Smoothing the future cost increases of providing universal superannuation to New Zealanders

Produced by the Guardians of New Zealand Superannuation for the Commission for Financial Capability's 2019 Review of Review of Retirement Income Policies.

For more information on the NZ Super Fund please visit: www.nzsuperfund.co.nz

Contents:

1. Introduction

The New Zealand Superannuation Fund (NZ Super Fund) invests money on behalf of the Government, to help pay for the increased cost of universal superannuation entitlements (New Zealand Superannuation) in the future.

By doing this the NZ Super Fund adds to Crown wealth, improves the ability of future Governments to pay for superannuation, and ultimately reduces the tax burden of the increasing cost of providing universal superannuation on future New Zealanders.

The NZ Super Fund is managed by an independent Crown entity, the Guardians of New Zealand Superannuation.

2. Executive summary

The NZ Super Fund exists to “smooth out” the increasing future cost of superannuation. We play an important part in covering the cost of the increasing percentage of New Zealanders who will reach retirement age in the coming decades, but we are just part of the picture. Taxes contributed in each respective year will continue to make up the bulk of cash required for superannuation payments.

NZ Super Fund disbursements are projected to provide 4.5% of the cost of National Superannuation in 2040, moving up to 10% by 2075.

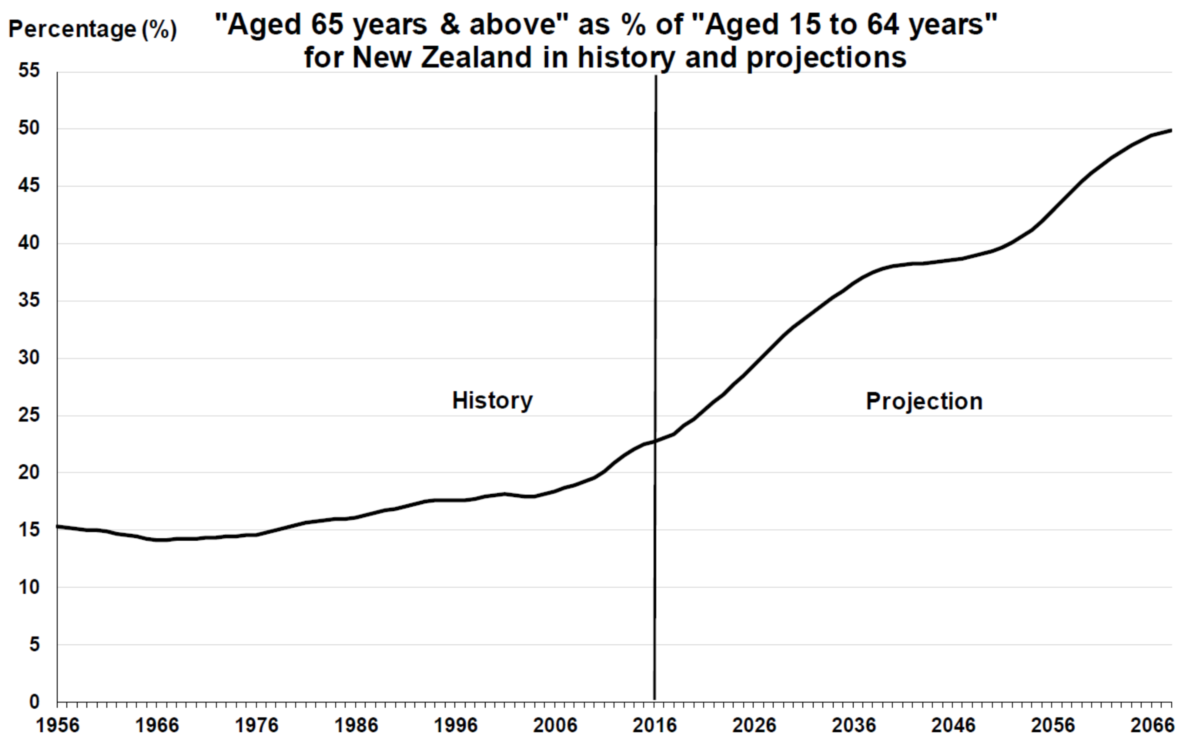
The Fund will also be paying tax to the New Zealand government in addition to capital withdrawals. At the Fund’s peak in the 2070s, the capital withdrawals and tax payments combined total 21% of the total net cost of pensions.

