04 September 2006

Bronwyn Turley
Ministry of Economic Development
PO Box 1473
Wellington

Dear Bronwyn

Purpose of letter

Two concerns of the New Zealand Society of Actuaries, and we understand the Government Actuary, relating to defined benefit superannuation schemes in New Zealand are:

- the under-funding of a number of schemes with only, or predominantly, pensioners
- trust deed provisions forcing an inequitable distribution of assets on wind-up.

At our meeting of 30 May, we undertook to set out some ways these could be mitigated.

Under-funding

There are two changes we have identified which could reduce under-funding.

Minimum solvency requirements: We do not favour this approach. International experience has shown that all schemes tend to adopt the minimum solvency requirements as a funding basis, which is likely to result in a number of schemes being less well funded than at present. It is also likely to result in the under-funded schemes being wound up and members losing the benefits they may otherwise have received. Finally, it is difficult to specify a standard which would cover all possible situations, compliance would be expensive to monitor, and may result in a perception that the Government is guaranteeing full solvency.

Allow assets to revert to an employer more easily: A major disincentive to funding at above the 100% level is that it is very difficult for an employer to get the money back if it is not needed. If the employer could get any unused monies back, it may be prepared to contribute more initially. Clear guidelines on when surplus monies could revert to the employer would need to be established. This could be only on wind-up or could be while the scheme continues. To ensure consistency of treatment we recommend the Government Actuary's approval should be required.

Inequitable distribution of assets on windup

Many employers are winding up their defined benefit schemes to reduce risk.

Many defined benefit superannuation schemes in New Zealand have a trust deed provision which requires the trustees to purchase annuities on behalf of pensioners when the scheme is wound up. This may be for all pensioners or for pensioners who request an annuity. In some cases, trustees must also purchase annuities or deferred annuities for active members.

The annuity terms available are not attractive. Typically trustees need to pay 30% to 50% more than the amount they are holding in the scheme in respect of the pensions to purchase annuities. There is only one insurance company currently offering annuities in New Zealand (Fidelity Life). Reasons for this are set out later in this letter.

The unattractive annuity purchase terms mean that in many cases there is not enough money in the scheme to both ensure a continuation of pensions at their current level through the purchase of annuities, and to pay active members the level of benefit they are expecting. Frequently, pensioners have priority, resulting in no or little money remaining for active members.

There is generally no requirement in the scheme's trust deed for the sponsoring employer to put extra money into the scheme on a wind-up.

Many defined benefit schemes are now closed to new members, and as the schemes mature, pension liabilities will make up a larger part of the liability mix.

Set out below are a number of possible actions that could be taken to address the problem. All will require legislative changes. In addition, an implied provision which allows trustees to pay a lump sum amount to all pensioners instead of having to purchase a pension would be helpful. Such a change may become essential if the annuity market in New Zealand disappears completely. It would also allow trustees to use discretion to not purchase annuities if, for some reason, they were unsatisfied with the only available annuity provider(s). The intention of this change is not to alter the amount paid from a scheme, only the way in which it is paid.

1. **Introduce an implied clause into every trust deed which allows the trustees to continue the scheme as a closed scheme for as long as the trustees consider it in the beneficiaries' best interests**. This would need to depend on the trustees taking advice, on an ongoing basis, that such a course of action was in the best interests of beneficiaries. This type of test is always subjective but the responsibility could be given to the Government Actuary to review the advice and approve, or not, the continuation as a closed scheme. The situation in the past when this would have been beneficial is when there was a large tax asset, which was lost on wind-up.

2. **Require trustees, on a wind-up of a scheme, to distribute the assets in a manner that they consider would give equity between existing beneficiaries**. This should only be available if the trustees consider that the existing trust deed provisions would result in a distribution of assets which is not equitable. The problem currently is that for some schemes if they were wound up they would end up distributing a high percentage of their assets to pensioners and not enough to active members. This is a very difficult area but there needs to be flexibility built into the current provisions.
3. **Establish a scheme from which schemes can purchase pensions**. This could be a National Provident Pension Fund style scheme. Government backing would be required to overcome the disincentives insurers face. A variation may be to allow schemes to sell their pensions to another scheme.
4. **Develop the annuity market**. This is difficult as the reasons insurers see the annuity market as unattractive are all valid. Options could involve relaxing the life insurance reserving requirements (which may reduce the security of pensioners' benefits), requiring certain persons to take pensions (to give economies of scale), making annuities more tax efficient, and opening up the market to non-conventional products which would be written by non-life insurers.

Reasons the annuity market is unattractive to insurance companies

There are many reasons why insurance companies do not regard the annuity market as attractive and why the rates available appear unattractive. These reasons include:

- **Concerns about future mortality improvements:** Most annuities (certainly all those in New Zealand) have the price determined at the time of purchase. The insurer must factor expected future improvements in mortality into the price at the outset. There are very real prospects of medical breakthroughs in the next 20 years or so which could dramatically improve life expectancy. Quantifying the scale and timing of such improvements is impossible.

- **Self-selection:** People who purchase annuities voluntarily are assumed by insurers to have better life expectancy prospects than the general population. This does not apply to some defined benefit scheme wind-ups.

- **Lack of long bonds and reinvestment risk:** The natural asset class insurers use to back annuities is bonds. The longest-dated Government stock is 2017, i.e. 11 years from now. Because suitable long bonds are not available, the insurer has to invest in assets of shorter duration than the liability (i.e. the annuity stream), and take on the reinvestment risk when the shorter bonds mature.

- **Lack of scale:** Annuities are not popular with New Zealanders, the market is very small and accordingly insurers cannot get economies of scale in the market. Compliance costs, such as maintaining an investment statement are spread over few purchasers.

- **Capital requirement:** Life companies need to hold high reserves for business which involves large guarantees. The cost of holding this capital needs to be costed into the annuity rates offered, so reducing the value of the product to purchasers.

There is little prospect of the annuity market changing in the foreseeable future, without extensive Government action.

Comment

There is a serious problem building up here which it would be good to address earlier rather than later. A process known as Part 3's was set up under the 1989 Superannuation Schemes Act which allowed trustees to submit proposals to the Government Actuary to change their benefits to take account of the change in the tax basis for schemes. This was subject to agreed rules and conditions. Such a model could be made to work here.

At the same time there clearly is a need in NZ for a proper annuity market and arguably the solution for superannuation schemes should be part of the decisions made for an ongoing annuity market.

The above requires building on and this can easily be done if there is sufficient support for any of the ideas given.

Yours sincerely

Janet Hayden
Convenor
Superannuation & Savings Committee
New Zealand Society of Actuaries