A FUTURE FOR WORK-BASED SAVINGS IN NEW ZEALAND

FINAL REPORT

OF THE

SAVINGS PRODUCT WORKING GROUP

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Summary

The context of this report

The Savings Product Working Group is required to provide advice to the government on the detailed design and implementation issues to be resolved in delivering widely adopted, generic, work-based savings products. We interpret the terms of reference as requiring this result to be delivered in a "voluntary"[1] savings environment.

Although we are not instructed to define the benefits that might be associated with more widespread personal saving, we have identified personal, social and macroeconomic benefits that are likely to flow from it. These benefits can be said to justify the government taking a lead in encouraging and facilitating change.

Our report notes that possible government actions, in leading, facilitating, funding and at times regulating the behaviour of employers, employees and the providers of savings and investment products can vary in intensity in line with judgements that need to be made about the extent of personal and public benefits that flow from increased saving. We have developed a pathway of escalating levels of intervention available to the government. At each step on that pathway, we offer advice on design and implementation issues, but do not presume to make the policy decision about how far along the pathway the government wishes to progress.

The Group's terms of reference are not prescriptive, but they are relatively directive. It is possible to make a case that they require us to go to the end of the pathway. That needs to be tested through two processes. One is a prospective review of the benefits to be derived from improved personal saving. The second is a retrospective review of the costs of such an approach, and whether it generates perverse effects that detract from the benefits that can be captured.

Interest in this topic, and debate on it, is growing both in New Zealand and abroad. We are aware that a privately funded foundation is actively encouraging renewed discussion on the benefits of increased acquisition of assets by private households through its "Creating an Ownership Society" project.[2] Work-based saving is an important (and potentially cost effective) instrument through which assets can be built up. (We were not asked to evaluate the relative merits of assistance to other forms of acquisition of assets, such as assistance to young or low-income people in buying a first home).

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[1] The words "voluntary" and "compulsory" are short-hand descriptors. In New Zealand, the first tier, universal, tax funded age benefit is in a sense "compulsory" because it is funded by tax. The second tier, work-based regime inevitably has elements of compulsion insofar as there will be requirements on employers and constraints on product providers, and our recommendations contain default design features that could be described as prescriptive. However, the central feature of the New Zealand regime is that the employee makes the ultimate decision on whether or not to save through work-based wage deduction facilities, and that single feature marks out our second tier as "voluntary".

[2] See David Skilling and Arati M Waldegrave, "The wealth of a nation: the level and distribution of wealth in New Zealand", Discussion Paper 2004/1, The New Zealand Institute, Auckland, 2004

Both Business New Zealand and the Investment Savings and Insurance Association have recommended that the conclusions of this Group be subject to another round of public input by releasing this report in the form of a discussion paper. Regardless of the process used, we feel that it is important for there to be a clear articulation of the reasoning behind choosing how far to go (and just as importantly not to go) along the pathway.

This report needs to be read subject to two other contextual qualifications:

- The government is reviewing the taxation of investment funds in general (through the Stobo Review), and final decisions on that will clearly impact on, and potentially require adjustments to, these conclusions.
- Changes in the regulatory regime that applies to work-based saving need to be assessed in line with the extent to which the government is prepared to back changes with additional funding. Budget decisions will therefore also influence the shape of any solution, so our advice on design and implementation issues is in that sense partially incomplete.

None of these comments should be read as implying that our conclusions are tentative. We believe that we have developed a robust, comprehensive, and mutually reinforcing set of options for increasing work-based saving.

The basis of this solution

Evidence from other countries suggests that *on its own*, neither education nor mandatory offering of access to schemes by employers generates significant increases in participation rates. Evidence also indicates that there is a substantial "*status quo*" bias, with savings behaviours heavily influenced by what individuals are doing at any time. If the impact of that bias is reversed, so that the *status quo* is participation in a savings plan ("opt out" rather than "opt in") there are good reasons to believe that savings rates will rise.

However, this effect should not be achieved by imposing significant additional compliance costs on employers, or by increasing inertia by making decisions on savings too complicated for employees.

Drawing on the international evidence, studies into, and submissions on savings in New Zealand, and our own experience and discussions, we have developed options that would in our view:

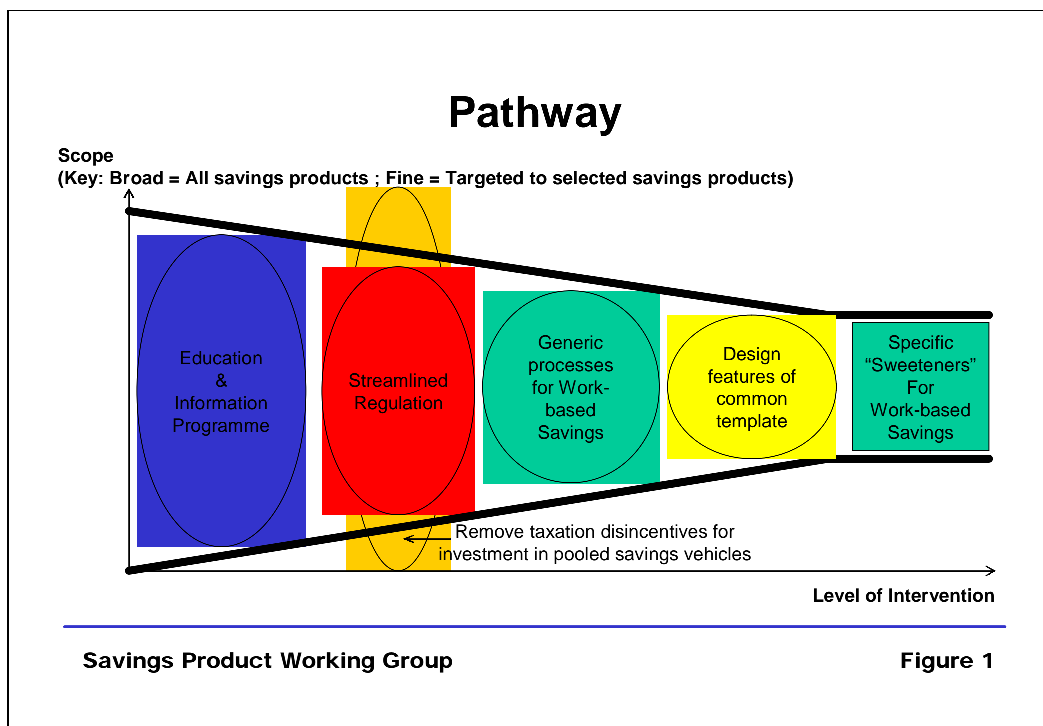
(i) Protect but expand participation in work-based savings plans. It is important to make it clear that our advice on the design of any new generic scheme seeks to avoid the new scheme *displacing* existing corporate and master trust schemes. {At last count[3], some 264,000 New Zealanders were saving through employer

[3] 30 June 2003 (see the Report of the Government Actuary for the year ended 30 June 2003, Appendix 5)

superannuation schemes, which had combined assets of nearly $10 billion, representing 14 percent of the labour force, with an average personal fund balance of $37,000}.

(ii) Encourage that expansion through a discretionary mix of approaches involving one or more of:

- an education programme that explains and reinforces the other elements;
- a streamlined and more effective regulatory system; and
- a tax structure that does not disadvantage work based savings vehicles;
- a standardised generic process for getting access to, and maintaining participation in, work-based savings products.



Compared with overseas jurisdictions, our proposals envisage a significant amount of individual responsibility for savings decisions, and the exercise of that responsibility inevitably has consequences for personal well-being. It is therefore essential to wrap quality information and advice around the product on offer. Accordingly, e*ducation* programmes need to:

(a) be resourced by benchmarking allocations against comparable "public good" campaigns directed at securing gains that are regarded as being of comparable value;

(b) encourage chief executives and chief financial officers to take a more positive approach to facilitating access to savings products;

(c) train human resources staff in enterprises in the processes and options associated with the workplace-based savings regime;

(d) build confidence and familiarity among employees with personal financial matters.

A streamlined and more effective *regulatory* system for savings products would be based on:

(a) registration or approvals (with strong deterrents for fraud and criminality), not comprehensive disclosures involving excessive “front end” compliance;

(b) relevant, but less intrusive and expensive disclosure requirements;

(c) increased clarity protecting employers from civil and criminal liabilities (or at least perceptions of those risks) that might otherwise arise from them being deemed to be promoters, or bound by the Investment Advisers (Disclosure) Act;

(d) more flexibility around the purpose for which approved plans might be designed, and in facilitating transfers and beneficial amendments to existing schemes/plans.

The *tax* structure should not disadvantage work-based savings vehicles relative to other (personal) savings options that individuals have. We note, though, that the taxation of different investment vehicles is under separate review, and will make a final comment on its compatibility with our advice when we have the recommendations from that exercise (the “Stobo Review”).

Any *generic process* would be built around:

(a) automatic enrolment in the savings system at the point of engagement with a new employer, with the right to opt out or to suspend contributions;

(b) standardised income thresholds below which contributions are not levied, but above which there are set proportions of additional income diverted into a savings plan (so that the contribution rate rises as income rises);

(c) a simple and cost effective mechanism for making deductions by using a special PAYE tax code, and transferring the funds into individually “tagged” accounts for onward transmission to the provider of choice;

(d) a capacity to remain in a scheme despite periods of absence from the workforce, or on change of employer; and

(e) flexibility to allow for voluntary opt-in by existing employees (simply by electing the relevant tax code) and for employers to negotiate special plan features with chosen providers.

We believe that, as a part of adopting any standardised and generic process for work-based saving, centrally administered collection and distribution of

funds would be both efficient (in terms of cost) and more effective in improving participation in savings plans. It would, however, take slightly longer to implement than would a simple model inviting (or requiring) employers to make voluntary bi-lateral arrangements with participants in the savings and investment industry, because the regulatory and system design features would be more complex.

Restricting automatic enrolment to the point at which an employee first engaged with a new employer, basing it on a special tax code being assigned to an employee (thereby excluding employees on another tax code that takes precedence – like one for repaying a student loan), and limiting automatic enrolment to engagement with an enterprise employing six or more workers would phase any generic scheme in over a longer period of time than would a "big bang" automatic enrolment of all employees from a set date. Over time, however, labour market churn would enrol most workers in the generic scheme, and there would be nothing in that design to limit voluntary "opt-in" elections to speed up the process.

We see this as preferable for a number of reasons, including the capacity of a new system to cope with a significant number of new enrolments at the same time, the need to minimise compliance costs on employers, and the need to resist the negative effects of imposing a visible cut in take-home pay on contributors.

We note that over time, as the Inland Revenue electronic filing system ir-File rolls out to small businesses, a near-universal coverage of the workforce should be achievable in a cost-effective way.

We have not tried to estimate the level of direct contribution (if any) that the government might make to stimulating savings through a generic regime, although we do list a range of alternative "sweeteners" that could be considered if the government were to conclude that an ability to capture public benefits through higher savings levels justified some level of financial input.

The *implementation* of any generic work-based saving solution:

(a) will depend on some prior decisions being made on matters such as tax and regulatory reform, and the degree of intervention that is considered appropriate, all of which will modify the detail of the design of a solution; and

(b) requires some specific tasks to be undertaken in constructing the machinery through which savings will be collected, distributed and managed.

The specific follow-up *tasks* that have to be allocated are:

(i) Manage the process associated with evaluating responses to a discussion paper.

(ii) Test the design details to confirm (or amend) the exemption, threshold and contribution rate parameters built into the core features of a generic product.
(iii) Oversee the legislative process associated with the regulatory revamp.
(iv) Review the recommendations of this report in line with the conclusions of, and government response to, the findings of the Stobo Review on the taxation of investment funds.
(v) Make final decisions on whether and to what extent "sweeteners" will be applied to encourage work-based savings, and carry out focus group testing on the sorts of sweeteners that are likely to be most effective in stimulating an increase in the numbers participating in savings schemes.
(vi) Determine the amounts that ought to be applied to education and training programmes associated with promoting uptake and improving financial literacy.
(vii) Establish a central scheme administrator facility, conduct a tender process to select the administrator and put a mechanism in place to meet the costs of the administrator.
(viii) Determine the detailed criteria for the approval of savings product providers.
(ix) Establish a body for approving providers.
(x) Construct a process for formally exempting existing schemes from the obligations that apply under the generic scheme.
(xi) Oversee the implementation of the communications, education and training activities envisaged by the Group.
(xii) Finalise decisions on withdrawal rights (amounts, frequency, notice periods) and commission further work on "decumulation" options (such as improving the provision of access to annuities).

In many cases, there are departments and agencies within the existing machinery of government that are the natural "home" within which the follow-up activity should be carried out (IRD for tax, MED for regulatory reform, Treasury on Budget issues, Retirement Commission on education). However, we see the process going forward as being crucial to the success of any project to improve work-based savings, and we stress the integrated and mutually reinforcing nature of the elements of the report's recommendations.

We therefore recommend the establishment of a co-ordinating and oversight unit, located within a government agency, operating under the guidance of an Advisory Board with an independent Chair. The Board would advise the Chief Executive of the host department. {The selection of the relevant Department is a matter for Cabinet}.

Making allowances for

(i) time to have this report evaluated and subject to public consultation;
(ii) the need to review the implications for the recommendations of any proposals to change the tax treatment of investment funds;

(iii) the demands of the Budget cycle; and
(iv) a realistic timeframe for making the necessary statutory and regulatory adjustments;

we estimate that a new regime could be functioning as from 1 April 2006, but recognise that that is an ambitious target and one that might have to be extended to allow for synchronisation with other reviews and initiatives, particularly on the tax and regulatory fronts.

In the remainder of this report we:

(i) outline the theory and evidence that informed our logic (chapter one);
(ii) explain how we sifted the options for addressing the main issues in our terms of reference (chapter two);
(iii) record the detail on how the elements of a new approach to saving would operate (chapter three);
(iv) discuss implementation and list additional tasks that need to be undertaken (chapter four);
(v) reproduce our terms of reference (Appendix I);
(vi) describe our methodology and consultation processes (Appendix II);
(vii) respond to some issues of principle and practicality that were raised with us (Appendix III).

1 OUR LOGIC

1.1 The task

The Savings Product Working Group was established in May 2004, with terms of reference as set out in Appendix I.

The central mission of the Group was:

"..to provide advice to the government on the detailed design and implementation issues to be resolved in delivering widely adopted generic work-based savings products."

The *generic* nature of the products contemplated sets them apart from more traditional employment related superannuation schemes. The desire for a wider adoption of products also suggests that a substantially different "mould breaking" initiative is envisaged.

The advice can relate to savings *products* or savings *solutions* (such as access to schemes, direct deduction facilities and education campaigns).

Savings products should be accessible by *all* employees, but this leaves open the question of whether that is best achieved through a unified "global" product, or "layered" schemes to cater for different categories of workers (low paid, casual, women, young).

The terms of reference stress the *ability* to maintain a scheme until retirement with changes in employment and interruptions to periods in employment, but not the *requirement* to do so. Lock-in is therefore not a necessary feature of any product design or solution.

In relation to the taxation of savings, we were asked to recommend on removing the over-taxation of low-income earners and to identify where the tax system discourages work-based saving. The terms of reference are not explicit about whether this refers to a comparison with nominal marginal income tax rates or the tax advantages of saving through non-standard vehicles.

We were asked to include some key features in our proposals unless they were shown to conflict with core aspects of a solution. These "default" design features are:

(i) Universal access for employees;
(ii) Automatic enrolment unless the employee declines;
(iii) A method to generate long term savings that contribute to well being in retirement; and
(iv) Portability between products.

The terms of reference state that generic savings products and solutions should address:

(i) The needs of low-income groups;
(ii) Ensuring that all employers offer access to a product;
(iii) Enabling ongoing participation (whether or not contributions are being made) during periods of non-employment;
(iv) Criteria for automatic enrolment;
(v) Circumstances that allow for early withdrawal of contributions;
(vi) Constraints on fund management (fees, investment profiles etc);
(vii) Minimising compliance costs; and
(viii) Practicalities of implementation and lead in times required by employers and fund providers.

While these terms of reference are not prescriptive, they are strongly directive and imply a somewhat radical or "aggressive" approach to finding a solution.

1.2 The context

The Group is examining what is generally known as "second tier" savings. The concept of "tiers" is located within what is often described as the "World Bank Model" for the financing of retirement income. That model has three "tiers":

(i) a basic, state funded "safety net", typically abated against private retirement income;
(ii) a second, employment based, typically compulsory, income related, personal contributory saving programme; and
(iii) additional, voluntary personal saving.

Australia, Sweden and Singapore probably align most closely with the features of this model. New Zealand departs from the model in material respects, and given the entirely private, voluntary, contractual nature of occupational pension schemes could be said not to have a second tier at all. (Occupational superannuation here being a component of the third tier). Many features of the New Zealand framework set it apart as the "odd one out" in the global savings scheme of things.

New Zealand's first tier is not abated against other income. It is also a flat rate. This means that it is relatively simple to administer and inexpensive compared to those regimes that seek to replicate in retirement the incomes (or at least the approximate living standards) enjoyed during working life. The fact that the universal age payment is a flat rate might imply that individuals who aspire to more than a basic retirement income would be motivated to save through second and third tier instruments. However, organisations like the OECD and IMF suggest that the flat rate is generous, and its generosity might blunt incentives in the other tiers, although we are not aware of any evidence that suggests that New Zealand Superannuation is a disincentive to other forms of saving.

Other jurisdictions that conform more closely with the standard model tend to match compulsory second tier savings with tax advantages, and even where compulsion is limited (such as only on employers to offer access to a second tier scheme) a preferential tax treatment of savings is common (USA, UK, Ireland). In New Zealand, other savings are entirely voluntary, for both employers and employees, and there are no tax advantages (and, for many, some disadvantages) associated with second tier savings.

We are formulating options in unique circumstances, and are in effect making recommendations for the construction of a local variant of the second tier. While we can draw conclusions from what works in other countries, what works there works within their total savings framework. Similarly, solutions here have to take account of the special features of the New Zealand framework as whole.

1.3 Lessons from abroad

This section is not intended to be a comprehensive analysis of other tier two savings systems, but we can draw lessons from the experiences in other countries. The Group examined the experiences of five countries to generate some insights into what might work here to boost work-based savings: Ireland, the UK, Sweden, Singapore and Australia. Because the last three are compulsory contributory models, they are not directly relevant to this exercise, but some design features can be informed by their experiences.