Most importantly, the Fund will pay more than 40% of the incremental cost increase due to the rising proportion of retirees in the population. While the cost of superannuation will still increase over time, it will be smoothed out by distributions from the Fund.

3. Purpose of the NZ Super Fund

All New Zealanders aged 65 and over receive New Zealand Superannuation payments paid for by today’s taxpayers (known as a “Pay As You Go” or scheme). Over the next few decades, however, the New Zealand population will age significantly.

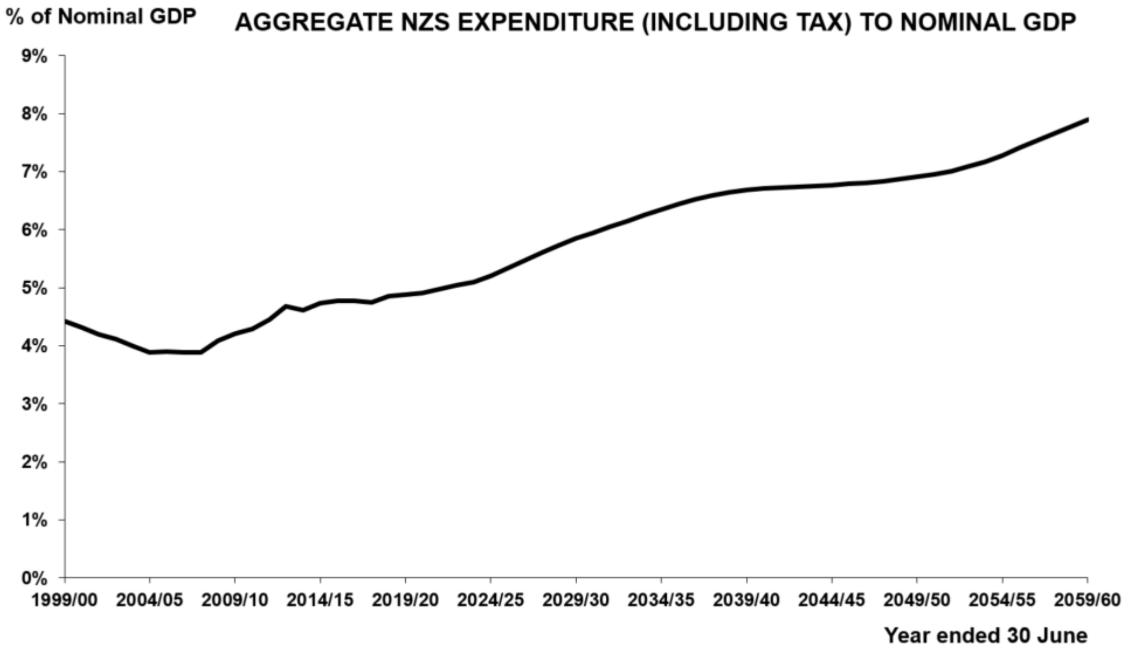
Statistics New Zealand predicts that the population aged 65 years and over will surpass one million by the late 2020s, compared with 550,000 in 2009. The 65+ age group will also grow as a proportion of New Zealand's total population, increasing from 13% in 2009 to more than 20% by the late 2020s. By the late 2050s, one in every four New Zealanders will be 65 years or older. New Zealand’s changing age demographic mix can be seen in the graph below:



This means New Zealand will have:

- more retirement age people as a proportion of the population, than ever before, and;
- fewer 'working-age' people to pay tax to fund the greater cost of retirement income.

