity at older ages. The introduction of means testing would be a “hard sell” politically.

Any change in NZS would need to be introduced with a reasonable transition period to avoid penalising those currently nearing retirement age.

## New Zealand Superannuation Fund

### Discontinued contributions

The Government recently decided to suspend automatic contributions to the New Zealand Superannuation Fund as part of a series of measures to avoid further increasing debt.

From an industry perspective, the decision to suspend NZSF contributions makes sense.

The purpose of NZSF is to smooth NZS spending. It does not alter NZS entitlements or address the underlying fiscal concerns but, by saving on New Zealanders behalf, it may have the affect of reducing private incentives to save.

### Management issues

The New Zealand Superannuation Fund is managed by an autonomous Crown entity (the Guardians) whose function of the Guardians is to invest, manage and administer the Fund.

In April 2009, the Minister of Finance instructed The Guardians of NZS to actively identify and consider investments in New Zealand, subject to remaining commercially prudent in their investment activities. This is the first such directive since the introduction of the scheme in 2001, although the previous government placed significant pressure on the Fund to adopt an ethical investment approach.

The Ministerial direction highlights a key risk that all sovereign wealth funds face, namely political interference in investment decision making. The risk from a public policy perspective is that the Fund, as a result of following such a direction, fails to generate adequate risk-adjusted returns. Empirically, there are many examples of publicly managed investment funds underperforming benchmarks due to weak incentives and political interference.

A further concern relates to a trend in sovereign wealth management towards in-house management. Impavido et al (2008) note that:

... funds ... [in Canada, Norway, Ireland and NZ] started by emphasizing passive management through external asset managers. However, this concept was relatively quickly expanded to allow active management ... and development of internal management capabilities, first in passive management and progressively in active management.

While NZSF currently uses external managers for most of its asset management, it has recently brought a number of New Zealand mandates in house and is building its internal capability. This would be to the detriment of the managed funds industry and also heightens concerns from a public policy perspective regarding the performance of the Fund.

## Kiwi Saver

KiwiSaver came into operation in July 2007 and has been a success story.

Membership of superannuation schemes, both corporate and personal products, was in decline prior to the introduction of KiwiSaver. Superannuation products were being wound up and individual superannuation schemes were not a preferred choice of financial product.

According to the IRD evaluation report for KiwiSaver, many providers who participated in the evaluation believed that KiwiSaver's introduction has stimulated the wider managed funds industry and has led to competitive opportunities for innovation in distribution, service and investment approach.

## Minimum contribution rate

From 1 April 2009, the minimum employee contribution rate was lowered to two percent of gross salary or wages and the compulsory employer contribution was capped at two percent of the employee's gross salary or wages. Employees can still choose to contribute four percent or eight percent of their gross salary or wages to the scheme but employers are not required to match this.

The decision to reduce the minimum contribution rate is both beneficial and costly for the industry. On the one hand, it may induce people to join the Scheme who were deterred by the original requirement to contribute at a minimum of 4%. On the other hand, to the extent existing members reduce their rate of contribution, the value of funds flowing into KiwiSaver schemes will fall.

We do not have data on which of the above effects is the most significant.

## Contribution holidays

At 30 June 2009, 25,935 individuals were on a contribution holiday with 3,280 of these for financial hardship reasons.

The number of members on a contribution holiday increased significantly during KiwiSaver's second year, with the number of individuals on ordinary holiday increasing by approximately 2,000 per month. This is unsurprising given the first members only became eligible to take an ordinary contribution holiday from 1 July 2008.

The proportion of members on long holidays (ie, five years) increased over the year. At December 2008, six months after members became eligible to take ordinary holidays, those on five-year holidays made up 52% of all members on holiday. By June 2009, this figure had increased to 63%.

Possible explanations include:

- members ceasing regular contributions at the first opportunity to minimise the contribution required to maximise the value of their member tax credit
- members facing greater pressure on household budgets in the current economic environment
- and IRD administrative quirk whereby people who apply to opt-out after having been members for less than one year are declined an 'opt-out' but are automatically granted a five year contribution holiday

Just because members are on contribution holidays does not mean they do not continue to contribute to their accounts. Of those on holiday, approximately two-thirds have contributed to their accounts while on holiday, with higher rates of 'on holiday' contribution coming from those on short holidays.

Contribution holidays reduce savings balances without significantly reducing administrative costs. The rules around contribution holidays could benefit from further investigation, particularly given some behaviour appears motivated by short-term economic gain that is inconsistent with the long-term objectives of the scheme.

## Compulsion

The question of whether New Zealand should introduce a compulsory retirement saving scheme has been a recurring issue in the retirement income policy debate, although the proposal has never achieved popular support.

Further calls for compulsion have dried up since the introduction of KiwiSaver, with its “automatic enrolment/opt out” feature. There appears to be little political appetite to consider compulsion at present.

From a policy perspective, compulsory schemes pose a large number of potential problems relating to affordability concerns, implicit guarantees, appropriate regulatory framework vis-à-vis a voluntary regime, and ambiguous impacts on national saving etc.