Ireland

The Irish approach is based on a tripartite agreement and a political consensus around the key elements arising from the National Pensions Policy Initiative (NPPI). The NPPI target was to increase participation in private/occupational pension schemes from 50 to 70 percent of the workforce. The central instrument by which this was to be achieved was the Personal Retirement Savings Account (PRSA).

The PRSA is a defined retail product created by legislation and surrounded by rules on investments, terminations, transfers, disclosure requirements and fees. Its distinguishing features are that it is tax advantaged, and employers must provide access to a PRSA if employees do not have access to an occupational scheme.

In the first year of its operation (February 2003 to March 2004), only 21,306 standard PRSAs had been taken out, involving not much more that one percent of the workforce.

This was in spite of the tax advantages accessible through these accounts, a national pensions awareness advertising campaign and expensive marketing of their products by providers. Promotional activity received little support from brokers: most likely because the fee limitations made PRSAs unattractive as a sales proposition. It is possible that PRSAs stimulated an increase in participation by incentivising employers to extend access to existing

occupational schemes in order to avoid having to create access to a new product. That is not relevant in a New Zealand context. Access to occupational schemes is so narrow that extending access to all employees in an enterprise that offers a scheme will not have a material impact on overall coverage.

The lessons from the Irish experience include:

(a) access to a scheme and awareness education campaigns may be necessary elements of increased work-based savings, but in themselves they are not sufficient to stimulate a significant increase in participation in work-based savings; and

(b) fee caps may limit the extent to which financial advisers will promote generic products.

United Kingdom

The underlying purpose of the UK “Stakeholder Pension” scheme is to move towards a replacement of state pensions with private pensions. The UK system is characterised by requirements on employers to offer access to a scheme, by strict caps on the fees providers can charge, and by heavy regulation of the industry. These pensions have had limited impact.

Impressions we have gained by talking to a UK expert on the operation of the scheme are:

(a) Employer attitudes, and particularly the willingness of employers to provide a contribution subsidy, are critical to the uptake of the schemes by employees. Outside of the areas where work-based savings would have happened anyway, there is not much evidence that mandatory access has made any real difference. The implication here is that education campaigns need to focus on *employer* awareness and attitudes.

(b) Perhaps as many as one in six employers simply do not comply: they do not offer a scheme despite an obligation to do so. This suggests that absent any more simple mechanism, a regime that is based on voluntary bi-lateral contracting (employers making arrangements with a provider) will face significant levels of non-compliance or involve reasonably extensive and intrusive enforcement systems.

(c) As many as eighty percent of the schemes that have been established to comply with the new regime remain empty (no contributors). Mandatory offering, on its own, does not seem to make a material difference.

(d) Heavy regulation and tight caps on fees have limited the ability and willingness of providers to develop innovative savings products and to market them extensively. (There are some legacy effects that have been an influence here, as the

extensive regulation was largely a response to earlier "mis-selling" scandals). This suggests that excessive regulation and tight caps on fees can be counter-productive, although there is a suggestion that the caps on fees in the Stakeholder Pension corner of the market has had an impact in driving fees down across the industry (i.e. including the "third tier").

(e) The tax advantages associated with the scheme have been captured by higher income contributors: one-half of the tax relief on offer is received by taxpayers on the top marginal rate. This implies that other mechanisms need to be developed if the intention is to direct public assistance to low and middle income contributors.

Sweden

Swedish pension reform began in 1994, resulting (in effect) in a pay-as-you-go scheme funded by an 18.5 percent payroll tax. The variation is that 16 percent of the contribution is placed in a notional individual account and 2.5 percent in an actual ("premium") personal account. The notional account is accessed on retirement via an annuity, and works on a *pro rata* income maintenance basis (with a safety net protection).

Although premium pensions are self directed into some of the 600 plus private funds available to choose from, they are collected by the national tax authority and distributed by the Premium Pension Agency, which is also a regulatory agency in that there are fee limits and rules on switching of funds. Individuals can spread their investment across up to five funds, but whereas two-thirds of savers used the elective option in 2000, by 2002, 86 percent of new entrants took the default option.

Both the compulsory nature and the level of payroll tax associated with the Swedish scheme are not replicable in New Zealand, but the Swedish model does indicate that it is possible to capture economies of scale in collecting and distributing funds, and maintain diversity of choice of funds. There are attractions in the "super-wholesaler" features of that system, but the system also illustrates that care needs to be taken around determining the nature of default options because they are likely to dominate any savings landscape.

Singapore

Singapore has an extremely high-rate, compulsory savings scheme, currently requiring contributions of 20 percent of salary from employers and 16 percent of salary from employees. (There is also a tax-advantaged voluntary scheme that complements the compulsory Central Provident Fund). Neither the compulsion nor the level of savings is relevant to the New Zealand context. The significant feature of the Singapore scheme is that work-based savings

can be used for a variety of life stage purposes, with only ten percent having to be applied to old age and contingencies.

The dominant part of the savings (75 percent) is channelled into an "ordinary account" which can be applied to home ownership, education, approved investments etc., as well as for retirement income.

The implication here is that "saving" has a more generic personal and public benefit, and if savings habits are established and maintained throughout working life, a residual portion (the amount of that portion is another matter) can build towards improving living standards at a later (retirement) life stage. This suggests that the New Zealand "model" of requiring a very specific "principal purpose" as a precondition for becoming a registered superannuation scheme may be counter-productive and direct savers into the third tier.

Australia

The particular circumstances in which the compulsory work-based savings regime emerged in Australia are well known, and it is not realistic to envisage a similar arrangement emerging from the economic, industrial relations and institutional circumstances that exist or are likely to arise in New Zealand. Our interest in Australia was their experience with the administrative costs and regulatory complexities associated with small deposits made by lower paid workers in the "high churn" segment of the labour market.

The advice we received was that there was a very complex and costly regime that had built up around the "gone no address" small balances held in (at times) multiple schemes that were associated with industry-based pension plans. These experiences led us to conclude that any "generic" scheme design adopted in New Zealand should involve:

(a) collecting small contributions in a "holding pen" until they reached a critical mass, so that they were being managed in realistic and traceable transaction sizes; and
(b) allowing a central scheme administrator to attach a unique personal identifier that linked any saver with one particular provider (it is a separate issue how that provider would be selected, and how the decision on retaining or changing that provider would be made).

Lessons from abroad: a summary

These experiences tell us that:

- Mandatory offering, even backed by education, is not enough (of itself) to stimulate genuine change.

- The attitudes of employers are critical.

- A centralised collection and funds distribution facility is workable and cost effective in relation to any generic product.
- Over-regulation stifles innovation.
- Fee caps, on their own, can be counter-productive.
- Some flexibility in the use of work-based savings for life stage needs prior to retirement is not inconsistent with savings making a contribution to improving well-being in retirement.
- It is important to resist funds becoming dispersed across a large number of schemes in small denominations, if the savings of low paid and casual workers are to be protected.

1.4 Lessons from psychology

All of the previous insights were gained by looking at the way different systems operated.

However, within any system, individuals make choices, and there is a growing body of research that has tried to link the design of systems with the way in which individuals make choices and/or alter their behaviours. This is broadly where "psychology meets economics". Much of the behavioural literature comes out of the USA, where researchers have studied the design of systems in relation to participation in, and rates of contribution to, "401K" plans.

The US literature needs to be treated with considerable caution, because although 401K plans are offered in an essentially voluntary environment (employers have to agree to offer them, but employees have to elect to contribute) they are significantly tax-advantaged and the schemes researched have typically also involved an employer subsidy. That environment is very different to one that might realistically be constructed here, so it is important to be cautious in attempting to translate experiences from that regime. Responses may differ materially when there is no tax advantage or subsidy, particularly if there is also a lock-in and loss of access to financial assets.

There is a volume of research relevant to this topic, but to make it accessible to readers of this report, references here are to the comprehensive research survey presented by Professor Olivia Mitchell of The Wharton School, University of Pennsylvania, to a recent seminar hosted by the Retirement Commission.[4]

The studies explore the effects of:

[4] Olivia Mitchell and Stephen Utkus; "Lessons from Behavioral Finance for Retirement Plan Design", PRC WP 2003 – 6, Pension Research Council, The Wharton School, University of Pennsylvania, 2003. This paper can be accessed through the Retirement Commission website www.retirement.org.nz/research_reports.html

- "bounded rationality" (problems are too complex for individuals to handle, and hence some standardisation of solutions assists with more effective decision making); and

- "bounded self-control" (where a lack of willpower means that despite good intentions, individuals put off decisions).

Various studies have found that:

(i) People tend to save less than they objectively calculate they need to save. {A survey of 10,000 employees at a single firm found that two-thirds of the workers were actually saving less than half of the amounts they thought they needed to save}.

(ii) Source deductions (money paid before it is received) generate participation rates that are four times as high as participation in schemes where the individual makes the contribution directly.

(iii) Restrictions on withdrawals can be an effective counter to lapses in willpower. {Source deductions are "out of sight, out of mind". Restricted access is "out of reach"}.

(iv) Automatic enrolment produces dramatically higher participation rates than "opt-in" arrangements. {In one study, participation rates jumped from 37 percent to 86 percent after automatic enrolment for new recruits was introduced. In a New Zealand context, the most recent AMP SuperWatch survey is less encouraging, but still implies positive returns. Of those employees who had access to a work-based savings scheme, 15 percent had not joined because they hadn't got round to it, 11 percent because they hadn't been there long enough (*status quo* bias is working against this group when they do qualify), and 4 percent because it was too late to join now (presumably at least some of them didn't make a timely election). In total, that implies that some 25 percent who might have been expected to participate didn't. It should be noted that the basic feature of New Zealand employment-based schemes are that they are "legacy" schemes: they were established under different historical conditions, and they are mature. Churn is less likely to be relevant, and it is churn that automatic enrolment works off to lift participation rates.}

(v) Individuals tend to select the default options selected by a third party (in the US case the employer) when deciding on both contribution rates and investment plans.

(vi) There is a very strong "*status quo* bias". {In one study, a seminar was held for those employees not participating in the company's 401K plan. All of the participants indicated that they would join the plan, but after six months, only 14 percent actually had}.

(vii) While in theory choice is good, there is a risk of "choice overload", particularly with investment options, where many people lack confidence to make decisions, and workers taking a "can't decide, therefore don't join the plan" attitude. {Anecdotal reports from the introduction of the new State Sector Retirement Savings Scheme in New Zealand this year indicated that this was a factor reducing take-up in a number of workplaces}.

(viii) Automatic contribution rate increases that are linked to pay increases ("escalators" such as the Save More Tomorrow or SmarT plans in the USA) have a dramatic effect in increasing the rate around which contributions mature.

(ix) Participants in savings plans have weak preferences for the portfolios they select. They tend to select either the plans that co-workers have selected, or the middle of any range of options they are presented with. There are two implications from this. One is that care needs to be taken in selecting default investment options, because conservative plans are not costless (i.e. the cost is the lower expected return) and optimal portfolios change over the life cycle, so defaults might optimally include a transition from growth through balanced to conservative at different ages. The second implication is that there is a need to ensure effective education in financial awareness.

(x) Inertia and procrastination are also powerful influences on investment decision-making. "Anchoring" is common: the first portfolio allocation decision becomes an anchor for subsequent periods. This means that timing (such as making a first decision after a period of declining share prices) can anchor savers into sub-optimal portfolios long after a negative episode has passed.

(xi) There is a risk that employees will over-invest in the shares of their employer if given an opportunity to do so. Not only does this result in an insufficiently diversified asset portfolio, but it also results in an excessively concentrated personal portfolio (If the company fails, the workers lose both an income and their savings). Arms-length investment rules protect against this.

(xii) Despite the fact that many of the risks workers face in retirement (longevity, poor returns on savings) suggest that they should draw down savings through annuities, annuities are not attractive to participants.

Mitchell observes that "it is because retirement savings decisions are at least an order of magnitude more complex than other economic decisions, that people need help."

Suitable design features that “help” do tend to change participation rates and savings rates by a very large order of magnitude. The lessons from these studies support the view that none of the “default design” features of the terms of reference are impractical or infeasible, and they therefore inform the logic that drives our design advice.

2 Options

2.1 Establishing a range of options

The Group's conclusions have been driven by a basic view that there is not one but a number of "solutions" that we could develop, depending on how aggressive/ proactive/ intrusive the government wished to be in stimulating a higher level of savings and in using the work-place to do that.

The work-based savings regime in New Zealand is tax neutral (at least in theory), and voluntary (both on employers to offer, and on the employee to contribute). Any attempt to change the practice that has emerged under that regime requires an intervention that in some way requires, coerces or manipulates practice to change the way in which free choice is being exercised. The interventions may be more or less intrusive, and lean more heavily on one or other of the relevant parties. Just how intrusive to be, and where to put the balance of intrusion, will depend ultimately on an assessment of what level of benefit might be expected to flow from the changed practice that is being orchestrated.

The Group's terms of reference are relatively silent on this topic: merely noting that "the government considers that work-based savings schemes are a good way for New Zealanders to save for their retirement" because such schemes allow for deductions at source, can benefit from economies of scale and can reach a high proportion of the population.

That begs the questions of:

(a) how aggressive policy should be in steering New Zealanders towards saving more, and towards saving for retirement (as opposed to allowing them to set their own financial priorities); and

(b) whether it is reasonable to expect employers to be conscripted as agents in achieving that wider goal.

There is nothing wrong *per se* in governments influencing or prescribing certain behaviours and practices. By way of example, governments assume that they "know best" when they discourage smoking through warnings and taxes, places limits on the operation of casinos, or fund campaigns to promote exercise. However, with savings, policy is developed from a less confident base. A number of studies have cast doubt on the proposition that New Zealanders do not save enough, or that they save through inefficient or sub-optimal vehicles. The furthest that formal policy statements go (perhaps best captured by the 2003 Periodic Report Group) is that there are risks that younger cohorts in the population may enter retirement and face a significant drop in their standards of living (and even then, those statements stop short of pronouncing that that would necessarily be an unintended life choice).

Equally, there is nothing wrong *per se* in expecting employers to meet a variety of obligations that are associated with the better or more efficient functioning of the political economy. These requirements are common: examples are to collect data on employment and wages, and to develop systems to improve workplace health and safety and the like.

The literature identifies three public policy grounds that would justify a more pro-active and assertive stance being taken by the government in stimulating higher saving.

(i) Risk mitigation

As noted above, managing the risks associated with potential undersaving by younger age groups lay behind the recommendations of the Periodic Report Group[5] that sought to boost private saving.

The PRG found that while "current research demonstrates that most older people are doing quite well and have relatively few material restrictions and difficulties in terms of basic needs", and that "for those close to retirement the available evidence suggests that they are also likely to have an adequate standard of living in retirement", "for younger cohorts of middle-income New Zealanders the picture is less clear." This is because there are a number of risks and opportunities that these younger cohorts face. The risks include higher debt levels, student loans, changes in relationship status, later child bearing and potentially lower levels of mortgage free home ownership, "which may lead to less private provision and lower standards of living in retirement."

(ii) Improved life outcomes associated with asset ownership

There is growing national and international interest in the body of research that concludes that adjusting for all other variables (age, educational qualifications, employment status, income level etc) the one factor that correlates most closely with improved life outcomes is ownership of assets. This has led to the growing interest in "asset-based welfare", or "asset-based policy", or what has been referred to in the New Zealand context as the "ownership society"[6].

The social, as well as personal, advantages associated with improved asset ownership are summed up by the New Zealand Institute in the following way:

> "Asset ownership is increasingly important for meaningful participation in society and the economy. Ownership enhances the ability of people to access opportunities and to invest in the future – by buying a house, financing education and so on – and

[5] Periodic Report Group. "Retirement Income Report 2003". December 2003

[6] see David Skilling and Arati M Waldegrave: "The Wealth of a Nation: the level and distribution of wealth in New Zealand, Discussion paper 2004/1, NZ Institute, Auckland.

> allows people to cope with shocks. Assets provide greater security, control and independence. A broad distribution of ownership also generates enhanced social cohesion at a national level, and ensures that more New Zealanders obtain the benefits of economic growth. So helping all New Zealanders acquire assets will make a significant contribution to New Zealand's economic and social future.
>
> "In recognition of the increasing importance of asset ownership, many countries are introducing and expanding "asset-based policies" that assist and encourage people to accumulate wealth. Creating an ownership society, in which ownership of assets is broadly distributed through the population and in which all people are able to accumulate wealth over their lifetimes, is a policy priority across many countries. And such policies are advocated by governments and political parties from across the political spectrum; it is not a policy solely of the left or of the right."

To the extent that these benefits do exist, capturing them justifies additional initiatives from the government. We are not in a position to pronounce whether, and if so to what extent, the asset ownership-to-improved life outcomes link applies. We do note, however, that the New Zealand Institute has announced its intention to open the topic up for debate and believe it is important that there is an active engagement in that debate.

(iii) Macroeconomic and financial system stability

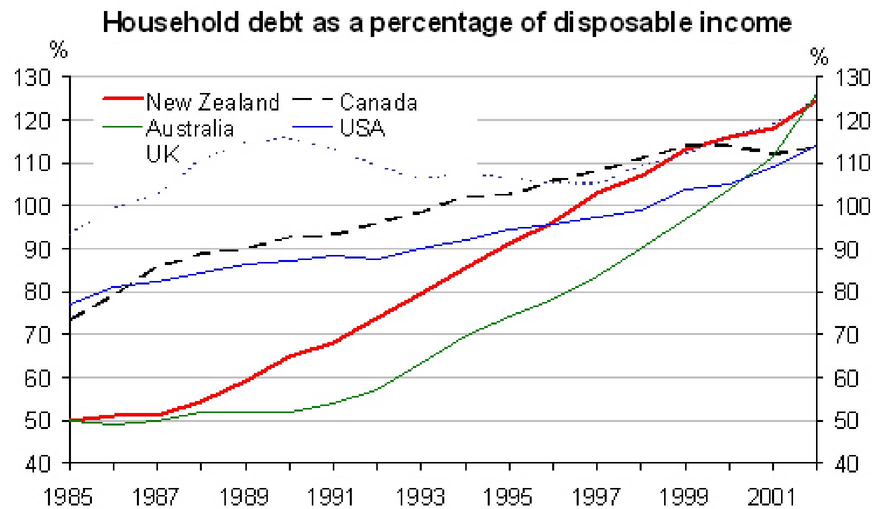
A recent speech by Reserve Bank Governor Alan Bollard[7] reinforced the *mutual* benefits for individuals, the stability of the banking system and the health of the economy generally that would flow from more effective (and by implication higher) levels of personal saving.