As New Zealand's population gets older, the cost to the Government of providing New Zealand Superannuation at similar levels to today will increase. The increasing cost of superannuation is shown in the graph below:



Source: Treasury

These projections have significant implications for the ability of future Governments to fund not just a universal superannuation benefit, but other vital areas such as health, welfare, education and law enforcement. In response to the challenge of New Zealand's ageing population, the NZ Superannuation and Retirement Income Act 2001 established:

- the New Zealand Superannuation Fund, a pool of assets on the Crown's balance sheet, and;
- the Guardians of New Zealand Superannuation, a Crown entity charged with managing the Fund.

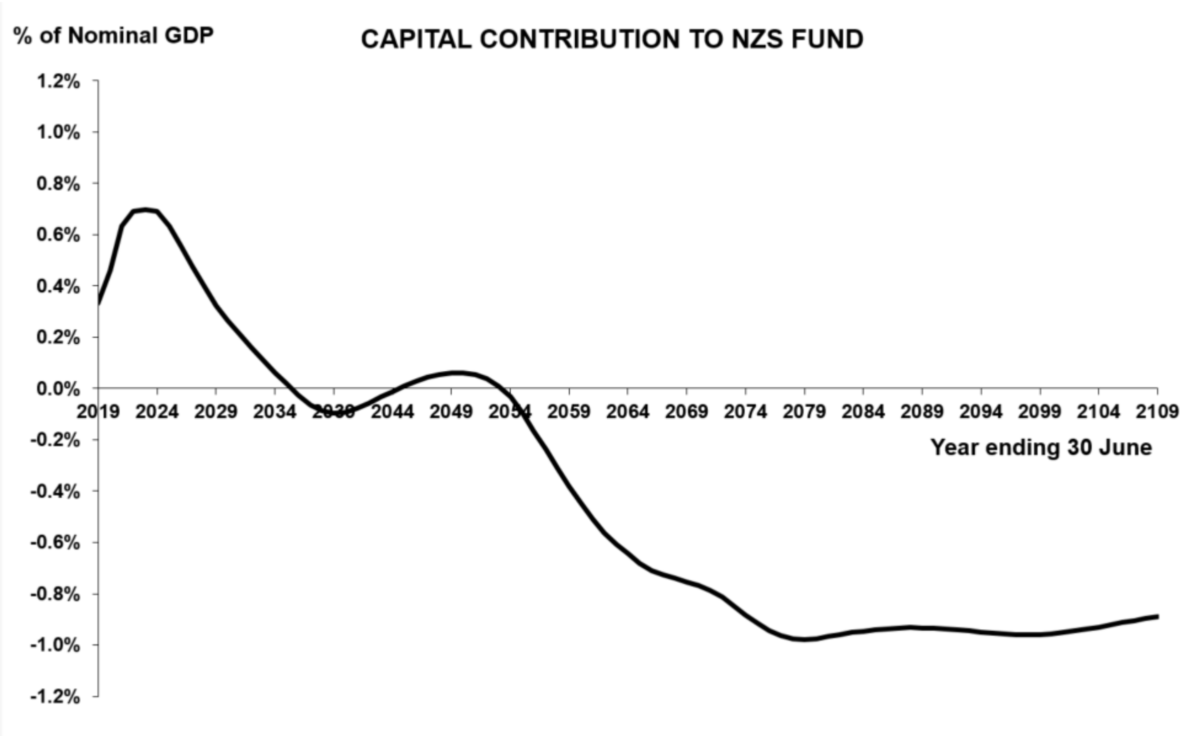
According to Treasury's most recent modelling, the cost of superannuation will grow at an average of 5.3% per year over the next 35 years, while nominal GDP growth will average only 4% per year.