That said, compulsion is one option for strengthening private incentives to save and may become more palatable as KiwiSaver membership grows. Compulsion may also address an emerging issue with the KiwiSaver scheme, whereby a number of self-employed contributors are contributing the minimum required to maximise the advantage obtained from the tax credit.

## Trans-tasman portability of superannuation savings

The Australia and New Zealand governments recently agreed to allow retirement savings to be transferred between the two countries. This will mean that savings held in New Zealand KiwiSaver schemes may be transferred to complying Australia schemes and vice versa. The agreement offers a number of advantages to individuals, notably being able to consolidate their financial affairs and avoid paying multiple sets of fees.

At present, the Australian superannuation system has an estimated A\$13 billion (NZ\$16.6 billion) in “lost accounts”. It is believed that much of these savings could belong to New Zealanders who have returned home. Some portion of this capital is expected to transfer into KiwiSaver Schemes under the new rules, providing a further boost for Scheme providers and the New Zealand funds management industry.

## Taxation of saving

The recent introduction of the PIE tax regime has improved the tax treatment of collective investment schemes relative to other investment classes. However, issues remain in relation to the taxation of saving.

In particular, housing is less taxed than some financial investments, contributing to unbalanced household portfolios.

The Victoria University Tax Working Group, led by Professor Bob Buckle, is currently considering the medium-term direction of the tax system and is working through the pros and cons of a variety of policy options.

Among the options being evaluated are changes to the tax treatment of housing and investment properties. We understand that the Board is considering a separate paper on tax issues and so do not comment further here.

## Policy relating to annuities and other drawdown products

The market for annuity products in New Zealand has virtually collapsed, with Fidelity Life being the only remaining provider.

Without a policy change, the older population will become increasingly reliant on managing accumulated financial assets to supplement New Zealand Superannuation without the benefit of longevity insurance. This will become more of a problem from 2012 when the first KiwiSaver members are able to withdraw their retirement savings.

There are a number of barriers to the development of the annuities market, including taxation and regulatory issues, and a number of systemic issues that contribute to market failure in a voluntary annuities market.

As a result, traditional annuities are often seen as illiquid, inflexible products that can be poor value for money. And from the provider point of view they are low profit and unattractive products to price accurately.

New Zealand Superannuation is also often cited as contributing to the lack of interest in annuities, although few middle- or higher-income people are likely to perceive it as adequate insurance against longevity.

Annuities markets also remain underdeveloped in many other OECD countries. Even in countries where markets are most evolved (eg, Australia, Canada, Switzerland, the US and the UK), annuities do not tend to be popular. In the UK, where purchase is compulsory, a majority of older people surveyed said they would not hold annuities if not forced to do so.

Government intervention is likely to be required if an annuities market is to develop and thrive. Tax reform, state subsidisation, inflation and longevity underwriting, regulation may be required to make annuity products more attractive.

## Appendix 1: Brief history of retirement income policy

Universal superannuation has existed in different forms in New Zealand since 1940 but, following the introduction of the National Superannuation scheme in 1977, the affordability and sustainability of the New Zealand Superannuation became a major concern for successive New Zealand governments.

When the universal pension system was introduced in 1977, it was accompanied by a lowering of the eligibility age from 65 years to 60 years, and a rise in the payment from 65% of the average wage to 80%. The removal of means testing, as well as higher pension levels and the increased numbers who qualified led to a dramatic rise in fiscal costs (to around 8% of GDP) which were not offset by dedicated tax increases.

Subsequent governments clawed back some of these concessions through pension rate reductions and other initiatives to trim the costs of NZS and remove tax incentives for private superannuation and other forms of designated retirement savings. Over time, these changes along with fewer retirees and a growing economy brought NZS spending closer to 4% of GDP.

In 1997 a referendum on the superannuation savings scheme was held. A Compulsory Retirement Savings Scheme (CRSS) that would provide retirement annuities at age 65, and which was intended to replace NZS over time, was put to referendum and strongly rejected by voters. However, other changes to NZS were made including the removal in 1998 of the surcharge for superannuitants, restoring the untargeted universal nature of NZS but with much reduced entitlements relative to wages and a rising age of entitlement.

In 2001 the government established and began contributing to the New Zealand Superannuation Fund, which was a mechanism to partially pre-fund the future cost of the NZS (out of government surpluses). The scheme held assets worth \$13.3 billion as at June 2009, although the government has now ceased contributions to NZSF.

Since 2001 changes to NZS have been relatively minor but a major change in retirement income policy occurred in 2007 with the introduction of KiwiSaver, a contributory cash accumulation scheme assisted by government and employer contributions. The success of KiwiSaver, with approximately 1.2 million members, has quickly established itself as the “second tier” of retirement income policy in New Zealand. Alongside KiwiSaver, changes in the taxation of Portfolio Investment Entities (PIEs) have made managed funds more attractive.