Some extracts illustrate this:

> "Households making well informed saving and investment decisions not only make themselves better off, but also contribute to the stability of the financial system and growth across the economy"…
>
> "Households have been borrowing heavily over the last ten years or so….and household debt compared to income is now at the highest levels on record. Debt now stands at about 130 percent of income, as against just 65 percent in 1990" (And 50 percent in 1985)

[7] Dr Alan Bollard, "Investing in a low inflation world", address to the Auckland Club and MBA Business Meeting; Auckland, 14 October 2003

Note also from the graph below that the household debt burden has been rising very rapidly in comparison with countries like Canada, the UK and the USA (though at a similar rate to that of Australia).



In addition, the rising debt has not been matched by an equivalent rise in the value of the housing asset that backs it: "…the ratio of household debt to the value of the house…has drifted upwards in the last 20 years or so, from 15 to 20 percent in the mid 1980s to around 30 percent today".

"The financial health of households is important to the stability of the New Zealand financial system and the New Zealand economy. Households that borrow do so almost entirely from banks, and lending to households makes up about 40 percent of total bank lending. Therefore the ability of households to service their debts is crucially important to the health and soundness of banks and the broader financial system"

"Partly as a result of strong household borrowing over many years, New Zealand has a very high ratio of net external financing relative to our GDP – indeed, one of the highest ratios of any advanced economy. Currently, New Zealand's net financing from offshore stands at about 90 percent of GDP, compared with just 60 percent for Australia, 25 percent for the United States and 15 percent for Canada."

"Lastly, we are interested in investing and borrowing behaviour because it affects economic growth. New Zealand's growth in the past has probably been lower than it could have been, partly reflecting poor savings and investment."

There is sufficient evidence and opinion to lead us to conclude that there are public policy, personal, and commercial benefits to justify a reasonably

concerted programme of mutually reinforcing measures to lift work-based savings.

We are not qualified or mandated to judge just *how far* such a programme should intrude on personal choice and employer obligation. We have therefore developed a stepped “pathway” of escalating interventions and it is a matter of policy discretion as to how far up that pathway it is appropriate to advance.

What we have tried to do is to say that at each step along the pathway, we offer what we consider to be the optimal design for the particular solution.

2.2 The starting point

Any movement along the pathway starts from where we are now and it is important to define that.

The existing “second tier” in New Zealand is a mix of:

- Voluntary provision of access to schemes by employers.
- Voluntary contribution by employees if a scheme is provided.
- Tax neutrality (or tax disadvantage if employees save through products that are taxed at a rate higher than their personal marginal tax rate and/or are able to save through private vehicles that in effect allow them to migrate across the revenue/capital boundary).
- A disclosure-based regulatory regime, applying to all publicly-offered securities
- An inflexible registration regime, applying to superannuation schemes, in addition to the disclosure-based regulatory regime.

There are, as a result, weak incentives on employers to offer, and fairly strong disincentives on employees to join, work-based savings plans.

Perhaps predictably, the proportion of the workforce that is contributing to registered, occupational schemes is low, and was steadily declining for a decade until the recent introduction of the State Sector Retirement Savings Scheme. {Membership of such schemes had declined from 22.6 percent of the employed workforce in 1990 to 13.9 percent in 2002}. In addition:

- Schemes that are open are substantially a result of industry tradition or of historical accident.
- These schemes are offered by very few employers (the base is narrow). We have analysed data from different sources, and while conclusions are necessarily tentative, it seems as if almost 30 percent of the contributors to occupational schemes are employed

by as few as 45 firms. Any attempt to focus a solution on extending access to, and increasing participation by, employees of firms that currently offer superannuation to some employees will not achieve a broadly-based increase in participation.

- Schemes tend to be somewhat elitist in that they are available to limited categories of employees (managerial, professional, permanent and long-term staff). {This was a finding of the ESR Consortium survey carried out for the Periodic Report Group.}

There is some anecdotal evidence that this rather hostile environment arose out of, contributed to, and reinforced a change in, employment philosophy and practice based on "total remuneration" principles. It is also likely to have been underpinned by the introduction of full taxation of fringe benefits in general.

That philosophy may be changing (as evidenced by some movement away from total remuneration towards cash plus benefits, alongside the introduction of the new State Sector Retirement Savings Scheme), but the breadth and pace of any such change cannot be quantified.

In the absence of more compelling evidence to the contrary, the Group has concluded that (episodic examples aside) current practice will not alter materially if the *status quo* prevails. Change will need to be orchestrated.

2.3 Reinforcing the foundations

Despite the negatives recorded above, we note that it is vital that work-based saving does not deteriorate further. Despite all of the "hostile" elements of the tax and regulatory environments, the fact remains that as at 30 June 2003, some 264,000 New Zealanders were saving through registered employer superannuation schemes, which had combined assets of nearly $10 billion. That represented 14 percent of the labour force, with an average personal fund balance of $37,000.

Any new generic scheme would build contribution numbers and member balances slowly, and those gains would be rapidly and materially counter-acted if design features gave either incentive or excuse to close existing schemes and distribute fund balances.

Our first building block in any solution is therefore to protect the base of the pathway.

We recommend achieving that in four ways:

(i) Updating and streamlining the regulatory regime that applies to occupational superannuation schemes. This should reduce compliance costs and increase the flexibility through which to make improvements/amendments to those schemes without first eliciting member consents. The regulatory regime that applies to superannuation schemes should be no more onerous than is

necessary to deliver acceptable levels of contributor protection, and no more expensive or intrusive than applies to any generic scheme.

(ii) Exempting employers who offer occupational superannuation schemes from compliance with any additional requirements prescribed for a generic scheme (such as the need to enrol new recruits in a scheme unless they opt out, and the need to establish an arrangement with a provider as a default destination for the savings of the employee), for all those categories of employees who have access to the existing scheme (i.e. not just those who are members of the scheme).

(iii) Ensuring "no less favourable" treatment of existing scheme members compared to potential contributors to a generic scheme in the event that any "sweetener" is introduced to encourage or reward savings in work-based schemes.

(iv) Moving towards tax neutrality in the treatment of these schemes compared to any tax advantages that can be obtained by saving through other vehicles, by saving in retail financial services products, or by saving through vehicles that might be approved under the generic model.

2.4 The light on the hill

In defining how our recommendations might shape orchestrated change, we have defined where work-based savings might end up in an idealised "world view". We have called this guiding destination a "light on the hill", and it is an aspirational target rather than an immediate operational one.

Compared with now, under the light on the hill:

- Employer schemes spread beyond the narrow range of firms currently offering access to schemes.

- That spread has a qualitative dimension: to lower-paid, casual and part-time workers and women ("who" is as important as "how many").

- Employers are confident that they are not legally liable under various statutes. {Perceptions of criminal and civil liabilities are likely to be a factor reinforcing employer reluctance to offer access to schemes}.

- Schemes (unless exempted) have special features that encourage participation
    - access at the time of engagement (no qualifying period)
    - universal eligibility (part-time, casuals etc)
    - automatic enrolment

- automatic contribution increase options (escalators)
- portability, with change of employer

As noted in chapter two, all of these features are associated with higher participation in any schemes that are accessible through workplaces.

- Savings products are simple and clear

    - transparent and comparable fee structures
    - backed by an effective information programme that ensures that choices made are well informed
    - simple and effective communication of developing contributor entitlements
    - default options to avoid the inertia associated with choice overload.

- Solutions align with the life cycle needs of savers

    - (changing) blend of personal insurance, saving and retirement saving over the life cycle
    - access to savings at key life milestones
    - savers shift to the optimal risk/return mix as their personal circumstances change (age, income, assets)
    - greater diversity of cost-effective retirement options (annuities etc).

- Regulatory regime is appropriate to the level of protection needed by savers

    - registration or disclosure-based, but not both,
    - strong deterrents for fraud and criminality rather than excessive front end compliance
    - practice develops a wider trust in the integrity of savings products.

2.5 Moving toward the light: the "players"

There are three "active" players in the process of increasing work-based savings: the employers, who have to deduct contributions; the industry, which has to offer products, and the workers, who have to sign up and stay in any scheme on offer.

The employers

The terms of reference require us to include, "unless they are shown to conflict with core aspects of a solution,…access for all employees (including part-time and casual) in a scheme as a result of their employment, including a salary or wage deduction facility for employee contributions."

Business NZ is concerned about the potential for significantly increased compliance costs that would arise from mandatory offering. That in itself does not conflict with “core aspects of a solution” unless the compliance cost increases in particular circumstances (size of firm, rudimentary nature of payroll system, nature of industry) are disproportionate to the potential increase in saving. Business NZ did not quantify the likely dimension of these costs, and we are not able to reach a general conclusion that they conflict with a core aspect of any solution.

Business NZ did, however, draw attention to the complexities of the modern workforce and the implications of those for automatic deduction facilities. Complications include the incidence of casual and seasonal employment, and the variability of earnings associated with payments for shift work, overtime and work on weekends and on public holidays.

We are aware of a more general concern that the government has about the compliance costs of small business, and had a brief discussion with the Ministry of Economic Development about that. In particular, we were aware that the government is considering adopting the UK rule of thumb to “Think Small First”. In simple terms, if a process works for a small business then it is likely to work for a large one, but the reverse of that should not be presumed.

Our discussions led us to two conclusions:

- All (but especially small) businesses already make a number of payroll deductions (for PAYE, ACC earner premiums, student loan repayment, child support payments and attachment repayment orders for things like unpaid fines).

- The government is considering a (capped) subsidy for the use of payroll agents.

This allowed us to identify two, non-exclusive, options to deal with the compliance cost and complications question should a new generic scheme be introduced. The first would apply to all businesses, the second to small businesses.

The solution is to ensure that a minimum of new processes or requirements are imposed on businesses outside of their existing obligations. This could largely be achieved by simply assigning a new tax code to workers who were saving through the generic scheme. The tax scales would be set to add the savings contribution to the tax payable, and the savings element would be diverted to a holding pen under the oversight of a central scheme administrator. Because no one worker could have more than one tax code, those with a code that took precedence (such as repaying a student loan), would need to make voluntary bilateral arrangements if they wanted to save through the scheme. The point, though, is that the employers would have no extra obligations: they would merely make deductions against the tax code

applicable to each employee and remit the money that applied under the relevant deduction scales that IRD supplies to them.

The contributions would be paid in exactly the same way that student loan repayments, ACC levies and similar deductions are paid: to IRD.

We did consider a further simplification: making the deduction against the same code as for student loans, so employers would not even have to administer another tax code and the related set of tax tables. {In this "super-streamlined" regime, if an employee had an outstanding balance on a loan, the contribution would be used to pay off the loan, and if not, it would go to the savings account}. We decided against this for three reasons. One was that we did not want to associate the scheme with any negativity that might surround the debt repayment aspect of student loans (workers are not paying off a debt to the government, they are saving for themselves!). The second was that it is not known if the IT infrastructure of IRD could handle an enhanced functionality on the potential scale of such a regime. Finally, there was some concern that the student loan repayment rate may be too harsh for a savings contribution rate. Having a special tax code and associated deductions table allowed a lower contribution rate to be built into the savings system.

Although employers would have an additional tax code to administer, we consider this to be a close to nominal addition to compliance costs.

The disadvantage with this form of mandatory offer is that employees with outstanding student loan balances, or with any other tax code that took precedence, could not access a scheme *through this vehicle.* They could do so through other voluntary or agreed processes (separate direct deduction agreed to by the employer to a savings account, or by periodic direct payment, or direct debit through a bank account). Any arrangement would be outside of the mandatory obligations of employers.

That disadvantage is likely to be nominal rather than substantial:

- Paying off student loans is a form of savings anyway;

- It is unlikely that significant numbers of persons paying off student loans would wish to make substantial savings in addition to that;

- The savings associated with the reduction of employer compliance costs would far outweigh the marginal increment of total savings generated by employees wanting to both pay off student loans and save through this deduction facility (if savers were that dedicated they would find other ways to save).

We appreciate that there is a risk that compliance costs for businesses might nevertheless increase because:

(a) the numbers being covered by the special tax code might increase substantially compared with the more limited catchment of the student loan repayment regime; and

(b) there will be more frequent switching of tax codes (with a generic savings regime, the employee could withdraw: an option not available to the ex-student).

We identified five options to deal with this.

- Employers below a certain size could be exempt from any automatic enrolment regime. Where the employer employs five or fewer employees, there is likely to be a working proprietor (and sometimes a spouse) who might not be on a PAYE system. They then do actually have to do something different to comply, and the compliance costs of any system start to become significant. Exempting employees with five or fewer employees would exempt about 75 percent of enterprises but only place 23 percent of employees outside of an automatic enrolment catchment.

- Employees should not be able to vary their election (either suspending contributions or varying the rate of contribution) more than annually and then only when they supply the annual details of tax status to the employer. There would therefore be no extra handling of tax code forms for employers.

- There should be no capacity to vary contribution rates via the PAYE deduction facility (one deduction table only). Any variation in the contribution rate would be effected by the individual making a voluntary and direct contribution to the provider, or by ceasing or suspending contributions by going back to a standard tax code.

- Contributions should only be required from employers covered by the IRD electronic filing system “ir-File”. Coverage of the scheme would therefore be linked to the roll-out of ir-File, and would be accompanied by almost no noticeable increase in compliance cost.

- The final option was not strictly within our terms of reference, but is presented for completeness. When setting the amount of any subsidy for the use of payroll agencies, the government should take account of the likely costs associated with a greater volume of non-standard tax codes that would be associated with the direct deduction facility relating to a generic scheme.

These options are all “live”, but we are working from a combination of:

(a) no requirement for automatic enrolment for employers with five or fewer staff, and

(b) a single contribution rate with the only variation option being to revert to the standard tax code.

The industry

Business NZ did not favour mandatory offering, and because automatic enrolment is more intrusive than access, it would not favour that design feature for any generic scheme. The Investment Savings and Insurance Association, on the other hand, supported mandatory offering but did not favour automatic enrolment. The reason was that there would be costs to employers associated with arranging and cancelling payroll deductions and for scheme providers in enrolling and providing annual reports to members who subsequently become inactive.

We have responded to the "small transaction, high turnover" problem in three ways.

(i) By channelling all deductions into a "holding pen" managed by a central scheme administrator, a number of the logistical problems faced by the industry are overcome. Those who opt-out at the front end would receive their money back without it ever passing through a provider.

(ii) By creating a central registry function within the scheme administrator, there would be a central database that tracks contributor and provider and does the switching when the employee changes provider, so that there is never more than one contributor matched to one provider (unlike the multiple small balance accounts for each individual in Australia).

(iii) By combining a holding pen function with a "*de minimis*" contribution level, funds would transfer in cost-effective transaction sizes.

The workers

There are a number of design variations that can be attached to a basic automatic enrolment scheme. The "basic" scheme is that employees "enrol" through having contributions deducted from salary using a particular tax code.

The variations are:

- Whether the enrolment is of all employees as at a particular date, or only enrolment of new employees at the point of engagement. {If automatic enrolment is only of "new hires", existing employees

would still have the capacity to enrol through the mandatory offering rule}.

- Whether employees can cancel the automatic enrolment at the time of engagement, or only after a pause.

- Whether the pause is a short time (such as a month), or a longer time (three months, or the start of the next tax year, or subject to notice period like three or six months.)

- How much of any contributions balance can be recovered at the point where the automatic enrolment is cancelled. The two options are for all balances to be recovered, or for recovery to be limited to contributions made after the last tax year anniversary.

The advantages and disadvantages of each variation are reasonably clear. Limiting enrolment to new hires works off the “gone before it is noticed” factor. Automatic enrolment of existing employees would generate an initial cut to disposable income, and might discredit the scheme as a whole.

The disadvantage is that a substantial proportion of the workforce would not be enrolled for some time and more stable and longer serving employees (who are probably those most able to save) would be the last to be captured by an automatic enrolment focus.

The longer the pause associated with withdrawal, the more likely it is that participation would increase, but the administrative costs associated with returning contributions would tend to increase, and the risk of resentment (“its my money”) increase. {With cancellation at point of engagement an option, no contributions need to be refunded, but there is an increased risk of “contrived” compliance: employers automatically enrol the new recruit and pass over a withdrawal form at the same time}. This balancing act is critical to the success of a generic scheme. Too long, and it is has negative compulsion connotations, too short and it is less effective in establishing *status quo* behavioural practices. The options are discussed in more detail in chapter three.

Under this scheme, the worker is enrolled when engaged, but can opt out. Hence there is free choice. The matter that remains is whether the worker is able to choose the provider of the savings product.

The most cost effective design would be for there to be no choice of provider. A central fund (like the NZ Superannuation Fund) would select various fund managers, and the contributor would simply nominate (from say three or four) their preferred risk profile.

We do not favour this centralisation of provider. It would in effect constitute a nationalisation of this part of the market. While there might be scale economies obtainable in the short term, there are risks that the absence of competitive pressures would see these dissipated in the longer term. In

addition, undermining the financial base of the industry by excluding it from providing generic work-based savings products would likely reduce its effectiveness in providing other forms of (retail) savings products, and mute the overall impact of the new regime on total savings levels.

Another risk is that with a single provider, there could be negative perception effects when share markets decline. ("The government made me save in this fund and lost my money").

This does mean that there would need to be a choice made about where the funds accumulating in the "holding pen" were sent to. There are in effect two choices:

(i) choice of initial provider, and
(ii) capacity to switch provider by choosing a different one.

There is a substantial body of evidence that too much choice can be a dangerous thing: confusing contributors and creating some inertia. Recent experiences with the State Sector Retirement Savings Scheme indicate that choice overload was a factor in delaying uptake of a savings option. However, if a competitive market is to be retained, choices must be made.