4. Meeting our objectives

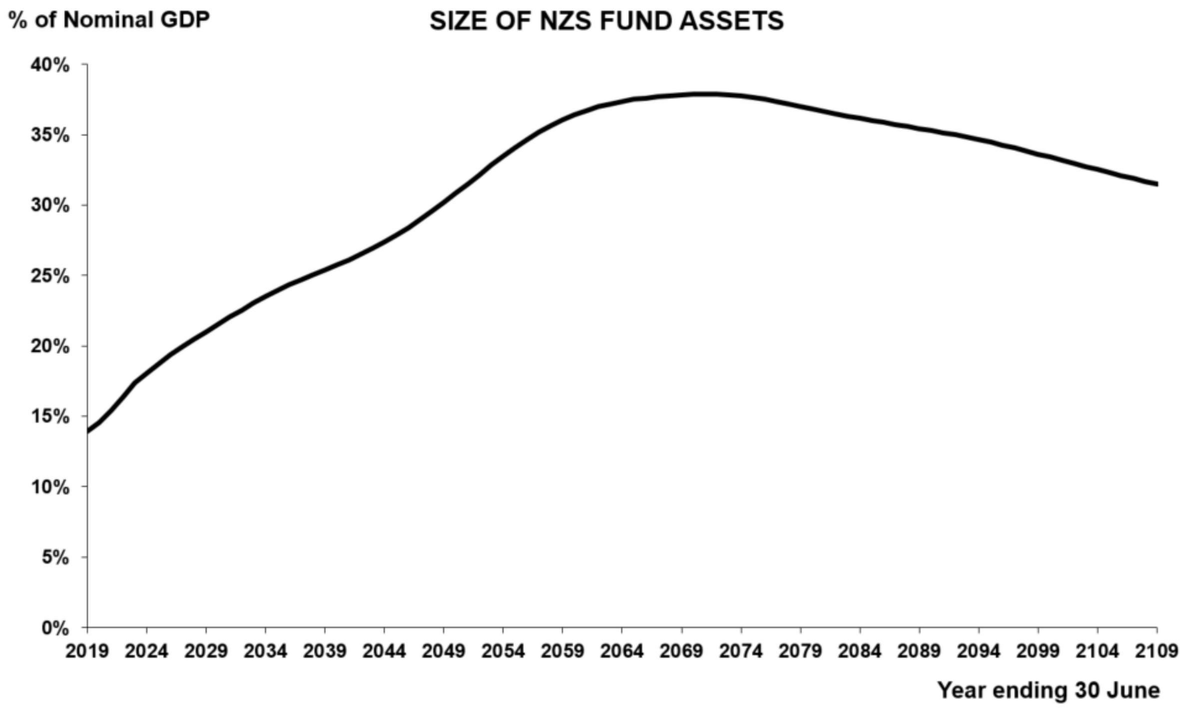
The Guardians of New Zealand Superannuation is the Crown entity charged with managing and administering the Fund. It operates by investing Government contributions – and returns generated from these investments – in New Zealand and internationally, in order to grow the size of the Fund over the long term. The Fund is therefore a long-term, growth-oriented, global investment fund.

The NZ Super Fund was therefore established as a "Save As You Go" (SAYGO) mechanism that will help prepare for this increase and smooth the cost of New Zealand Superannuation between today's taxpayers and future generations. It will supplement the "Pay As You Go" approach in the future and improve the affordability of universal superannuation as a result of accumulated savings and investment returns at a level above the growth of the New Zealand economy.

Under current modelling, the Government will begin to withdraw money from the Fund in 2035/36, with full disbursements to begin in the mid-2050s. The following graph shows the shift between contributions from the government to the Fund, and disbursements (excluding tax) from the Fund back to government to pay for superannuation:



The Fund will continue to grow until it peaks in size as a percentage of GDP in the 2070s. After that time it will continue to grow nominally, but will reduce in size relative to New Zealand's GDP:



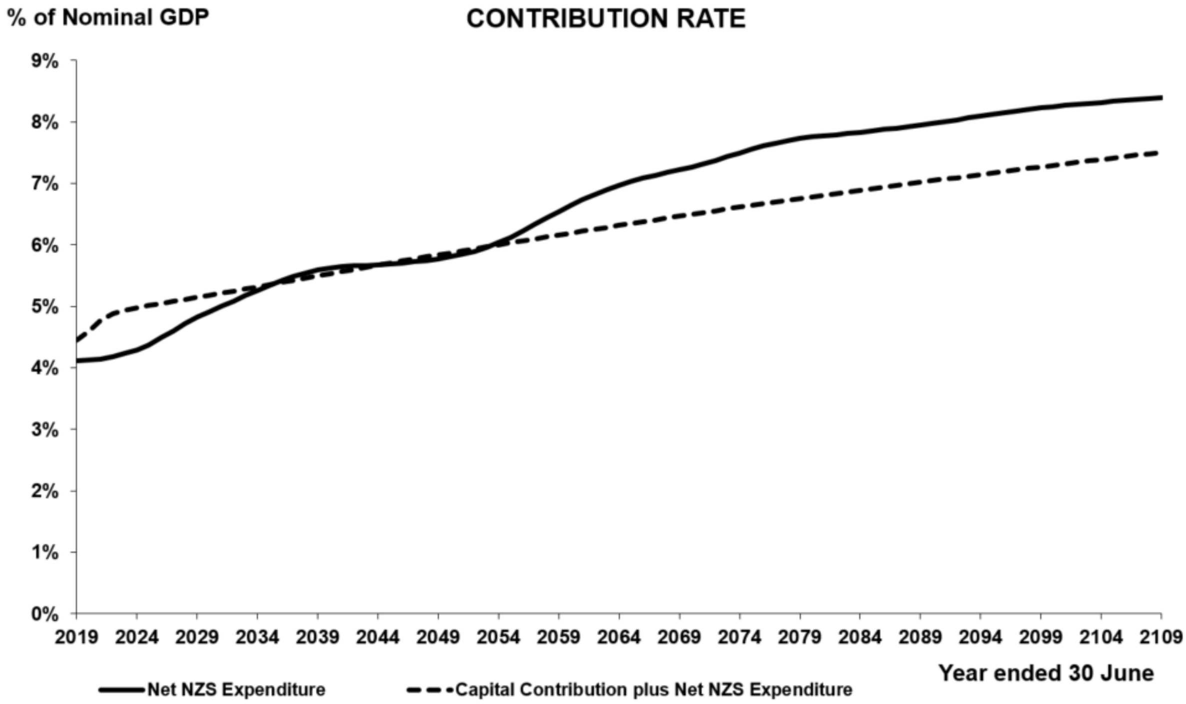
Source: Treasury

5. Understanding our contribution to providing universal superannuation

Based on current Treasury projections,, capital withdrawals from the Fund will be meeting 10% of the net cost of Super by 2066, peaking at 12.8% in 2078, and averaging 11.2% for the 50 years from 2060-2110.

The Fund will also be paying tax to the New Zealand government in addition to the capital withdrawals. At the Fund's peak in the 2070s, the capital withdrawals and tax payments combined total 21% of the total net cost of pensions, and more than 40% of the incremental cost increase due to the rising proportion of retirees in the population.

This graph shows how the Fund's distributions help smooth out the increasing cost of providing superannuation into the future:



Source: Treasury

The NZ Super Fund also reduces risks around superannuation funding because its investment returns are a function of global economic conditions and asset markets, rather than New Zealand conditions alone, as is the case with a pure PAYGO system.

We have four "endowments" or competitive advantages - core features of the Fund that are derived from how we were established and which help guide us in our investing decisions. The four endowments are:

- Long Fund horizon - we have the ability to invest in illiquid assets and to ride out short-term market movements
- Known liquidity profile - we have a public funding formula that determines our cash flow

- Operational independence - Fund investments are made on a purely commercial basis
- Sovereign status - this allows us to pay lower tax in some jurisdictions and is often favourably regarded by business partners.

In combination, these "endowments", which stem from the way the Fund has been set up, optimise the Guardians' ability to generate superior investment returns for the Fund.

Due to the long-term growth-oriented risk-return profile of the Fund, the Guardians are confident of adding many billions of dollars (in present day terms) to Government (and national) savings over coming decades. These are investment returns over and above the alternative Government saving option of reducing Government debt.

This expectation is based on economic logic, long-term historical investment performances, and our modelling of likely future outcomes. This research is supported by global expert opinion and the global investment practice of the vast majority of long-term endowment and pension funds.

