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Global Variable Annuity Experience Reflected in New Zealand Product Design

By Murray Hilder and Ralph Stewart

New Zealand is about to launch its first variable annuity with guaranteed lifetime withdrawal benefits. The product design is mindful of the lessons from the financial crisis in the United States, Europe and Japan.

NEW ZEALAND RETIREMENT SAVINGS BACKGROUND: KIWISAVER

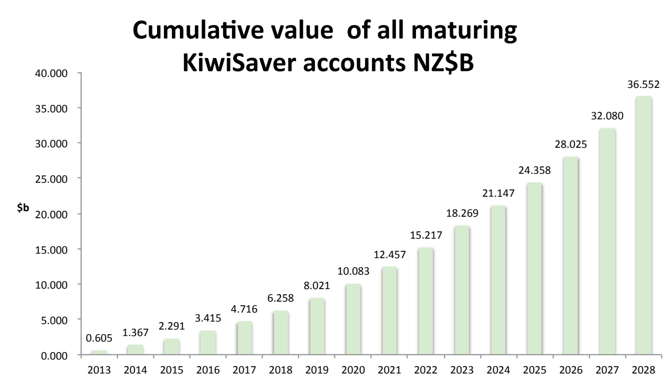
New Zealand has a unique state funded pension scheme which commenced in 1898 and today guarantees all New Zealanders 66 percent of the average wage for life from age 65. The scheme is not asset tested and is funded from general taxation. The generous scheme has contributed to an environment where there has been little development of post retirement income products, as the state scheme has been perceived to be the primary provider of retirement income.

Raising awareness for the need for personal retirement savings in addition the state funded pension, lead the government to launch a new retirement income scheme in 2007 called KiwiSaver. KiwiSaver required all employers to enroll employees in a retirement savings scheme with co-contributions from their employer. Initially the rates were set at an equal contribution from employee and employer of 4 percent. The current default rate is 3 percent. Employees are automatically enrolled but do have the option to "opt" out if they wish. Up until May 2015 all new KiwiSaver enrolments qualified for a NZ $1000 (US $730) sign up bonus. Savers also receive a government contribution of NZ $521 (US$384) each year towards management costs if they save at least $1,042 (US$750) each year. No savings can be withdrawn until age 65 and there are currently no limitations on how the savings are used.

KiwiSaver has been extremely successful, from a population of 4.5m people, 2.5m are now KiwiSavers with NZ$29b (US$21b) saved to date. The scheme offers three savings profiles conservative, balanced and growth. Savings are collected through the state taxation system and then invested individually with 27 private sector investment management firms. The state monitors asset allocation, fees and disclosure.

Attention is now turning towards decummulation and future of the accumulated savings in KiwiSaver. In 2014/2015 savers aged over 65 withdrew $422 million from the scheme, an increase of 12.7 percent over 2012/13. Given the scheme was launched to help supplement the income from the state funded scheme, the issue of KiwiSaver and the future of retirement income is becoming a topical issue in New Zealand. In practice the management of KiwiSaver savings is the most significant investment in the New Zealand's funds management sector dominating the local managed funds industry

FIGURE 1



THE OPPORTUNITY: VARIABLE ANNUITIES FOR KIWISAVER DECUMMULATION

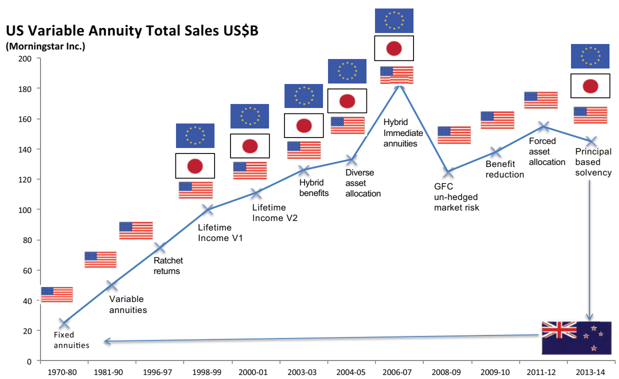
In 2013 an enterprising New Zealander, who had previously been the chief executive of AXA in New Zealand and one of the first to launch a KiwiSaver scheme in 2007, launched a research project to better understand how the rest of the world managed decummulation.

The research began in the United States with numerous company visits and solid support from the Insured Retirement Institute (IRI) in Washington and the retirement product division of the American Association of Retired People (AARP).

It was during this process that a connection was made with Tim Paris, CEO of Ruark Consulting, an annuity consulting and reinsurance specialist based in Connecticut (who has subsequently become a director of the New Zealand business) and Ken Mungan at Milliman, the variable annuity specialist firm based in Chicago.

The research focused on variable annuities with rider benefits and in particular the changes in liability management after the recent financial crisis. The research moved from the United States to Europe and Japan with Tokio Marine Group a variable annuity provider in Tokyo providing a significant contribution to the Japanese experience of guaranteed lifetime withdrawal benefits.

FIGURE 2



A return to New Zealand, and with the help of Ruark Consulting, a basic product was designed and New Zealand's first workbench variable annuity with lifetime withdrawal benefits was developed.