We recommend that the choice of provider at the entry level (first scheme that the employee is enrolled in) would be made by the **employer.** Decisions to switch or transfer would be made by the **employee.**

The advantages of the employer choosing the provider would be:

(a) it would avoid the main problem of choice causing confusion and inertia (i.e. where the employee feels overwhelmed);
(b) it would retain the essentially wholesale nature of the offering and reduce the costs that would be associated with competitive offering in the retail market;
(c) it would allow the employer to choose a provider and a product that fitted best with that employer's need for and use of savings in its human resources strategy, and have a greater chance of leveraging an employer subsidy of the saving;
(d) there would be reduced administrative costs associated with notification of the chosen provider.

The employee could transfer or (perhaps more likely) remain with the initial provider after a change of employer.

The problem that remains is what happens when an employer has not chosen a provider, despite an obligation to do so.

There are two options:

(i) The central scheme administrator selects a random provider from the approved providers;
(ii) There is a national default provider selected by the provider approvals panel after a competitive tender.

The advantage of the first option is that it avoids perceptions that the default provider has been specially selected and is either government approved or (worse) government guaranteed.

The advantage of the second is that a competitive tender might drive down fees across the industry as a whole, and “anchor” a low cost alternative as a discipline on the other providers. A disadvantage is that perceptions of “best on show” might mean that rival providers are squeezed, and variety and choice narrow over time (“foot in the door monopoly”).

Setting the contribution rate

The contribution rate selected for any generic scheme could be:

(i) a percentage of salary (with a minimum contribution level)
(ii) a percentage of salary above some basic exempt base.

The latter is favoured because it allows for low income groups to remain in a scheme (low effective contribution rates at the lower ranges of contributory income) and for contribution rates to rise as salary rises (and contributions become more affordable).

It is a second question as to what the contribution rate above the exempt threshold should be. We recommend that acceptable levels of contribution be set after some focus group testing. However, it is important to set a contribution rate after considering *both* what is affordable *and* the desired savings target. If aspirations are for a reasonable end balance, it may be necessary to “stretch” contributions.

In appendix III we model some scenarios, showing the effects on final balances (expressed as a percent of final annual salary) of different starting ages and salary levels (after making some assumptions about earnings on funds and salary escalation rates). We have used two rates in the comparison: ten percent and five percent above the exempt base. The final balances vary dramatically. The tables provide a clear indication of the nature of the trade-off between meeting the savings target and making contributions “comfortable”.

We also note that the higher the contribution rate, the more likely it will be that a 30 day “holding pen” will cause problems and complaints. Conversely, if the rate is low, for any given level of *de minimis* contribution, the cut-in salary level will be higher. Paradoxically (or perhaps by design), a lower rate excludes a greater proportion of low and middle income earners from the automatic enrolment mechanism.

Choice of contribution rate

While in theory it might be desirable to allow employees to choose contribution rates that fit their life circumstances and savings preferences, this would add considerable complexity and compliance cost at the level of payroll deduction, and considerable confusion and inertia at the level of the individual.

The mechanism we recommend for any generic scheme is not consistent with choice of contribution rate.

Either:

(a) if there is a desire to build this flexibility into scheme design, it would have to be built into a customised scheme that sits outside of the generic scheme; or

(b) choice of contribution rate could be achieved *ex post* through a *variation* mechanism outlined below.

Variation of contribution rate

Ideally, employees should build up contribution rates as life-stage events pass (paying off a student loan or a house, children leaving home, promotion etc). This would, however, add significant costs to employers.

{By way of example, the "student loan repayment" regime **does** have a capacity to increase the contribution rate, but these discretions only last for one year, and there is limited choice.}

The main problem is that depending on the contribution rate set for salary increments above the exempt thresholds, the contribution rate can become quite high, and the capacity to vary the rate may well present more often as a desire to **reduce** contributions.

Escalators

"Escalators" have been shown to increase contribution rates.

These escalators are built into the deduction mechanism recommended in this report, because with a set percentage contribution above an exempt threshold, the effective contribution rate rises as salaries rise over time.

Lock-in versus access

Our terms of reference require us to include

> "a method to generate long term savings that contribute to well being in retirement, such as lock-in of contributions until retirement except in limited circumstances…"

> and to address the question
>
> "If early withdrawal of contributions are allowed, what circumstances would apply to allow for such earlier withdrawal of contributions?"

ISI is particularly harsh in recommending that "withdrawals will not be possible for other purposes before age 55 (at the earliest). We (ISI) do not support the proposal to allow withdrawals for limited purposes…."

Our Group has a lot of difficulty with this logic. If there is no tax incentive or subsidy associated with savings, why should employees lose access to funds? What is the "benefit" they are expected to get for the cost of loss of access? We cannot find one. There may be a logic in employers only offering subsidies if it is a subsidy of retirement savings, but our terms of reference stop short of our recommending compulsory employer contributions.

This is a core tension in our task: how to achieve long-term savings in a voluntary regime when there is no objective benefit to the saver. Savers can simply avoid the cost by walking away from the generic scheme and saving through personal, non work-based plans.

The Singapore experience is that drawing out savings is not necessarily a bad thing anyway. Periodic access to savings reinforces positive messages about the advantages of saving, and can contribute to savings habits and more of a savings (as opposed to a debt) "culture". It also relates the use of savings to life-stage need, so that when a life-stage associated with pending retirement ("mid-age") is reached, there is a greater chance that people might accelerate retirement related provisions.

Any constraint on access might work on a psychological level (out of reach, out of temptation). It is, though, arbitrary, and the balance between achieving a result (lock-in) and reducing participation might usefully be explored through focus group work before a final formula is settled on.

The design details that apply to access are discussed in more detail in chapter three.

<u>Fees</u>

Fees are a significant factor in influencing both perceptions of value for money in contributing to a scheme, and in the actual returns from contributions. Both factors will impact on the willingness of employees to join or stay in schemes.

The issue is currently a high profile one in New Zealand, with the Consumers Institute and media commentators ensuring that there is a close scrutiny of providers' charges.

The Olivia Mitchell simulations conclude that only a 50 basis point fee will erode the final balance of a working life pension by one-eighth, if the fund

achieves a rate of return of 6 percent a year. A 100 basis point fee will erode it by 25 percent. These are large intrusions into the value of savings. However, the simulations beg the question about whether the rate of return will itself justify the additional fee, or if a low fee or fee capped product will earn 12 (or 25) percent less over the term of the product.

For reasons associated with the UK (and to an extent Irish) experiences we recommend against fee caps, but do tend towards transparency and comparability in fee disclosure regimes.

2.6 "Solutions"

As noted, we have produced a range of solutions, rather than a single solution. Each reflects different end destinations along the pathway.

In the next chapter, we drop down into the detail about how each element in the range would work. This is because we interpret the terms of reference as requiring more detail than would be associated with a high level "basic principles" report.

The detail may give the impression that the solutions are complex. They are not. The consistent theme in our discussions is to make a generic work-based savings system simple, clear and effective.

As a result, the options we have settled on:

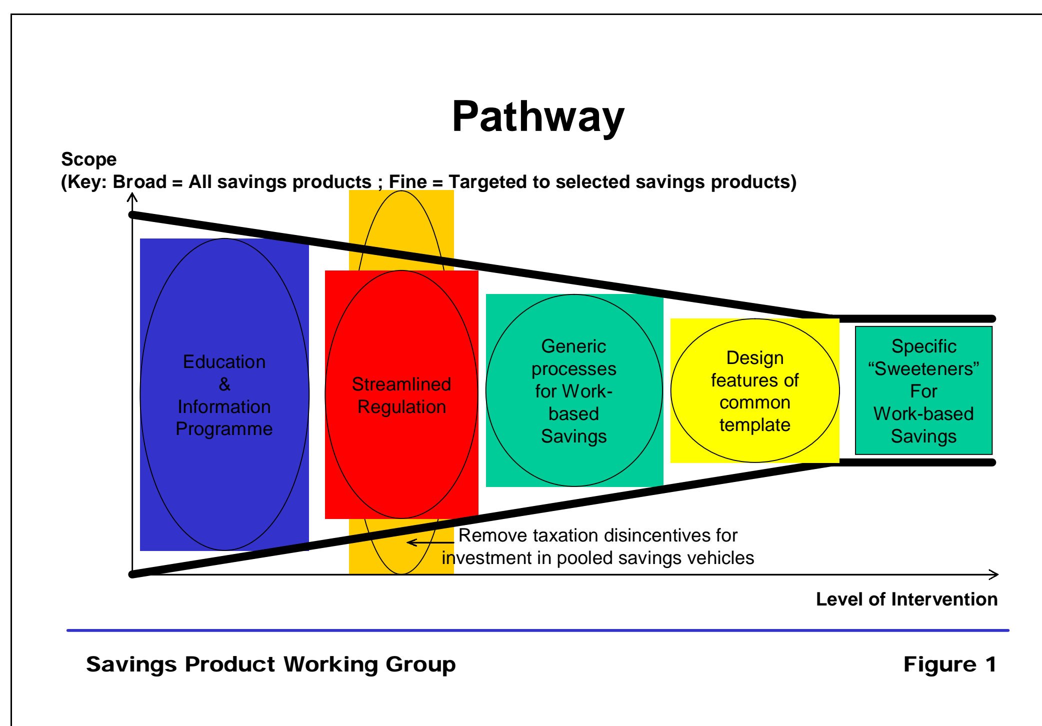
- Develop a much more simplified, flexible and consistent regulatory regime.
- Move towards a more tax neutral treatment of savings vehicles.
- Impose minimal compliance costs on employers.
- Make it as easy as possible for employees to take up work-based savings opportunities, but preserve choice for those who want to exercise it.
- Collect contributions and distribute them to providers in a cost effective way, and maintain a register matching contributors and providers.
- Ensure that payments to providers are in realistically sized amounts.
- Provide for transparent and comparable fees.
- Ensure that education and information promotion programmes are appropriate to the enhanced level of individual responsibility that our proposals envisage.

3 DESIGN DETAILS

The “pathway”

In chapter two of this report we introduced the concept of defining a “pathway” of escalating levels of intervention that are likely to lead from the *status quo* (at least some way) towards the light on the hill. It is a matter of public policy as to how far to travel, although we offer some views of our own in the following sections of the report.

The pathway works to reverse the impact of the behavioural influences outlined in chapter one. Figure 1 illustrates the grouping of options along the pathway representing increasing levels of intervention and more focussed targeting of the intervention moving from left to right.



Savings Product Working Group **Figure 1**

Each element along the pathway builds on the preceding options. At the more targeted and invasive levels of intervention it is contemplated that options can be phased in over time, or relate only to workplaces above a certain size (either in terms of number of employees or payroll size).

The “pathway” sets out a set of rising obligations, but within what remains an essentially voluntary regime.

Progress towards the light on the hill requires, at a minimum:

- Employer acceptance of the importance of work-based savings.
- Employer enthusiasm in promoting access.
- Employee participation in schemes.

However, this attitudinal and behavioural change needs to take place within a work-based savings environment where the advantages to an employer of offering a savings facility (ability to recruit and retain workers by differentiating the employment package, building an image of a progressive employer) are limited. It is also required in an environment where the dominant commercial motive of the finance sector is to market *credit,* not to encourage savings. (There is no pressing need to raise the funds for on-lending because institutions intermediate offshore savings for onshore lending, to the tune of 90 percent of GDP!)

Short of direct subsidies and tax incentives (which, based on overseas evidence, appear to be expensive, inequitable and ineffective in terms of raising overall savings rates), various measures could be considered that would encourage the change in attitude and practice that is needed. Contributions could come from a mix of appropriately resourced, relevant government agencies (IRD, Employment Relations Service, MED), specialist agencies like the Retirement Commission, “customised” support groups and industry agencies and participants.

3.1 Education and information programme

Three elements that need to come together to support the entire pathway are:

(i) Education
(ii) Information and
(iii) Promotion

Education is a key lever on hand for public policy. It can help people make more informed personal financial decisions, whether to save and how to save, for example. This element of a communication programme should also reach the general population spanning families of employees and potential employees.

Information about processes, products and solutions will need to be developed to ensure smooth introduction and ongoing implementation of novel steps along the pathway. It should be accessible and appropriate, matching the needs of key workplace leaders to ensure buy-in and support inhouse dissemination, as well as clarifying key aspects of importance to employees. In the past, this type of information has not been clear and at times has been of little use to the ‘saver’ in making decisions about their money.

Promotion, as a separate element, will help make people aware of new initiatives, and/or about the education and information sources available to them. The government would need to decide at what level it can fund a behaviour change campaign. Recent experience of campaigns around second-hand smoke, sun exposure and education suggest formation costs lie between $250,000 and $400,000, media and communication elements form the main part at $800,000 to $1 million for a year, and support and evaluation layers add another $200,000 or so.

To support communication of the work-based savings pathway to "the light on the hill" would involve a sequence of actions spanning:

Employers (Particularly CEOs, CFOs, HR managers)

(i) Informing employers of the commercial and professional gains their company can benefit from as a result of offering a workplace saving scheme e.g. employee retention, loyalty, peace of mind.
(ii) Give employers information about workplace schemes, streamlined registration, generic solutions and any specific sweeteners they can easily adopt and administer without unrealistic compliance costs.
(iii) Create and disseminate resources and provide personal assistance on workplace schemes that employers can offer their employees.
(iv) Continue to update progress and development of workplace schemes. Develop an acknowledgement system ("socially responsible employer" type award).

Employees

(i) Highlighting the issue that individuals and families need to prepare for their retirement.
(ii) Offer a solution to retirement savings by having their employer administer a trusted workplace saving package (including outlining any sweeteners).
(iii) Ensure those employees who want further information on workplace schemes are given it.
(iv) Ongoing reports of progress and personal net worth growth should continue to maintain inclusion in a workplace scheme.

The Retirement Commission has one resource, its public education programme *Sorted,* within which is a range of personal financial information services available that target employers and employees. In its present alignment this system supports all aspects of generic products and processes and it would be well placed to continue in this role in support of new steps along the pathway.

There would also need to be a complementary communications strategy, driven by those implementing the changes, so that the informational and

promotional aspects of new products, solutions and processes come in alongside a general educational push.

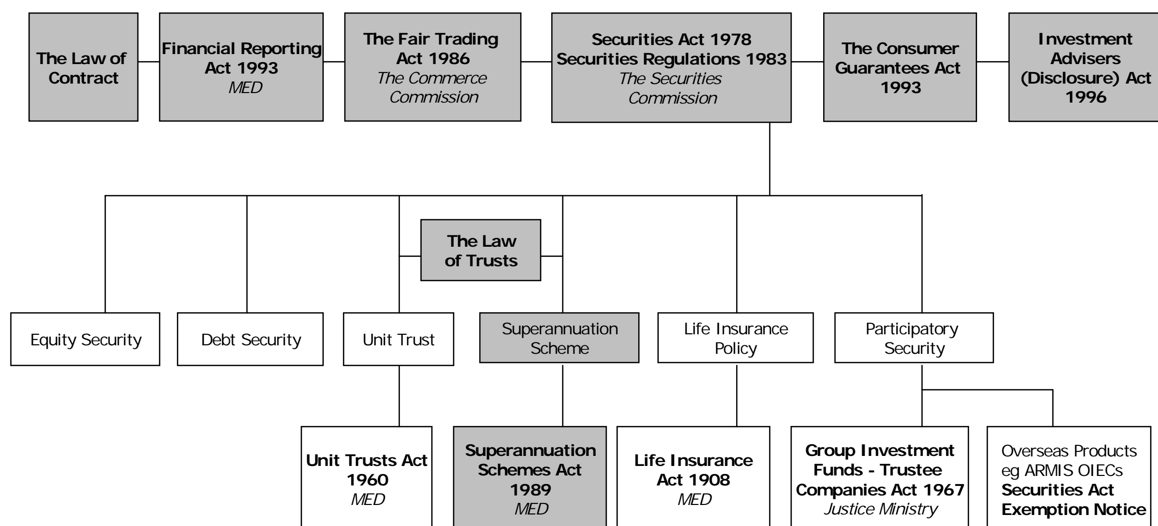
Finally, both the PRG report and comments made to us, stress the vital role that trusted (and independent) "champions" can play in carrying the message about savings into workplaces. These champions can be particularly important in providing reassurances about choice of fund, and in communicating key messages about managing long-term savings (and not reacting to every short-term market fluctuation). By their nature, "champions" are trusted and enthusiastic, and cannot be government or provider "agents". This does mean, though, that trustees, unions and employers need to be aware of the importance of reinforcing the savings message through independent communications channels.

3.2 Streamlined regulation

During consultation we discovered that the low level of interest shown by employers in the voluntary provision of access to savings results, to a significant extent, from perceptions of cost and risk caused by regulatory requirements.

3.2.1 Overview of existing regime

The following diagram sets out an overview of the regulatory structure governing publicly offered securities, with the shaded boxes setting out the regime applying to superannuation schemes:



A particular feature of the regulatory structure applying to superannuation schemes is "regulatory overlap". As well as being subject to a range of consumer protection legislation and the disclosure-based regime prescribed in the securities legislation, registered schemes are governed by the Superannuation Schemes Act. This provides the framework for the registration of schemes, and prescribes:

(i) protective provisions concerning matters such as scheme alterations and transfers between schemes (various notice and consent requirements);

(ii) requirements for the preparation of annual accounts (which must, with exceptions, be audited) and the provision of annual reports to members (in prescribed form);

(iii) a range of request disclosure entitlements for both prospective and current members (trust deeds, actuarial reports, valuation assumptions and accounts);

(iv) a requirement for three-yearly actuarial reports where a scheme is funded on an unallocated basis; and

(v) "whistleblowing" provisions protecting scheme advisers from civil, criminal or disciplinary liability when disclosing to the government Actuary any serious problem with the administration of a scheme.

The Government Actuary has various supervisory powers over registered schemes. Those include cancelling registration or ordering winding up where he or she has reasonable cause to believe that the scheme is not operating in accordance with the Act, or that its financial position, the security of members' benefits or scheme management is inadequate. Trustees can be required by the Government Actuary to supply specified information.

Additionally, registered superannuation schemes must have as their principal purpose the provision of retirement benefits to natural persons, or paying benefits to the trustees of other registered superannuation schemes. Schemes may not be promoted or operated in a way that might resemble a normal banking account, by enabling natural persons to draw on funds too easily and regularly in the non-retirement situation. However, there are no absolute "lock-in" requirements preventing or limiting pre-retirement withdrawals from schemes.