6. Contributions and Withdrawals – understanding the impact of policy changes

The level of contributions and timing of withdrawals is governed by a formula set in legislation. It takes into account the level of superannuation expenditure, nominal GDP and Fund returns. Changing assumptions and/or policies relating to superannuation has the effect of altering inputs into the formula, thereby changing the level of required annual contributions, and how and when Fund disbursements contribute to supporting superannuation. This is the case even if those policy changes might only take place many years in the future, given the 40 year period the model uses.

The key message is to properly understand how the impact of policy changes will impact on the Guardians ability to meet their purpose – reducing the future tax burden on New Zealanders of the increased cost of superannuation. This is often a second order effect.

This point is important for policy-makers to keep in mind, for example:

- The "contributions holiday" from 2010 to 2017 significantly impacted the build-up of Fund assets meaning it is approximately $26 billion smaller today than it would have been if contributions had continued and performance remained constant. This delays the point when the Fund can disburse and support the level of superannuation expenditure vis-à-vis the level of GDP.
- Requiring the Fund to pay tax (**most comparable domestic and international peer funds are tax exempt**) creates:
    - a deadweight cost (from having to manage taxation requirements),
    - an actual cost from not being able to claim sovereign tax exemption status in other countries (meaning we pay tax in some foreign jurisdictions), and
    - most importantly, results in real withdrawals from the Fund in periods when contributions are suspended. In 'normal' times when government is contributing to the Fund, any tax paid is netted off by higher contributions to

ensure the Fund meets the objective of covering a certain level of superannuation cost. In periods when contributions are suspended, the Fund still pays tax, in effect “withdrawing” capital that would otherwise be available to invest and therefore deferring the point the Fund can contribute to smoothing the cost of New Zealand superannuation.

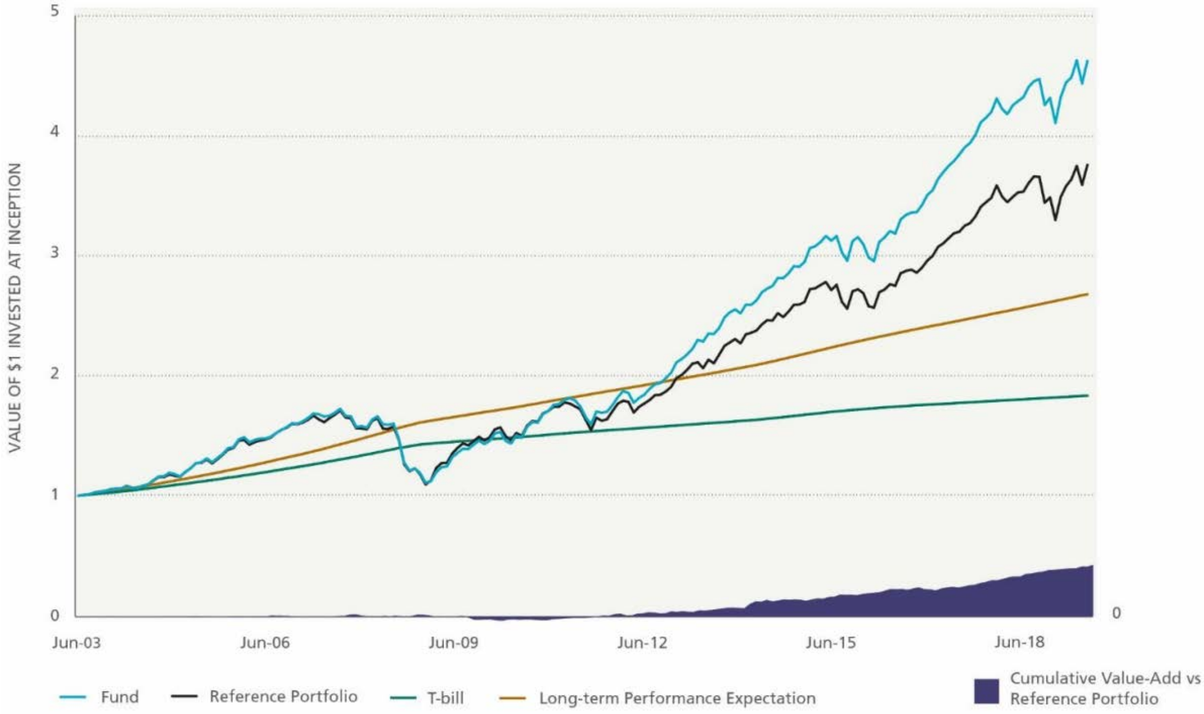
- Raising the age of superannuation eligibility has the effect of delaying the point when distributions are required from the Fund, in effect pushing out the point the Fund can be used to smooth out the cost of providing superannuation. Again, even if this change is to begin 20 years hence, it will have an immediate and negative impact on the level of fund contributions, as a result of the smoothing formula.