The design drew on a number of core principals, which featured throughout the research as learning's post financial crisis:

- as there were no deferral tax benefits available in New Zealand the product would target retiring KiwiSavers aged 65 years+
- the maximum age would be 85 years
- there would be no choice over asset allocation
- asset allocation would be 50 percent growth and 50 percent income assets
- index tracking exchange traded funds would be used (Vanguard)
- both the balance sheet of the insurer and the underlying investment would be actively hedged (Milliman)
- the guaranteed minimum withdrawal benefit was set at 5 percent increasing with age
- there is no spouse benefit (remaining account balance to the estate)
- the insurer would have the freedom to increase the price for new business
- as a new business in NZ the insurer would have the right to cancel the guarantee and return premium at any time within the first two years of launch
- the price for the asset management 0.95 percent
- the price for the guarantee 1.35 percent

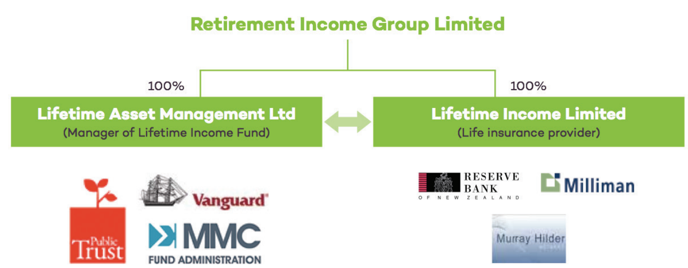
The concept was feasibility tested with Milliman's Sydney's office, who provided guidance and support in the product development process. After three rounds of testing, deferral features were added from 65, which set the annual Lifetime Withdrawal Benefit Rates at:

TABLE 1

Age 65-69	5.00 percent
Age 70-74	5.50 percent
Age 75-79	6.00 percent
Age 80 +	6.50 percent

BUILDING THE OPERATING STRUCTURE

The next step was an operating structure that would maximize consumer protection, treat tax in retirement fairly and work within a regulatory framework that had never contemplated variable annuities in New Zealand. We took the lead from the New York example of Vanguard and Trans America and applied this is in a New Zealand context.



As a single entity, the Retirement Income Group Limited was established which in turn owned 100 percent of an asset management company (Lifetime Asset Management Limited). This company outsourced investment management to Vanguard and used local trustee and administration services companies (Public Trust and MMC). The Retirement Income Group also established a 100 percent owned subsidiary, Lifetime Income Limited, to provide longevity insurance to the investors in Lifetime Asset Management.

The prudential supervisor of life insurance in New Zealand is the Reserve Bank of New Zealand who administers the Insurance (Prudential Supervision) Act 2010. The Act did not contemplate variable annuities and did not have a solvency determination for longevity insurance. The Reserve Bank considered the proposal and agreed to commit the resources to develop a new solvency standard for variable annuities in New Zealand, something they did not need to do, given their limited resource and a heavy regulatory agenda.

In April 2015, after several drafts and industry consultation, the Reserve Bank of New Zealand Solvency Standard for Variable Annuity Business 2015 was issued. It contained a number of elements which we had not anticipated. The first was a requirement for a triennial review of solvency estimates by an independent actuary and the second was a phased introduction of solvency credits for dynamic hedging.

As there was no local experience, we appointed KPMG in Australia to complete the first review of our business plan and pro-forma financial condition report. This introduced concern over our mortality assumptions and resulted in us commissioning Milliman to complete a review of a "like for like" mortality treatment in Australia, the United States and the United Kingdom. This resulted in the application of new mortality assumptions to the product which were more conservative than those used in the wider life industry.

KPMG's review was completed and an application made to the Reserve Bank of New Zealand to be New Zealand's first variable annuity provider was submitted under the existing life insurance requirements and the new variable annuity standard.

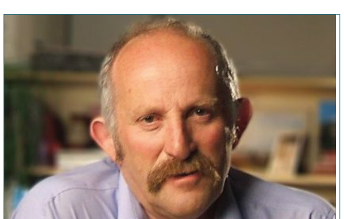
At the same time, as the business spanned both life insurance and asset management, approval was required from the regulator for the asset management industry—the Financial Markets Authority.

The regulator was in transition moving from an old legislation—the Securities Act 1978—to the Financial Markets Conduct Act 2010. Our timing again was not helpful given we presented a "new" concept spanning two regulatory regimes. Nonetheless, we found a willingness to help and a sensible process was agreed to accommodate our application and the transition in regulation.

In a New Zealand context the notion that the regulator will not entertain innovation has not been our experience.

Both the Reserve Bank of New Zealand, the Financial Markets Authority and the New Zealand Inland Revenue Department have, within their given mandates, given us fair and reasonable support.

CAPITALIZATION AND LAUNCH


Gareth Morgan

In concert with this process, there was the commercialization of the project and capital raising to support both regulatory and working capital. It's fair to say this was hard work, but we just got on with it, and after nearly 12 months of capital raising, secured $NZ6.5m (US$4.75m) of new capital. This would cover both our regulatory and working capital needs for the first two years. After two years we will need to raise an additional $1.5m (US $0.73m) in new capital. Retained earnings are expected to meet our capital needs thereafter (if sales were achieved and cost managed). The capital raising process brought a convertible facility from one of New Zealand's best-known entrepreneur's, Gareth Morgan (see photo).

With capital in hand, an application was made to the A.M Best in Singapore for a credit rating, to provide the Reserve Bank and consumers some comfort over the capital required to back the minimum lifetime withdrawal benefits. Given this was a new business, the process was fairly clinical and BB- was issued. We thought this was fair, as in practice we had minimum regulatory capital of $NZ6.5m ($US4.75) without any proven demand.

Some three years after research commenced, the business is expected to launch in 2015. A significant amount of work has been invested in pre-sales marketing support, with financial advisers, KiwiSaver fund managers (who are experiencing outflows at age 65) and New Zealand's dwindling defined benefit superannuation industry (which badly needs an alternative to old defined benefit obligations).

The new business is called the Retirement Income Group Limited and the product is the Lifetime Income Fund which seeks to resolve the key retirement income questions:

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