3.2.2 Key problems with existing regime

The key problems identified by the Group as meriting some attention include:

(i) The perceived risk of liability owed by employers as "promoters" under the Securities legislation when facilitating access to savings products. While perhaps overdone as a potential risk, because trustees/product issuers are principally liable for untrue statements, potential promoter

liabilities are routinely identified by employer groups (along with cost concerns) as a material impediment to greater take-up of schemes;

(ii) The risk of employers becoming "investment advisers" when facilitating access to schemes. Employers express significant concerns over the legal implications of giving "advice" in this context. The Investment Advisers (Disclosure) Act (IADA) prescribes that investment advice includes any "recommendation, opinion or guidance" given to a prospective subscriber, so an employer representative responding to an employee request for advice on externally managed funds thereby risks becoming an "investment adviser" subject to the mandatory and request disclosure obligations (and enforcement procedures) prescribed in the IADA. This concern is heightened by proposed changes to the IADA, whereby investment advice will not be permitted without the adviser first disclosing certain key facts;

(iii) The requirement in the Superannuation Schemes Act that a scheme be established "principally for the purpose of providing retirement benefits". This is inappropriate where there are no tax or other incentives justifying a restrictive "lock-in". It can disincentivise new members from joining and

(iv) The restrictions in the Superannuation Schemes Act on transfers between schemes (which require written consents even where members are to be transferred to a no less generous replacement scheme) and on scheme amendments (restricting, according to some interpretations, otherwise beneficial amendments that will or might reduce existing members' contingent wind-up benefits).

Another difficulty identified by commentators concerns the existing Securities Act disclosure regime, particularly as it relates to superannuation and savings products. The content prescribed for investment statements, in particular, is considered overly detailed and too generic to provide the readily understood key information to potential savers, which is its primary purpose. Anecdotal evidence from the recent launch of the State Sector Retirement Savings Scheme has reinforced this impression.

There is scope, in the Group's view, for exploring an approach whereby schemes are permitted either to provide investment statements or alternatively to provide a suitably focussed product disclosure statement of the kind already contemplated in the Superannuation Schemes Act (under provisions which do not apply where an investment statement is required).

3.2.3 Streamlining existing regulations

Desirable changes identified by, and in submissions made to, the Group for the purpose of streamlining existing regulation, and thereby reducing costs and risks (both real and perceived) which currently limit or impede employer take-up and the development of schemes, include:

(i) clarifying the Securities legislation to prescribe that an employer which simply facilitates access to a scheme or product by way of payroll deductions is not a “promoter” and has no attendant liability. It is also essential for employees to be very clear that their participation is voluntary and that the role of the employer is that of a conduit, not a promoter;

(ii) including in the Investment Advisers (Disclosure) Act an exclusion from the “investment adviser” definition, or other compliance relief, which protects employer representatives from potential liability when advising employees about participation in an externally managed scheme; and

(iii) for existing schemes in particular, pursuing amendments to the Superannuation Schemes Act to:

- relax (or remove) the restrictive “principal purpose” requirement, which the Group considers unjustified;
- permit bulk transfers between schemes, or sections within a scheme, in certain circumstances without the need first to elicit member consents; and
- clarify the Act’s restrictions on amendment without member consents, to resolve the current legal uncertainty as to whether certain amendments are possible if they will or might reduce existing members’ contingent wind-up benefit entitlements, despite on balance being beneficial.

The Group considers that careful attention should be given to the possibility of permitting superannuation schemes and other savings products to use a simpler and more focussed member booklet/product disclosure statement in place of a generic investment statement. In saying that, we are conscious that:

(i) any proposal to streamline disclosures in this area must be evaluated against the principles developed by the International Organisation of Securities Commissions; and

(ii) the Ministry of Economic Development “is aware of concerns regarding the efficacy of the disclosure required by the Securities Act” and will be commencing a fundamental review of the Act in 2005, involving prior research into the knowledge and behaviour of retail investors in New Zealand’s securities markets.

The Group accordingly recommends a “measure twice, cut once” approach to reform in this area. We also agree with submissions made to the Group to the effect that (as a matter of principle) any relaxation of disclosure requirements, if merited, should not be confined to any “generic” scheme or product but should extend across all forms of savings schemes.

We agree with the comment made to us by the Ministry of Economic Development that:

> *"If research indicates that disclosure under the Securities Act is widely ignored or not understood, it may be necessary to either reconsider the focus on disclosure, or alternatively place greater emphasis on investor education. But … there should not be piecemeal amending of requirements in respect to some products and not others."*

The prospectus requirement has had a significantly detrimental effect on workplace-based schemes by reason of its cost and complexity. In our view, consideration should also be given as soon as practicable to exempting all non-retail superannuation schemes from the requirement to maintain prospectuses as a condition of admitting new members. A limited exemption applies currently to a class of single employer/group "stand-alone" schemes under the Securities Act (Employer Superannuation Schemes) Exemption Notice 2004, but:

(i) it does not extend to certain otherwise "stand-alone" schemes which are not-for-profit but are not confined to a group of associated employers, such as the industry schemes through which unrelated employers in a common industry provide superannuation to their respective employees; and

(ii) the compliance difficulty and "conditionality" surrounding the existing exemption merits attention, with a view to the Securities Act itself providing a suitably robust exemption upon which employers can rely with the necessary certainty.

3.3 Remove the existing taxation disincentives for saving through work based savings vehicles

Our terms of reference note that the government "proposes to provide some degree of funding…by removing some of the current tax disincentives such as the over-taxation of low-income earners saving through superannuation products".

It may be that such "relief" will only apply to a certain category of savings products. The Group is to design a product that could be offered by several providers so that employers could offer access to the designated tax neutral vehicle.

In addition, the Working Group "may also identify where the current tax system discourages participation in work-based products".

Current tax disincentives (or perceived disincentives) occur at various stages of the savings process in a registered superannuation scheme.

These are discussed in turn:

(a) Tax on contributions

Until recently, employer contributions to superannuation schemes on behalf of an employee were generally taxed at 33 percent regardless of the employee's marginal tax rate. There is a facility available to address this at the employee level in the Income Tax Act.

From 1 April 2004, employers have the option (but are not required) to pay specified superannuation contribution withholding tax ("SSCWT") at the PAYE rate applicable to the last dollar of the employee's salary and wages in the previous tax year. So in principle this disincentive can be removed.

Member contributions come out of after-tax pay.

(b) Tax on investment earnings within the scheme

In general, superannuation schemes pay tax at 33 percent on assessable income including realised capital gains.

This creates two disincentives:

- The disincentive to save for people on marginal tax rates less than 33 percent, and

- The unfavourable treatment of capital gains compared with other investment vehicles e.g. direct investments held on capital account by an individual.

The two are linked, but in general the first tends to discourage a longer term savings *horizon*, and the second favours particular savings *vehicles*. They *can* be dealt with by a single solution, but need not necessarily be. For example, even if a TOLIS type regime was developed, it may still be preferable for workers to save through other vehicles that escape the tax treatment applied to work-based products.

There is a separate exercise under way looking at the tax treatment of managed funds (The Stobo Review). Our terms of reference cover a subset of the terms of reference of the Stobo Review.

There are three dimensions to this:

(i) The divergence between the marginal tax rate of the individual saving/investing through a managed fund and the tax treatment of the vehicle through which that saving is taking place.
(ii) The matter of the tax treatment of capital gains made by such funds (the business and purpose test rules).

(iii) Differential treatments of on-shore and off-shore investments.

The first two elements at least fall directly within areas of our interest.

A part of our response to the first might be found in regulatory solutions.

There are retail products available that assign ownership of assets to the individual member of a scheme, so that not only is the individual taxed at their own marginal tax rate, but the individual is not regarded as "trading" and is not taxed on any capital gains associated with the assets.

If other products qualify as work-based saving vehicles, the design is pushed back to the market and it has to work out if it wants to attract customers by delivering returns directly to the individual saver.

The taxation structure of the vehicle seems to be a far more relevant consideration than the issue of divergence of taxation levels from investors' personal marginal tax rates. A 33 percent marginal tax rate may in fact not disadvantage low and middle income groups. The abatement regime now applying within the Working for Families income support package – which penetrates deeply into the wage structure and will, when it matures, cover 60 percent of families with dependent children – means that effective marginal tax rates for many are now or soon will be above 33 percent, and a 33 percent rate may *undertax* them.

One observation we make in respect of the Stobo Review is that there is an inherent tension between the accuracy of tax attribution and the costs to the provider (and hence the saver) of offering the savings vehicle.

Currently a superannuation scheme pays tax at 33 percent "on behalf" of the savers invested in the scheme. One of the issues the Stobo Review is considering is whether the tax liability should be pushed down to the level of the saver, as it is with investment in many other vehicles. While this may appeal in terms of accuracy, the practical implications need to be considered. In particular, such a regime would introduce significant complications and extra costs into any generic work-based scheme such as the one discussed in this report, as presumably savers would need to complete a tax return in respect of their savings in the scheme.

A workable alternative which addresses the first overtaxation issue in (b) above, might be to tax the scheme at a proxy rate, perhaps based on the effective average PAYE tax rate of contributors.

There is still the issue of trying to justify "capturing" savings for periods of time (i.e. lock-in of a portion of any balance for some period of time) when there is no reward to the saver from having given up access to funds. If the tax system rewarded longer term saving, it would reinforce the effectiveness of our solution in meeting some of our objectives.

For example, to the extent that there is a positive return to risk in the longer term, the risk free rate of return method does not tax this return and hence tends to reward longer term saving.

We will not progress this aspect of the solution at this stage, but note that we have been in close contact with Craig Stobo, he is aware of the tax dimension of our terms of reference and we wish him well in recommending a tax structure change that ensures that the treatment of savings is consistent as between type and location of delivery vehicle.

Once the results of the Stobo Review are available, their impact on existing savings vehicles and any proposed generic scheme will need to be assessed.

3.4 Generic Process for access to and maintaining participation in work-based savings

The measures along the initial steps of the pathway tend to be relatively soft. Moving further down the pathway therefore raises the issues of the "default" design features in our terms of reference.

The terms of reference specified the following key features should be included unless they could be shown to conflict with core aspects of a solution:

- access for all employees (including part-time and casual) in a scheme as a result of their employment, including a salary or wage deduction facility for employee contributions;
- automatic enrolment of employees to such a product, unless an employee declines such enrolment;
- a method to generate long term savings that contribute to well-being in retirement, such as lock-in of contributions until retirement except in limited circumstances; and
- portability of contributions between approved products.

We interpreted our terms of reference as having two fundamental objectives; to deliver widespread access to schemes offered by employers and to ensure widespread adoption or uptake of generic work based savings products by employees. Against this background we think there are three broad options for the role required of the employer:

(i) Require (all or) relevant employers to provide access to a savings scheme. The employer and provider would have a bilateral contract, under the terms of which the employer offered to deduct contributions on behalf of employees and pass them directly to the provider. Participation by employees would be voluntary, however.

(ii) Require (all or) relevant employers to provide access to a savings scheme. Contribution deductions would be made through the tax system, to minimise transaction costs for employers and product providers. The employer would select a provider from an approved list or panel, but participation by employees would remain voluntary.

(iii) As for option (ii) above, but require automatic enrolment (with some opt-out mechanism) to attempt to overcome the risk of low employee participation in a voluntary regime.

Option (i) is very similar in approach to that adopted by the stakeholder pension regulations introduced in the United Kingdom in 2001 and the more recent Irish PRSA system. It would preserve the truly voluntary choice of the employee as to whether he or she should elect to contribute to the savings scheme. For the employer, there would be the task of selecting a provider, which with the generic regulatory changes outlined above ought to simply become a task of selecting a suitable provider for his or her employees.

However, the evidence from both the United Kingdom and Ireland using a similar approach is that the post implementation participation in work-based savings remains low and intermittent. This is despite the additional strong tax advantages available in both countries. Employers may grudgingly comply (in the United Kingdom as many as 15 percent of employers simply choose to defy the regulations), but do not promote schemes and stress rights to leave or opt out when communicating with employees.

As a result many providers have established new schemes with very few active contributing members. The strict fee caps that apply to the products in both countries amplify the impact of this, because anecdotal evidence suggests that providers are not incentivised to sell the products.

Option (ii) borrows from the design of the Swedish compulsory system in which a centralised administrator acts as a “clearing-house” for contributions made by employees to a pension scheme they choose. The strongest advantage of this over option (i) is that it would reduce some of the administrative friction and complexity that employers would face under option (i). This advantage would be maximised if the process for managing payroll deductions was identical to that used for administering the existing PAYE tax codes on behalf of employees. Similarly for product providers, it would be feasible to develop a single common interface with the central clearing-house, leading to potential efficiencies within the administration of member accounts.

Notwithstanding these benefits, there would be nothing additional under option (i) or option (ii) to increase the likelihood of the employee becoming a contributor. This would not meet the second underlying objective of our task - to deliver widespread *uptake* of the product. To that end, the balance of this chapter outlines the development of option (iii).

3.4.1 Leveraging existing payroll deduction mechanisms

To limit compliance costs on business beyond their existing obligations, we would propose using the tax system as a conduit for contributions to saving schemes.

This model is based on the existing deductions process developed for the student loans scheme. The proposal would require the creation of a new tax code (IS for example), that, when selected, would result in the contributions being deducted at source and forwarded to the IRD. The IRD would then pass the money to a centralised administration clearing-house whose role would become the allocation of contributions to a provider.

Enrolment in the scheme would be automatic on commencement of employment, but participation would remain voluntary through an opt-out process, which we outline below.

Figure 2 illustrates the basic operation of the generic process:

Generic Process Operation

Employees
J
K
L
Y
Z
Employers
A
IRD Taxation Collection Mechanism
Administration Clearing-House
Holding A/c
Providers
1
2
Savings Product Working Group

Figure 2

Employer A

Employer A has actively sought to use her buying power to negotiate a collective or group account deal with Provider 1 on behalf of her Employees J, K & L. The group account with Provider 1 becomes the default product for all new employees who begin working with Employer A. Employer A may decide to bolster the attractiveness of Provider 1's product by offering to make additional employer contributions into the product.

Employer A registers the tax code IS for Employees J, K & L and submits this information through the normal IRD taxation collection mechanism.

The administration clearing house accepts all IS tax code contributions coming through the collection mechanism. Using a unique employee identifier, possibly derived from the individual's IRD number (although there may be Privacy Act compliance issues to address if this is to be achieved), the contributions are matched to Provider 1 as the current registered provider for Employees J, K & L.

Provider 1 then matches the contributions into the collective or group account established through Employer A. Employees J, K & L are able to benefit from bulk discounts or other affinity benefits that have been negotiated on their behalf by Employer A.

The role of the central administration clearing-house is critical. From the employer's perspective the complexity of the task need not involve any more than the payroll deduction administration they are required to operate presently plus the selection of a default fund provider for employees.

The system concentrates the economies of scale in collecting and distributing contributions within the clearing house.

3.4.2 Automatic enrolment and opt-out options

The international research discussed earlier makes a powerful argument in favour of automatic enrolment. In addition the international research implies that a minimum period of contribution to the scheme is required to create some "stickiness" after enrolment and to avoid any token compliance by employers.

The length of the minimum period of contribution is a critical area of the detailed scheme design. The creation of "stickiness" will probably serve to overcome inertia and encourage participation by those who might otherwise have "never got around to it". Against this however, holding money, even for a short period, may generate resentment and discredit the scheme for those who have neither the intention nor perhaps even the need to persist with voluntary contributions at the expiry of the minimum period, particularly in the absence of any obvious advantage to the saver in doing so (e.g. a tax break on the contribution).

We considered four options:

- Opt out from day one, via the employer. Whilst perhaps the most attractive option for employees, this would carry a high risk of effectively negating automatic enrolment, rendering the process an unnecessary administrative loop, possibly encouraged by the employer.

- Opt out from day one, via the scheme administrator. This would add a small additional step in the process that may help to create the environment that helps those who might not otherwise get around to it.

Employers could however arrange processes or systems to render the process a more cumbersome version of the first option and merely an unnecessary administrative loop.

- Opt out after 30 days, consistent with other decision-making cool-off periods required by the Employment Relations Act. This would go some way toward achieving the objective of balance between creating habitual regular contributions to savings and allowing individual freedom of choice whether to participate. Notwithstanding this, it is questionable whether 30 days is an appropriate length of time to allow the habit of regular savings contributions to form and there is certainly the risk that for some people even a 30-day notice period would be too onerous without any offsetting benefit. For both this option and the next, interest payments may be necessary during the cool-off period.

- Opt out after 90 days, attracting interest payments for the time value of money. This option would create a more meaningful time window during which the employee could develop a familiarity with the deduction process and become accustomed to the habitual regular contributions. Offsetting this would be the significantly increased likelihood that many employees would face hardship as a result of the longer period of deferred access to money, which they would eventually withdraw once the notice period had expired. This would also be likely to heighten resentment and public discrediting of the scheme.

On balance our Group sees merit in a minimum period of 30 days' automatic enrolment if there is also some *quid pro quo* or sweetener to compensate the employee for deferred access. Without such a sweetener, however, the preference of the Group is to allow an opt-out through the employer on day one.

If a 30-day automatic enrolment period were implemented, we would propose that automatic enrolment be prescribed only for new employees at the time they joined an employer. This approach would limit strains on the collection system and limit administrative complexity for employers, providers and the administration clearing house. Offsetting these, the increase in participation would be more gradual.

In any event, we recommend that there should be no restriction on any existing employee voluntarily joining the scheme simply by requesting her employer to use the IS tax code. We would also recommend ongoing promotion of the scheme, in conjunction with employers, to champion the benefits of the generic scheme to all current non-contributors. At larger work-sites this could be effectively achieved through an annual workplace seminar or similar dedicated activity.

The introduction of a minimum period of 30 days' automatic enrolment also raises the question of what to do with the money during the holding period. In this instance we recommend the creation of a centrally managed holding

account that is attached to the centralised administration clearing-house. The operation of this approach is illustrated in Figure 2. An appropriate rate of interest would need to accrue during the holding period (a bank bill rate or similar).