7. Super Fund performance

Since 2003, the Government has contributed $9.88 billion to the NZ Super Fund (net of the tax the Fund has paid back to government) and at 30 June 2019, the Fund was worth $43.1 billion. The Guardians has successfully invested the Government’s contributions in New Zealand and overseas, returning 10.15% per annum, after costs and before NZ tax, since inception in 2003.

Since inception, we have outperformed our market reference portfolio (current made up of a mix of 80% equities and 20% fixed income) by 1.43% per year, adding $8.32 billion of value. Over the lifetime of the Fund, this above-market return adds many tens of billions of dollars to the Fund.

Taking another measure, since inception the New Zealand Treasury Bill (T-Bill) return has been 3.9% (this is the cost of debt to the Government). The Fund has delivered a net return (actual return less T-Bill return) of 6.25%, meaning we are delivering more benefits to taxpayers that what they could achieve by simply paying down debt. In dollar terms, the contribution over the Government’s cost of debt is $25.5 billion. This graph shows the contribution the Guardians has made:



The Government, using section 44 of the Act, suspended capital contributions from 2009 until 2017. In December 2017 contributions resumed, with $500 million in financial 2018, $1 billion this year, $1.5 in 2020 and $2.2 billion in 2021.

8. Additional mandates

The legislation that established the NZ Super Fund has a single "mandate" that says the Guardians must invest the Fund on a prudent, commercial basis and, in doing so, must manage and administer the Fund in a manner consistent with:

- best practice portfolio management;
- maximising return without undue risk to the Fund as a whole; and
- avoiding prejudice to New Zealand's reputation as a responsible member of the world community.

This means the Fund is focused on commercial investments that deliver the returns required to help smooth the future cost of superannuation. The single mandate ensures the Fund remains dedicated to this hugely important task.

As part of Budget 2019, the Government announced it was giving the Guardians an additional mandate (separate to the Super Fund) to administer a new Venture Capital Fund. Legislation to establish that Fund is likely to be passed at the end of this year. It was important that this additional mandate was separate to the Super Fund's mandate, in order to maintain the commercial independence of the Guardians in relation to the Super Fund (rather than directing the Super Fund to invest in venture capital).

Internationally, sovereign wealth and pension funds often have different mandates. For instance the Australian Future Fund has six covering: traditional investing, medical research, aboriginal and Torres Strait Islander economic development, disability care, infrastructure and education.

Recently there has been discussion that NZ Super Fund should be given an additional mandate to cover superannuation annuities (this has been called KiwiSpend). This would see individual KiwiSaver accounts transferred to a subsidiary of the Super Fund, which would then be paid out as an inflation-adjusted income supplement for the rest of a person's life.

While the Guardians is not adverse to additional mandates, we advise caution relating to their introduction. The feedback we have from peer funds overseas is that additional mandates result in a dilution of focus on the primary function of investing commercially to cover the future cost of providing superannuation. Multiple mandates can create competing objectives for funds and add complexity to their operations. Our concern with KiwiSpend is that it would impact on the Fund's asset allocation decisions and add considerable capital management complexity.

Further, significant customer relationship management capabilities would need to be added to the Fund in order to handle the requirements of managing individual accounts. In addition, caution must be exercised to avoid impacting the operational independence of the Guardians – a fundamental endowment of any successful long term investor. This was reinforced by the recent independent review of the Guardians commissioned by Treasury from Willis Towers Watson.