Employees Y & Z

Employee Y and Z are new joiners at Employer A. A has already selected an initial provider for her employees marketed by Provider 1. As new employees, Y and Z's tax codes are automatically set to IS, meaning that contributions will automatically be made through the tax collection system.

However, both Y and Z have a 30-day reflection period during which time they can decide whether to opt out of the scheme. The contributions are held in a centrally managed holding account during this period. After 30 days, their contributions are either:

- Allocated to the initial provider chosen by Employer A (the default option if no other election is made);
- Directed to the preferred fund selected by either the employee individually; or
- Returned to the employee at the end of the 30-day period once they have notified their election to opt out of the scheme.

The central holding fund can serve to minimise the impact on the system of many small accounts that are established only for a relatively short period. In this way providers are given some assurance that those participating (or more accurately not opting out) will have some commitment to maintaining contributions through the scheme.

In figure 2 Employee Z has no pre-existing fund account and his contributions are directed into the holding account for the first 30 days. Z makes no election to opt out of the scheme so, after 30 days, his accumulated and all future contributions are directed to the initial provider chosen by the Employer.

Employee Y already has a pre-existing fund account established with Provider 2 perhaps through his previous employer or voluntarily himself. Y requests that his IS tax-code contributions are directed immediately to Provider 2 through the centralised administration clearing-house. In doing so Y maintains his existing fund account but is forgoing any of the additional benefits from the default scheme Employer A has negotiated with Provider 1.

3.4.3 Contribution levels and employee participation

The appropriate base level of contribution to any generic scheme is almost impossible to define, given the diverse savings needs and choices faced by individual employees.

Feedback from several parties consulted during our research endorsed strongly the desirability of maintaining simplicity and limiting the number of

variables as key components of the regime. Introducing flexibility in contribution rates for various categories of employee would also increase the administrative complexity of the system.

The design parameters of the student loan scheme serve as a useful initial reference point. The student loans system requires contributions of 10 percent of salary above a threshold of $16,712. This repayment threshold is built into PAYE tables used by all employers. Special deduction rates are available through an application process administered by IRD. We propose adopting computational rules on definition of qualifying earnings and income thresholds, similar to those already adopted in the student loan scheme.

We recommend a buffer zone above the $16,712 threshold so as to provide a minimum fortnightly contribution of approximately $20. Anything less than that risks limiting choices in scheme design for providers, and may lead to providers imposing a higher level of fees to reflect the inefficiencies of dealing with small contributions, so that the more substantial contributors end up subsidising the smaller contributors.

The contribution rate and the level of qualifying earnings, which would determine an employee's automatic enrolment in the scheme, would be set in that context. Purely by way of example, a minimum fortnightly contribution of $20 and a 5 percent contribution rate would mean that all those employees with minimum qualifying earnings in excess of $27,112 would be automatically enrolled on starting with a new employer.

This approach provides a built-in escalator of contributions as gross salary increases. Consideration could be given to an upper level of gross earnings beyond which the escalator no longer applied, although this would introduce extra administrative complexity.

We were asked to consider whether the automatic enrolment rules should apply to all employees including part-time or casual. In our opinion the parameters discussed above deal adequately with this question. Repayment of a student loan takes priority over automatic enrolment in the scheme. Once the student loan was repaid, employees would be automatically enrolled into the savings scheme when they change employer. In addition they would have the option voluntarily to opt into the generic scheme by requesting tax code IS.

Otherwise the parameters of the student loan scheme would continue to determine automatic enrolment. If part-time or casual employees were earning in excess of the $27,112 per annum threshold in the example cited above, then they would be automatically enrolled.

Likewise, minimum age restrictions are often placed on membership of private savings schemes. The existing IRD tax code system requires those aged 18 and under and still at school to use a designated tax code (M) until both of those thresholds have been passed. We would not foresee any further age restrictions being placed on participation in the scheme.

3.4.4 Minimum Firm Size

Our terms of reference contemplated all employers being required to offer access for employees through this type of system. A critical question we confronted was whether a minimum firm size should apply. Feedback through the consultation process stressed the need to minimise compliance, particularly on very small firms. Moreover, many of those in small firms are likely to be the self-employed owner/spouse of owner for whom investment in the business often represents a form of long-term saving.

In light of this we recommend that either:

(i) firms with 5 or fewer staff would be exempt from having to provide access to the scheme and automatic enrolment. On current figures, this threshold would ensure mandatory access coverage for 1,179,830 (FTE) employees, and would exempt 347,370 (FTE) employees working in 253,665 very small firms (86 percent of all firms); or

(ii) firms with total PAYE deduction liabilities below a certain annual threshold would be exempt.

As illustrated above, there would be no restriction on any small business employer choosing to make a scheme available to her employees using the tax collection mechanism and negotiating directly with a provider. Similarly small business employees could elect to participate in the scheme voluntarily simply by giving the employer the IS tax code and notifying the clearing house of their preferred provider.

The Inland Revenue's electronic filing system, ir-File, offers employers, tax agents and payroll bureaux an efficient means of meeting their PAYE obligations. We understand that work is planned to continue rolling out the application of ir-File to small businesses around New Zealand. Implementation of any mandatory access requirement could be linked to the roll-out of this system.

3.4.5 Choice of provider and the default option

Given the nature of the scheme, a provider needs to be selected for a new entrant automatically enrolled in the generic scheme, and to select the type of fund that contributions are directed to if the employee does not make an election. {We describe these as the "initial provider" and the "default fund option"}. In practice the default option is frequently the one that is chosen. However defaults are not costless in terms of either risks or returns.

Our recommendation is that it should be the employer who chooses the initial provider and the default fund. The rationale for this is that it would:

(i) increase the prospects of employers actively negotiating with providers to customise an offer and product design to meet the needs of their employees, which, in turn, could increase the chances of leveraging an employer contribution;

(ii) reduce the inertia and confusion associated with the option of an employee choice of provider and/or fund;

(iii) perhaps be more efficient in enabling distribution of annual reports and statements of employee entitlements through the employer work site.

This requirement to select an initial provider and default fund would effectively be the only new function or obligation required of an employer. The balance of the scheme would rely on the employer completing administration obligations he was already compelled to complete in meeting his PAYE tax obligations.

Companion regulations would of course need to make very clear that choice of an initial provider and default fund would not (of themselves) give rise to either “promoter” or “investment adviser” liabilities.

There is a possibility that in spite of any obligation to choose an initial provider, some employers may not do so. The funds of a new recruit automatically enrolled on the IS tax code would remain in the holding pen until an election is made. This could result in confusion and delay, and hence a mechanism is needed to select a default *provider,* as well as a default *fund.* We have listed two options for selecting a default provider in chapter two, and recommend that a final decision on the preferred mechanism be made after considering responses to any discussion process on this report.

3.4.6 Employees’ right to choose their own provider

Many employees will have pre-existing savings relationships with existing providers or will wish to direct their contributions somewhere that better suits their requirements than the initial provider selected by their employer. Choice also reduces a source of possible tension between employees and employers if a fund that the employer chose performs poorly: it is effectively the employee’s responsibility if he or she remains in the default scheme of enrolment.

The role of the centralised administration clearing house is pivotal in allowing the employee discretion to make her own choice of provider. The unique employee identifier and ability to direct contributions to eligible providers attached to the clearing house would reduce the administrative burden that the employer would otherwise face through more traditional payroll methods.

Conversely it should still be open to an employer to negotiate preferential terms with a provider on a collective or group account basis. Similarly in the event that the employer is making additional contributions or meeting product administration charges on the employee’s behalf, the employer should be able to determine a particular provider of their own choosing. In this instance

employees exercising a right to choose their own provider would do so forgoing the preferential terms or employer contributions offered.

3.5 Definition of a "vanilla" product

The Terms of reference define our task to design a generic work-based savings product, or guidelines for current products that could be offered by several providers that every employee can access. Furthermore we are asked to include the following key features unless they conflict with aspects of the core solution, viz:

- a method to generate long term savings that contribute to well being in retirement, such as lock-in of contributions until retirement except in limited circumstances; and

- portability of contributions between approved products.

3.5.1 Portability and transfer options

The use of the tax collection system and administration clearing house would allow for straightforward transfer of contributions when individuals changed or left employment. As described in the section above, an employee would be able to elect, on changing jobs, to direct his contributions made through the IS tax code to the former employer's provider. The central administrator would be able to match the individual's contribution with the provider.

In so doing, however, the employee might be turning down additional benefits or contributions that the new employer had arranged or was prepared to contribute on his behalf. In this instance, the new employee might wish to transfer his accrued savings from his existing provider to the new provider chosen by the new employer. To facilitate this penalty-free transfer of accrued savings between providers must be possible.

Detailed rules would be needed to govern transfer of funds between providers to ensure that employers making additional contributions on the employee's behalf could continue to maintain access or vesting constraints.

3.5.2 Fees, disclosure and constraints on contribution

We were asked to consider whether any limitations should be placed on the contractual terms that could be offered by providers of approved schemes. For example, level of administrative fees chargeable, the acceptance of small regular contributions, and allowance for periods of non-contribution.

The evidence from the UK and Ireland suggests that a cap on fees only acts to discourage participation and innovation by providers. More specifically in New Zealand, there is evidence that complexity in fee charging structures detracts from even the most sophisticated saver being able to make a meaningful comparison of products on an "apples with apples" basis.

Our preference is to require participating providers to conform to a standard fees disclosure model. The primary purpose of the disclosure model would be to enable straightforward comparison of the impact of fees between products and providers. For this approach to work, it might require some constraints on the form of fees charged, for example only one form of charge, e.g. percentage of assets invested, percentage of contributions received, or fixed member account fees.

In any event it is preferable that all fee comparisons are conducted on an absolute dollar basis as opposed to percentages. Many consumers are unable to make rapid mental calculations to understand the absolute dollar impact of percentages.

3.5.3 Investment risk profile of the default fund

In section 3.4.5 we outlined the function of a default fund selected by employers to capture the contributions of those employees who make no election to direct their contributions to one of the funds on offer by the initial provider.

Ideally, the default option should change across the life cycle, adapting to the risk profile of the individual, but this would create design complications. The provider could build this into an offer, rather than having it centrally determined.

On balance we recommend a conservative default risk profile, reflecting the fact that many New Zealanders want a small nest egg for their retirement rather than investing their limited savings, consequently the security of their savings is very important to them. While we recognise that a balanced option may be more appropriate for some people, we believe that a conservative default (at least initially) will help foster confidence in the scheme (i.e. there will be a negligible chance of negative returns)

3.5.4 Access to accumulated funds and withdrawal options

Our terms of reference emphasise that the focus should be on long-term savings for retirement and to consider imposing a requirement that accumulated savings should be locked in until retirement.

This creates a major difficulty for us as, unlike many international systems where a lock-in or limits to access are offset by a *quid pro quo* or “sweetener” such as taxation concessions, no such trade-off is contemplated by our terms of reference. In light of this, we struggle with the logical or moral justification for restricting the individual’s access to personal funds and meeting the objective of widespread support for the scheme.

Furthermore many existing corporate employer-sponsored superannuation schemes allow access to some or all accumulated contributions on leaving

their employer, or earlier. Similarly the terms of some personal contracts allow for frequent partial withdrawals.

We believe there is a benefit in improving attitudes toward saving and encouraging a behavioural change if some access to funds is allowed. A middle ground would allow access to a proportion of the funds but also ensure some funds were being accumulated over the longer term. By way of illustration, members could be allowed to access 50 percent of their accumulated funds after the first 5 years had elapsed and a further 50 percent of the remaining accumulated balance every three years thereafter.

This approach would have the benefit of removing the subjective judgements and empirical evidence often required under existing contracts where terms allow for hardship provisions or ability to withdraw funds for limited purposes.

In addition we see merit in requiring a prior notice period requirement before funds could be withdrawn – perhaps three months – to emphasise the longer-term nature of the purpose of the savings.

Ultimately full rights to withdraw could be allowed from ten years prior to the age of eligibility for NZ Super, i.e. age 55.

We stress though, that rules on lock-in would be somewhat subjective and arbitrary, regardless of the form they take.

3.5.5 Forms of Withdrawal

Given the tax-neutral nature of the generic scheme, it does not seem fair to impose restrictions on the form the benefit can take. A range of options should be available which will meet the needs of most people, although in the interests of keeping administration costs down, there may be restrictions on, for example, withdrawing very small amounts regularly.

Options should include:

(a) Lump Sum: the full benefit is paid out in one lump sum.

(b) Annuity: the lump sum is converted to an annuity. Given the current state of the annuity market (with just two providers selling annuities), it is probably not feasible to require all approved providers to offer annuities.

(c) Drawdown facility: the benefit is drawn down in regular (or irregular) instalments.

(d) Some combination of the above options.

To keep costs down, rules would need to be written around such issues as minimum drawdown amounts and frequency of withdrawals.

We believe there is significant work to be done on the decumulation phase of retirement savings in New Zealand. Of particular concern is the annuity market, an issue which was raised in the 2003 PRG report[8].

New Zealand suffers from the same core problems as overseas annuity markets, namely adverse selection (i.e. the purchaser knows more about their life expectancy than the provider), and uncertainty over future population mortality improvements.

In addition, the taxation of annuity products (effectively at 33 percent at provider level) makes them unattractive to retirees on low marginal tax rates.

These and other features of the market (reinvestment risk, lack of inflation-linked bonds) have led to a situation where there are just two providers of annuities, and pricing is so unattractive as to deter most investors.

Some of the market problems clearly can only be addressed by the government (such as the lack of long-dated bonds and inflation-linked bonds, tax treatment), while we believe that the government can also have a useful role to play in developing other aspects of the market.

3.5.6 Interaction with existing schemes

A critical difficulty we faced in defining the terms for any generic product was to ensure that we aligned the rights under the generic scheme with rights under existing occupational schemes (e.g. access to funds on leaving the employer) and existing personal superannuation savings.

As expressed in chapter three we see no merit in introducing a system that served to undermine existing employer-sponsored schemes. There is a risk that any generic scheme might jeopardise the continuance of existing schemes unless extreme care was taken. Employers might have an incentive to move employees on to the proposed scheme and away from existing schemes, which (because that would involve an intermediate cash-up, except to the extent that employees elected to transfer their benefits direct to the new scheme) would be likely to materially reduce overall savings levels. By transferring from an existing scheme to a generic scheme, employees might also lose valuable ancillary benefits such as employer contributions and group-discounted death and disablement insurance.

We have sought to create balanced proposals whereby any generic savings product and existing schemes could co-exist. Ideally the system should *encourage* employers to maintain existing schemes, and perhaps also encourage some employers to consider providing a separate superannuation scheme rather than using the centrally administered scheme we propose.

We propose that employers who provide employees with:

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[8] A fuller discussion of the issues is found in St John, "Planning for the drawdown phase of retirement saving in New Zealand" July 2004.

- access to an existing scheme for all employees earning in excess of the minimum qualifying earnings threshold ($27,112 in the example cited earlier); and

- incur, or source from any surplus assets comprised in a scheme, contribution or expense costs at least equal to scheme administration costs (i.e. the subsidy requirement imposed as a condition of invoking the prospectus exemption prescribed for an “employer superannuation scheme” in the Securities Act (Employer Superannuation Schemes) Exemption Notice 2004);

would be deemed (in relation to *both* existing members *and* all eligible non-members) to have complied with their obligation to provide access and automatic enrolment to the proposed new scheme. Employers who provide access to an unsubsidised scheme would be deemed to comply to the extent that employees are already members.

To comply with the proposed exemption employers who confine access to only some of their employees must, subject to the comments in the next paragraph, instead make the scheme available to all their employees who meet the minimum qualifying earnings threshold or alternatively provide access to the generic scheme.

Notwithstanding this, many employers currently provide employer-sponsored superannuation for a wide variety of reasons. An often-quoted rationale is to retain and attract key staff. The terms of many existing schemes have accrued rights that need to be preserved, but it may not be practical to extend these rights to all employees. In this instance the employer could choose to retain the restrictions on access to the existing scheme and would be required to comply with the proposed terms of the generic scheme for new employees ineligible to join.

Providers of existing personal or retail superannuation schemes could continue to maintain and promote their products alongside the generic work-based savings vehicles. Alternatively, it would be open for existing products that were modified to comply with the requirements of the generic product for:

- portability and transfer options;

- fee structure and disclosure; and

- withdrawal and access options;

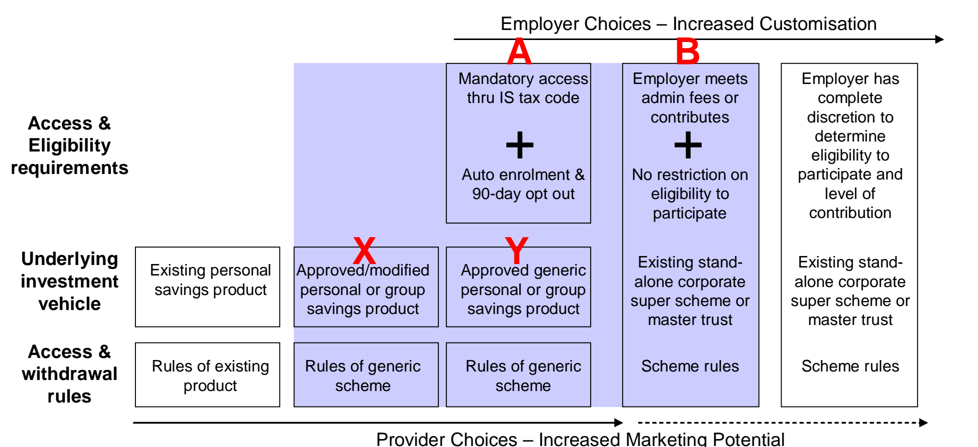
to be eligible to become “approved products” under the generic scheme and therefore compete to receive contributions from both new and existing clients.

Figure 3 below illustrates the interaction with existing schemes and summarises the choices that would face employers, providers and employees. The shaded area denotes the domain of the generic work-based savings scheme.

Employers could meet their obligations to offer access and automatic enrolment of new employees by adopting either:

- option A, in which case they would need to select a default fund from the ranges of approved products offered in boxes X and Y; or
- option B, in which case they could offer their employees greater flexibility and customisation of the scheme.

Interaction with Existing Schemes



Savings Product Working Group **Figure 3**

Employers who continued to offer sponsored superannuation schemes with restrictions on eligibility would need to at least offer option A for new employees appointed who do not meet the eligibility criteria for the sponsored scheme.

Employees whose employers elected option A could elect to direct contributions to any approved product within boxes X or Y.

Product providers could elect to modify the terms of their existing products to meet the requirements of the generic savings scheme (or the exemption requirements) and/or develop new generic personal or group savings products.

All employer-sponsored superannuation products and schemes, regardless of their compliance with the generic scheme, would benefit from the proposed streamlined regulation amendments outlined earlier in this report.

3.5.7 Provider participation approvals

All participating providers under the generic scheme would have to comply with the scheme's regulatory framework and the fees disclosure model outlined above.

We propose allowing all providers who meet the regulatory and fee disclosure requirements to participate through a process overseen by an approvals authority. This body would also be responsible for monitoring providers to assess their compliance with the rules of the scheme and for "deregistration" of schemes if required.

3.5.8 Centralised administration clearing-house

The role of the centralised administration clearing-house is pivotal to our proposal for the generic work-based savings scheme.

Its primary purpose would be to act as a conduit between the IRD tax collection mechanism and product providers.

The administrator's role could be tendered to the private sector. The administrator's operating costs could be recovered from providers/members or funded by the government.

3.5.9 Specific regulatory reform

The Group envisages that the existing regulatory framework (disclosure, accounting and reporting requirements) would continue to underlie the generic work-based savings scheme, but that additional regulations may be required to cover the setting of, and compliance with, the core design features outlined above.

The "automatic enrolment" feature of any generic scheme would necessitate careful amendments to the Wages Protection Act (under which deductions from salary are currently prohibited without employees' prior written consents).

The 1997 White Paper on the Retirement Savings Scheme (RSS), proposed that each RSS Fund would be regularly certified by an approved (and independent) certifier to confirm that it complied with the core conditions for an RSS, and that the certifier would be responsible (among other things) for ensuring that there were appropriate structures and systems, and adequate personnel, in place to ensure that core conditions were not circumvented and the provider's duties were performed. A variant of that certification requirement might be appropriate for the generic scheme, and could extend to ensuring compliance with certain additional basic rules such as scheme balances not being used as security for borrowings by savers.

The generic scheme should also be structured, and defined, in such a way as to come within the jurisdiction of the Insurance and Savings Ombudsman scheme.

3.6 "Sweeteners"

In chapter two, we noted that although the primary beneficiary of personal saving is the individual, there are some public benefits that are associated with a broader base and higher level of saving. To the extent that these third party benefits ("externalities" in the jargon) exist, a case can be made to use public monies to capture them. It is not our role to estimate the extent of this benefit or to recommend the quantum of resource that should be spent in capturing it. Those decisions will inevitably be somewhat subjective, and potential funding has to be assessed in relation to competing claims from other causes (which will have different, but potentially similar or higher public benefits). Resourcing will also have to be assessed in relation to the fiscal position at any time, and may need to be phased in.

In short, the financing of any "sweetener" is properly a matter for the full Budget process, and cannot be developed in isolation.

Despite that, we do say that if the government decides to apply some funds to encouraging work-based savings, an optimal process should be used in deciding how they should be spent.

We have some personal and subjective opinions, but those opinions are not grounded in any robust testing of their effectiveness. We therefore recommend that:

(a) the government decides the amount (if any) to be spent in directly incentivising work-based saving (this would be separate from and additional to any amounts spent on education and training programmes, which tend to try and reach a broader savings target);

(b) focus groups be used to improve confidence about what sort of incentive would be most effective in improving participation in the work-based savings plans;

(c) the primary purpose of the focus groups would be on determining which type of incentive would be most effective in improving the numbers participating in plans; [Note that it is not the amount of saving that is the primary target, because large gains in savings levels might be achieved by generating big increases from high worth individuals. Not only would these savings most likely have been made anyway, but there is a high risk that they would simply have been diverted from other vehicles into the incentivised plans. Also, because it is inculcating savings habits that is a key policy target, the spread of participation is the aim. In addition, with set contribution thresholds and rates in the default design, amounts saved would tend to be roughly proportional to numbers participating];

(d) equity considerations would then be applied, to direct a disproportionate share of any incentive to the savings balances of low and middle income earners. [Note that increasing numbers of savers probably targets lower income earners anyway, because all other things being equal they are the hardest to enlist, so these objectives are not likely to be conflicting].

In the event that "sweeteners" are applied, consideration should be given to the following range of possible options:

(i) Administration costs of the central scheme administrator

Meeting the administration costs of the central scheme administrator ensures that the full amount deducted from wages appears as the opening balance in the personal savings plan, and avoids the psychological disadvantage of appearing to "start from behind".

A material disadvantage is that it would not offer equality of subsidy to existing occupational schemes, which will in any event typically have a higher cost structure. Even so, relatively "minor" an advantage (paying for the transmission of funds from payroll to provider) would open up a "gap" between the generic scheme and existing occupational schemes making them less attractive to employers (who meet the cost of deducting contributions from wages and remitting them to the occupational scheme).

(ii) Fund management fees

Covering fund management fees of providers, either up to a maximum percentage level (basis points per funds under management), or of a set dollar annual amount, increases the rate at which funds accumulate. The set amount tends to advantage the lower paid most.

This does have a material impact on the rate at which funds accumulate in the schemes that get the fee and could have a negative impact on occupational schemes if they were excluded from it. There is no reason why the occupational schemes could not get the subsidy as well, but it does add to costs and spreads any incentive thinly. Given the vast differences in opening balances between existing occupational schemes and new "generic" scheme plans, and the fact that the existing schemes tend to cater for higher paid employees, equity considerations suggest that if fund management fees are paid to both, they should be of a fixed dollar per account amount.

(iii) Life insurance cover

It is possible that employees with young families could feel that the first call on any income that can be diverted from meeting weekly outgoings should go towards obtaining some life insurance protection for dependents in the event

of the early death of a household earner. To the extent that this priority exists, savers would be inclined to opt out of the generic scheme to keep insurance policies up to date.

Personal life insurance protection is, however, relatively expensive: there are the direct retail selling costs, necessary medical declarations, and account administration fees to cover before the actual risk premium is charged. Intuitively it seems to us that this is an area that could benefit hugely from economies of scale. A “group” cover, of say $50,000 for the death of a member of an approved plan under the generic scheme who dies under age 40, and of $25,000 if death is between 40 and 50, has a number of attractions. It meets equity principles. It frees up income that would otherwise go into a life policy to apply to a savings balance, and decreases likelihood of opt-out. It tends to encourage people to stay in the scheme from younger ages and therefore starts the savings habit earlier in the life cycle. It discourages withdrawal of funds.

An initial estimate carried out by Group member Bernard Reid suggests that life cover of this sort for the whole of the employed population aged 15 to 50 would cost $65 to $70 million per annum excluding administration costs. Obviously take up of the savings opportunity would only be a portion of the total employed population, and an age limit would exclude the youngest cohort (this latter factor alone reducing the cost by $4 million per annum).

The sweetener could be extended to members of existing registered occupational superannuation schemes, but many of them have insurance cover built into plan benefits already. Extension would increase costs, but would not be materially inequitable (the cover is for a set amount regardless of income).

A “sweetener” of this sort, confined to prescribed age bands, would necessitate a specific exemption from the age discrimination prohibitions prescribed in the Human Rights Act.

(iv) Kick start

“Kick starts” of various sorts can be considered, depending on the purpose they are designed to achieve.

- Generous interest payments applied to amounts in the “holding pen” during the first 30 days could be seen as compensating for losses associated with an involuntary enrolment. This would mitigate the negative publicity that would be associated with restricting access to “my money”, for however short a period of time. Because members of existing occupational schemes are not involuntary contributors for any length of time, this can be seen as compensation, and not as favouring the generic scheme over others.

- A dollar amount to boost the first transfer after 30 days from the pen to the plan. It encourages savers to stay with the scheme, and increases

the prospects of “stickability”. It can legitimately be fenced off from any subsequent withdrawal right, and hence meets some of the requirements for lock-in. A fixed dollar booster meets equity goals. It does have a logic that justifies separate treatment from occupational schemes, but that is not as strong as it is for the holding pen interest payment. However it is unlikely to be large enough to persuade existing schemes to wind up, or to legitimise wind-ups that try to use it as an excuse.

(v) Reward payments

Rewards at different milestones can encourage savers to stay with a plan. The rewards can be based on either:

- Savings balances (at every $10,000 for example), but these tend to be inequitable because higher earners are more likely to meet these targets.

- Duration of participation at the default contribution rate (say $x on every fifth anniversary of joining). Because the scheme contribution is delivered through a tax code, it is possible to track qualification, if audits of claims from providers for the reward payments are needed. This tends to meet equity goals.

Rewards would not be accessible under any withdrawal regime before age 55 (and therefore assist with lock-in), and can be dependent on the saver not having withdrawn balances since the last qualifying milestone (which again helps lock-in, but might discriminate against those with genuine hardship reasons, and against low-income savers, who are more likely to need to dip into amounts that can be withdrawn from time to time).

Conceptually they could be offered to existing scheme members, but it would be administratively complicated. Reward payments are likely to advantage members of generic schemes, and consideration of them should be sensitive to possible impacts on existing scheme wind-ups.

(vi) Top-ups

Top-ups can be restricted to particular income levels and meet equity goals by being applied as a set dollar amount. They would need to be applied only if at least the default contribution level is met, can be fenced off from withdrawal rights, and can be suspended for a stand-down period if some balances are withdrawn under any access formula.

They do, though, have three very major disadvantages:

- They tend to be expensive if they are to be visible and meaningful;

- They would be arbitrary if there was a cut-off point defining qualifying low income (not only at the point at which qualification ceases, but also

as between casual, part-time and full-time workers) or expensive to administer if an abatement regime applied;

- They would discriminate against established schemes, and could be the factor that gives employers the excuse they need to wind up schemes.

It is this last risk that leads us to recommend against this type of sweetener.

4 IMPLEMENTATION

Our terms of reference require us to provide advice on the detailed design *and implementation* issues associated with delivering widely adopted generic work-based savings products.

In many cases, we have addressed implementation issues through the details of the design of a solution. By way of example, the implementation of automatic enrolment and source deduction features of the solution is seen as taking place by using the PAYE deduction facility.

We should note, though, that much of the implementation

(a) will depend on some prior decisions being made on matters such as tax and regulatory reform, and the degree of intervention that is considered appropriate, all of which will modify the detail of the design of a solution; and
(b) require some specific tasks to be undertaken in constructing the machinery through which savings will be collected, distributed and managed.

There is therefore a set of decision-making stages that has to be managed. Decisions on one issue (how to tax investment funds, how far down the pathway to travel, whether or not to apply sweeteners etc) generate refinements to, reviews of, or confirmation of the design details in this report. Because we do not know what those decisions will be, we have identified a number of tasks that have to be allocated (to "somebody") as an integral aspect of the implementation of the solution.

The specific follow-up *tasks* that have to be allocated are:

(i) Manage the process associated with evaluating responses to a discussion paper.
(ii) Test the design details to confirm (or amend) the exemption, threshold and contribution rate parameters built into the core features of a generic product.
(iii) Oversee the legislative process associated with the regulatory revamp.
(iv) Review the recommendations of this report in line with the conclusions of and government response to the findings of the Stobo Review on the taxation of investment funds.
(v) Make final decisions on whether and to what extent "sweeteners" will be applied to encourage work-based savings, and carry out focus group testing on the sorts of sweeteners that are likely to be most effective in stimulating an increase in the numbers participating in savings schemes.

(vi) Determine the amounts that ought to be applied to education and training programmes associated with promoting uptake and improving financial literacy.
(vii) Establish a central scheme administrator facility, conduct a tender process to select the administrator and put a mechanism in place to meet the costs of the administrator.
(viii) Determine the detailed criteria for the approval of savings product providers.
(ix) Establish a body for approving providers.
(x) Construct a process for formally exempting existing schemes from the obligations that apply under the generic scheme.
(xi) Oversee the implementation of the communications, education and training activities envisaged by the Group.
(xii) Finalise decisions on withdrawal rights (amounts, frequency, notice periods) and commission further work on “decumulation” options (such as improving the provision of access to annuities).

In many cases, there are departments and agencies within the existing machinery of government that are the natural “home” within which the follow-up activity should be carried out (IRD for tax, MED for regulatory reform, Treasury on Budget issues, Retirement Commission on education). However, we see the process going forward as being crucial to the success of any project to improve work-based savings, and we stress the integrated and mutually reinforcing nature of the elements of the report’s recommendations.

We therefore recommend the establishment of a co-ordinating and oversight unit, located within a government agency, operating under the guidance of an Advisory Board with an independent Chair. The Board would advise the Chief Executive of the host department. {The selection of the relevant Department is a matter for Cabinet}.

4.1 Opportunities for feedback on our report

Business NZ in particular has urged that our report be released as a discussion document, on which more general comment is invited from the wider community likely to be effected by its recommendations. Their basic theme is that they need time to adequately consult their various stakeholders, and that the extent of reflection required to minimise unintended consequences would be unsuited to a typical Parliamentary Select Committee consideration with its intrinsically political character.

Our view is that there are two considerations that suggest a discussion paper phase might by useful.

The first is that the essence of these recommendations is that they involve escalating levels of intervention. It is as important to build some shared view on how far to go as it is to refine the design detail at each step on the way.

The second is that some of the improvements that we propose (such as reducing the compliance costs of the regulatory regime, clarifying and limiting civil and criminal liability of employers who offer work-based savings products, increasing the flexibilities that are allowed to introduce beneficial changes to existing schemes) we see as being justified regardless of whether any other steps are taken. It would be helpful to canvass views on improving the existing regime, even if the more radical overhaul that we suggest is feasible is not undertaken.

We would, however, enter two notes of caution.

(i) A discussion phase should not become an instrument for relitigation and delay. A number of the submissions we received went under a general banner of "you have done a good job with your terms of reference, but you had the wrong terms of reference." That line of submission actually seeks to comment on the detail of our proposals as a surrogate mechanism for challenging the policy initiative itself (i.e. the need to encourage an increase in the level of work-based saving). Any discussion paper needs to make it clear that the basic policy intention is not the issue on which comment is invited. That manifestly <u>is</u> an appropriate subject for Select Committee submission.

(ii) Discussion needs to be focussed on what the Group actually recommends. There is a risk that the recommendations can be distorted so that the core message can be discredited. By way of example, some comment we have received suggests that exempting employers of a certain size from the automatic enrolment mechanism excludes those employees from the scheme, or that limiting automatic enrolment to new recruits excludes existing employees. Nothing in our proposals excludes voluntary extensions of the compulsory core. Small employers are perfectly entitled to opt in to the automatic enrolment mechanism (and should be encouraged to do so). Employers can offer access through the cheap and easy PAYE deduction mechanism to existing employees. An employee who has entered the scheme can retain the tax code and continue contributing even if they move to employment with a small or exempt employer. A discussion paper needs to be highly focussed so that responses close in on the detail of a solution and avoid a return to the endless indecision of the last twelve years.

We therefore recommend that any discussion phase in response to our report be tightly focussed on key design details, and be limited to no more than a six weeks submission period.

4.2 Testing key design details

In some key areas, we have had to rely on subjective judgements about what might be fair and reasonable contribution criteria (guesses and personal prejudices, not to put too fine a point on it).

We did not have the time and resources to undertake more detailed focus group analysis of what employees might find acceptable.

The key areas on which more objective opinion sampling could usefully be undertaken are:

(i) Age of exemption from automatic enrolment requirements (if any). We have used age 18 as a basic cut-off age above which the automatic enrolment mechanism would kick in (subject to meeting the income threshold) Should this be 20, or 25, or is there some other age at which there are expectations that personal financial management is expected to become part of the work-life mix of employees?

(ii) Minimum exempt threshold. We have assumed that for whatever reason, public policy has already determined that below a certain income level ($16, 712 per annum), it is not reasonable or credible for people to be expected to “live without” a portion of their additional income. Above that level, they can (and repay student loans). The question that might usefully be tested is whether that is now embedded in expectations, or whether for a savings regime a higher threshold would be regarded as more sensible.

(iii) “*De minimis*”. Although there will be a portion of income exempt from contribution calculations, extracting contributions on small amounts above the threshold might be trivial, not cost-effective and expose the regime to ridicule. {For example, saving at 5 percent on income above $16,712 would mean that a worker on $20,000 would only make a contribution of about $3 a week – an amount that would be expensive to collect and that could appear trivial}. Establishing a *de minimis* payment can retain the exempt level, and the “escalator” feature associated with levying a set percentage above an exempt base, but only collect “realistic” amounts. Just what is seen as “realistic” (say $10 a week) would then be used to calculate the salary level from which deductions would be made. {In this example, amounts would only be collected on incomes above $27,112, even though it is only the first $16,712 of that amount that is exempt}. Focus groups might be used to refine what would be regarded as an acceptable minimum payment.

(iv) Contribution rates. Some comment we have received is that the student loan repayment rate is “too high” to use in a long term savings plan (because it is seen to be a temporary thing, and because the presumption is that it will be paid back at a time when the individual has no or few dependents). We don’t know that, or

what actual rate may be seen as more affordable, and if a “cap” on contribution levels would increase the acceptability of the scheme.

Focus groups will never provide a complete answer, but they will improve confidence levels and could well be used to test the “raw” (top of the head) conclusions that we have come to. Again, they should not be used as a delay mechanism, there is no reason planning for them cannot be underway while the discussion paper exercise is being carried out, and we see any refinements arising from this exercise as being completed in two months.

4.3 Regulatory review

The Law Commission is carrying out a review of the Life Insurance Act 1908, and is due to report at the end of November 2004. While superannuation products do not fall within the definition of “life insurance”, the review could have implications for the detail of the design of new work-based savings vehicles because the review does cover the provision of annuities, and some life insurance products “bundle up” other features to provide some retirement benefits.

The Ministry of Economic Development is undertaking a comprehensive review of the Securities Act starting in 2005.

It is not obvious that a regulatory revamp of work-based savings products needs to wait until all other review work is completed, but a revamp does need to be mindful of these other processes and to interface with them. It also needs to steer through the consultation and law drafting processes that are essential elements of sound public policy development.

An agency will need to take responsibility for initiating, steering and progressing this upgrade, which we see as being necessary regardless of how much further the government decides to travel down the pathway.

4.4 Policy alignment

Our proposals need to be aligned with key policy developments:

(i) The Stobo review of the taxation of investment funds.
(ii) Final decisions on whether, to what extent, and in what form, the government will provide assistance (a “sweetener”) to encourage tax-based savings.
(iii) Decisions on appropriate funding levels for education, training and promotional programmes.

The Stobo Review report is not due until the end of October, and even then it is likely to go through the (fairly time consuming) generic tax policy process. However, there is no need to delay aligning the recommendations of this Group with the Stobo review until the GTPP is complete.

Decisions on sweeteners and on the funding of the education and training package cannot be made outside of the Budget process, and therefore will not be finalised until presented in the 2005 Budget (normally May 2005).

That seems to be a reasonable target date for aligning tax and assistance measures with the Group's report, and for revising and refining the design details. The task of making the adjustments that flow from those decisions needs to be allocated. It is feasible to reconvene this Working Group for a single function, time limited exercise.

Translating these processes into a legislative programme to give effect to the new scheme would target the introduction of legislation somewhere around the middle of 2005. This might impact on Cabinet Manual constraints on introducing new legislation in a "stand-down" period before a general election, but even if they do not, we cannot see the legislation passing before the election, and hence see final enactment of a new package as taking place around March 2006.

4.5 Design of generic product machinery

There are a number of details that need to be filled in in relation to how a generic scheme would work in practice. Some detailed work was done in developing the mechanics that would have applied to the 1997 Retirement Savings Scheme had it been approved by referendum. Some obvious variations (compulsion and lock-in) aside, that background work can be used to build some of the machinery that would be needed in a generic scheme.

There are other features of the machinery that would need to be developed:

(a) criteria for the approval of products;
(b) an organisation with the statutory authority to approve products and providers;
(c) a computer platform to service the conduit through the PAYE system to the central scheme administrator;
(d) the central administrative machinery itself.

These are tasks that have implications for each other, but that involve somewhat distinct skill sets and areas of expertise. It will be necessary to ensure a high degree of coordination of the work streams associated with them.

4.6 Sequencing

The package we have recommended involves some steps that should be taken regardless of other decisions (such as a streamlining of the regulations governing work-based savings), some that follow naturally from decisions in principle on key design features (such as mandatory offering and automatic enrolment), and others that are contingent on decisions that will only be made at some time in the future (such as on sweeteners).

There is no need to wait for all relevant decisions to be made before starting work implementing any of them.

In sequencing terms then, a regulatory upgrade can start almost immediately, and its form can be outlined (depending on legislative logistics) by mid 2005.

It is important to meet this target early, so that later refinements (obligations on offering and on enrolment, access to the PAYE collection mechanism, establishment of the central administrator) can be rolled out using products that have been developed around the new regulatory framework.

This is essential if an (ambitious) start-up date for a new generic scheme of 1 April 2006 is to be met. We are conscious of the risks of delay at every step of the process, and note that if there are slippages in meeting any of the key milestones, the most likely start date for the full package would be a year later (April 2007). This does not mean that many of the other features of a solution could not be operating in a voluntary, bi-lateral environment by the earlier date.

4.7 Implementation: a summary of stages

Timeline	*Stage*
October-November 2004	Discussion phase for the Working Group report. Focus groups on setting age and income thresholds, *de minimis* contribution levels and contribution rates.
November	Evaluation of implications of Stobo Review for design of generic scheme. Commissioning of officials work on revising and updating regulatory framework that covers work-based savings products in general.
December – February 2005	Consideration of funding levels for education programme and savings sweeteners as part of the Budget 2005 process. Decisions made on how far to advance up the pathway.
February – March 2005	Focus group testing of attractiveness of options for sweeteners. Drafting of legislation to amend relevant legislation.
April 2005	Introduction of Bill to upgrade legislation. Preparation of legislative options providing for other elements of the generic solution.
May 2005	Budget: sets base for finalising of generic scheme detail design and for planning the education programme.
June- July 2005	Introduction of legislation providing for generic scheme and start of Select Committee process. Passing of legislation upgrading regulations depending on legislative logistics.
July – December 2005	Preparation and planning time, election protocols generate a pause around passing new legislation. Private providers decide on whether to start developing new products in line with their evaluation of the prospects of the new generic regime going ahead. IRD examines systems requirements for new deduction facility. Discussion between officials and industry body on establishing a central scheme administrator.
March 2006	Final legislation enacted
April 2006	Elements of new regime not awaiting final legislative clearance implemented. Fuller implementation of all elements dependent on legislative and administrative practicalities.

Appendix I

Terms of Reference
Savings Product Working Group

The Savings Product Working Group ("the Working Group") is appointed to provide advice to the government on the detailed design and implementation issues to be resolved in delivering widely adopted generic work-based savings products. The term "work-based" refers to the employer's role in providing a direct deduction facility for contributions, providing access to savings schemes and providing education on retirement saving to employees through the work place, rather than actually managing a superannuation scheme. The government considers that work-based savings schemes are a good way for New Zealanders to save for their retirement as such schemes provide for deductions towards savings to occur at source, benefit from economies of scale, and provide an avenue to reach a high proportion of the population.

While a number of employers do offer their employees access to superannuation schemes, the coverage in the New Zealand context is not significant and if an employee ceases to be employed by such an employer, the employee usually has to terminate their membership of the scheme. The problem to be addressed by the working group is the ease of access to superannuation schemes for New Zealanders and the ability to maintain that access until retirement. The government considers that the availability of generic products that every employee can access and the ability to maintain a similar scheme if he or she changes employment has merit and may lead to increased savings for retirement. The government further considers that the broad adoption of generic work-based savings schemes of this sort is unlikely to develop without government action.

The government proposes to provide some degree of funding to assist with the uptake of work-based savings products by removing some of the current tax disincentives such as the over-taxation of low-income earners saving through superannuation products. It may be that any such relief provided will only apply to a certain category of savings products. The task of the Working Group will include the design of a work-based savings product, or guidelines for current products that could be offered by several providers and further to resolve barriers to widespread offer of such products by employers. With respect to tax policy, the Working Group may also identify where the current tax system *discourages* participation in work-based savings products.

The issue of any tax incentive or subsidy for such a class of savings products will be considered separately by the government as part of its consideration of the appropriate tax treatment of savings vehicles.

The government considers that the Working Group's proposals should address the following key features, including them unless they are shown to conflict with core aspects of a solution:

- access for all employees (including part-time and casual) in a scheme as a result of their employment, including a salary or wage deduction facility for employee contributions;
- automatic enrolment of employees to such a product, unless an employee declines such enrolment;
- a method to generate long term savings that contribute to well being in retirement, such as lock-in of contributions until retirement except in limited circumstances; and
- portability of contributions between approved products.

In this regard, the government seeks advice from the Working Group on the detailed design and implementation of guidelines for generic work-based savings products or solutions. In particular, the government requires the following questions and issues to be addressed:

- what design features will be necessary to take into account the needs of low-and middle-income employees and how will any proposed product would facilitate the retirement saving of this group?
- what design features will be necessary to ensure that all employers offer access to such a product? For example, one design feature to achieve this could be mandatory offering.
- what design features will be necessary to allow for on going contributions to such a product or maintenance without contributions during periods of non-employment?
- what group of employees should the automatic enrolment rules apply to? Should there be any period between commencing employment and automatic enrolment to deal with employee turnover issues? For example, should automatic enrolment apply to all employees including part-time and casual?
- if early withdrawal of contributions is allowed, what circumstances would apply to allow for such earlier withdrawal of contributions?
- what limitations, if any, should be placed on the management of approved schemes? For example, level of administrative fees chargeable, the investment profiles of such products, the acceptance of small regular contributions, and allowance for periods of non-contribution.

- how can the compliance costs for employers, fund providers and employees associated with implementation and on-going provision of such a product be minimised?
- what is the best way to implement a generic work-based savings product and what are the lead-in times required by employers and fund providers?

The Working Group is to report back to the Minister of Finance and Revenue by the end of August 2004. That report will provide advice to the government on how to resolve the detailed design and implementation issues associated limiting the broad adoption of generic work-based savings products.

Appendix II

PROCEDURES

Participation in Group discussions

The members of the Savings Product Working Group were

Diana Crossan	Retirement Commissioner
Peter Harris	Consultant (Chair)
Ross Kent	General Manager, Alliance Capital Management (from 30/8), previously Managing Director, AMP New Zealand
Andrew Leys	Chief Executive, Southland Credit Union
Bernard Reid	Actuary, Watson Wyatt
Mike Woodbury	Principal, Chapman Tripp

Departmental officials from The Treasury, Inland Revenue and the Ministry of Economic Development assisted the Group and participated in discussions.

Colin Lynch from consultancy firm LECG provided research support up to August 6, and Andrew Huddart from consultancy firm Innovation and Systems Limited assisted the Group with the preparation of the final report.

A large number of individuals, both in New Zealand and overseas, offered expert advice, participated in reference group discussions and workshops, and made submissions to us or commented on draft proposals. We do not name them all, but do wish to record our appreciation of the tremendous amount of goodwill and voluntary public service that was associated with their input. Our task was obviously seen as a matter of significant public importance, and this augurs well for the development of work-based savings schemes in the future.

Consultations and methods of work

Work-based savings – or perhaps more specifically work-based *retirement* savings – has been the subject of numerous investigations and reports over the last few years. Two recent examples are the 2003 Savings New Zealand Forum and the Periodic Report Group exercise.

A number of individuals and organisations made submissions to the PRG and participated in the SNZ Forum. Given that most of the issues that we need to address have been thoroughly canvassed, and that the positions of most of the key stakeholders have been clearly articulated and are well known, we have not approached our task through an exhaustive process of consultation and the calling for submissions.

There is a considerable body of expertise and experience residing within the membership of the group. In addition, we had access to PRG material. Finally, we were required to report within a relatively tight time frame.

Our approach was more of a “think piece” than a “referendum”.

We asked for reports from Departmental Officials and from experts in relevant private sector organisations on specific topics that needed to be addressed.

We convened a workshop with a Reference Group (in Auckland) made up of key personnel engaged in the superannuation policy debate, providers, employers, scheme trustees and trade unions.

We invited a number of peak organisations to provide comment to us on the matters that fell within our terms of reference. Individuals and organisations who contacted us were invited to make submissions and we considered all of those that were made.

We discussed our early thinking on our recommendations in a joint session with the employers (Business New Zealand), the unions (New Zealand Council of Trade Unions), consumers (Consumers Institute), the industry (Investment, Savings and Insurance Association) and Women in Super.

We also held a workshop with officials from a number of government departments and agencies. (Economic Development, Inland Revenue, Retirement Commission, Social Development, Te Puni Kokiri, Treasury, Women’s Affairs).

We consider that this approach was sufficiently open to allow us to access the necessary range of views and perspectives, and do not think that a more time consuming and exhaustive consultation would have exposed us to any information and evidence that would have had a material influence on our core recommendations.

Appendix III

ISSUES

In the course of our consultations and discussions, a number of issues were raised about the practicality or desirability of our range of “solutions”. Rather than comment on each of them in the body of the report (which has a focus on how and why we reached our conclusions), we have listed some of the key issues in this appendix.

Interface issues

Our consultations identified two areas in which our proposed solution might have policy implications as a result of how a new generic work-based savings scheme might interface with other programmes. They are:

(i) the interface with the savings and investment activities of the private, retail financial services sector; and
(ii) a possible interface with the government’s “Working for Families” income support system.

Retail savings products

The argument that has been put to us is that a number of programmes both reduce the incentives on individuals to save, and squeeze the retail side of the savings industry in competing for the business of those who do save. Arguments on the former are that New Zealand Superannuation acts as a disincentive to save privately for retirement, and the welfare state is a disincentive to save privately to protect against periodic income loss. Arguments on the latter are that the partial prefunding of NZS is achieved by maintaining a higher tax rate than would otherwise be necessary (squeezing the capacity of individuals to save) and that the State Sector Retirement Savings Scheme offers a subsidy not available to other providers of retail savings products.

Against this background, it is argued that routing deductions from employee pay through the tax system will provide a significant implicit subsidy to the generic scheme, possibly by as much as 50 basis points of contribution levels. This is seen as a threat to existing work-based schemes and to new schemes that might otherwise be set up under the present superannuation regime. These effects will be further compounded if the new generic scheme receives tax advantages or other subsidies not available outside its scope. Not only will the arrangements drive private industry increasingly towards the top decile of wealth owners, but low and middle income employees of small enterprises exempted from generic scheme automatic enrolment mechanisms will not be catered for, because it will not be cost effective for private retail providers to market to a small and scattered client base.

We do not wish to enter the debate on how, and to what extent, “first tier” income protection mechanisms impact on behaviour. {We note that while on the one hand some of the critics of new initiatives to boost private savings point to the lack of conclusive evidence on the need for it, they nevertheless assert various incentive effects despite a similar lack of firm evidence.}

We do think, though, that the design details in our solution deal with all of the other retail interface concerns that have been raised.

We did consider one option around a “centralised” allocation of funds collected under the generic scheme. In this option, the scheme administrator would have run a tender process to select a small number of fund managers (in much the same was as the Guardians of NZ Superannuation do for the NZSF). Contributors could select from conservative, balanced and growth options. That scheme would have had a significant impact on the private industry. However, to the extent that new initiatives (regulatory reform, tax neutrality, generic processes) boost participation in savings products, the boost should create opportunities across the broad spectrum of industry providers (who can pitch to employers to become the provider of choice).

Indeed, preliminary work done by the Retirement Commission suggests that those who save through work-based schemes also save more in the retail market (tier three). Improving savings habits through the workplace is therefore likely to actually expand the market for retail products. The regulatory and tax reform processes that we outline should also improve the relative competitive position of retail products *vis a vis* registered superannuation (i.e. wholesale) schemes.

Income support

An issue raised with us was whether earnings on work-based savings would qualify as income and abate against any income support that might be otherwise payable to families. If they did, the process would provide a strong disincentive to save, and would work against our terms of reference objective to encourage saving among low and middle income groups.

A subsidiary issue is that any “pause” associated with the automatic enrolment facility would contradict the rationale behind the Working for Families scheme, which is predicated on a presumption that families with that income level need that money.

We have not examined the rules governing eligibility for income support, and in any event the interface question is likely to be influenced by the outcome of the Stobo Review.

We feel that there should be a ring-fencing of earnings in work-based savings products so that they do not result in an abatement of any income support payable through the Working for Families package, and simply record our view that if this is or becomes a problem, it should be fixed.

Our design of the "pause" in the holding pen should minimise any hardship aspect associated with temporary involuntary contributions. Besides, we do not accept that (above the thresholds) Working for Families is a poverty relief payment: it is an incentive to and reward for engaging in paid work, and being able to save to improve future prospects is in fact an additional "reward".

Machinery of government concerns

Preliminary feedback from Departments have raised concerns that

(i) collecting contributions through the tax system does not fit within IRD's primary roles and responsibilities because the scheme does not involve revenue collected on behalf of the government (compared with, for example, ACC and student loan repayments, which are);
(ii) there may be "moral hazard" issues associated with the government being seen to deduct contributions and therefore being responsible for losses that might arise for whatever reason; and
(iii) the new regulatory environment could be seen as weakening consumer protections.

A suggestion by IRD that if the scheme does go ahead, the central administrator becomes the visible "face" of the front end collection process (with IRD very much in the background) seems to overcome primary role and moral hazard questions. Adequate prudential requirements (backed by insurance cover for theft and fraud) can be introduced into the design of the central administrator facility to ensure that monies collected are not misappropriated.

Finally, we must reassert the view that a streamlined regulatory structure does not weaken consumer protection: it merely makes it more appropriate.

Contribution rate

A number of comments have raised concerns about what contribution rate is "affordable".

We recommend that setting the actual rate should be done after testing the feasibility of different contribution scales through focus group discussion. There is, though, a tension. Setting a contribution rate that is too low generates savings balances that may appear to be trivial, and not worth the effort. Just what is a reasonable target to aim for is a subjective matter, and the target will to some extent drive decisions on the rate. (Saving only what is easily affordable is not the only consideration: saving enough to achieve what is wanted is just as important a consideration).

Evidence from here and abroad indicates that poor people do save. Often they have to save because they don't have the incomes or the assets to

access capital markets or the mainstream financial sector. It is important not to be too patronising when setting contribution rates.

Decisions on saving need to involve a compromise between “how much can I afford”, and “how much do I need/want”.

Amounts that will accumulate in a personal account depend on a number of interlocking factors:

- The age at which savings start;
- The age at which saving stop (55 or 65)
- Starting salary.
- Rate at which salary increases.
- Earnings of any fund.

In the tables below, we set out the amounts of a closing balance, at age 65, as a percentage of final annual salary, for different starting ages, assuming

(a) investment returns of 6.5 percent,
(b) annual salary inflation of 3 percent,
(c) a nil contribution on the first $16,712 of annual income,
(d) contributions of either five or ten percent of salary on amounts earned in excess of that exempt base.

Note that these amounts:

(i) are additional to entitlements that exist under New Zealand Superannuation and
(ii) exclude balances held in other personal accounts.

Final balance as percent of salary at age 65, contribution rate of five percent above exempt base

Starting age	25	35	45
Starting salary			
30,000	191	117	65
50,000	280	172	95
70,000	318	196	108

Final balance as percent of salary at age 65, contribution rate of ten percent above exempt base

Starting age	25	35	45
Starting salary			
30,000	381	234	129
50,000	560	344	190
70,000	636	391	216

Monitoring of performance

The essence of the capacity of the contributor to change provider is that it is the contributor that implicitly monitors the performance of the provider. One suggestion we had was that the employers should be proactive in monitoring and assessing the performance of providers on behalf of employees, and that providers should be required to report performance against various benchmark indicators.

We recommend against being too prescriptive in this area. Obligating employers to carry out a monitoring role increases compliance costs, and increases perceptions that they are promoting or advising on particular schemes.

We believe that in a robust savings environment, where employees can switch providers without encountering penal exit fees, providers themselves will generate performance indicators. General consumer legislation such as on fair trading should be sufficient to guard against misleading performance claims.