Submission template: Review of KiwiSaver default provider arrangements

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Section 1: Your details

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Are you requesting that any of this submission be kept confidential? No

If yes, please let us know why the information should be kept confidential in accordance with the Official Information Act. Please also send us a redacted version of your submission for publication.

Reasons for withholding: N/A

Section 2: Feedback on discussion paper

1. **What is your feedback on the proposed objective for the review?**

The discussion paper states the main objective is to enhance the financial wellbeing of default members, particularly at retirement. We completely support this objective.

We do note, however, that in scoping the terms of the default review, several important issues have been deliberately excluded such as contribution rate, employer contribution rate, the linking of employee and employer contributions etc. While this makes sense given this is a review of default providers, not KiwiSaver itself, it does significantly reduce the impact this review will have on the main objective.

2. **What is your feedback on the proposed criteria for the review? How should the criteria be weighted?**

Of the five proposed criteria, we agree completely with the inclusion of Criterion 1 and feel it should be given the greatest weight, given its clear linkage with the overall objective of the review.

We also support Criterions 2, 3 and 5. With regards to criterion 5 however, it is worth questioning whether innovation should be encouraged given the (well-known) low engagement rates of default members.

We have deep concerns regarding the inclusion of Criterion 4. While Criterions 2, 3 and 5 support criterion 1 and the overall objective of the default review, Criterion 4 splits the focus of KiwiSaver. If the goal is to maximise retirement savings for New Zealanders, then investment managers should be provided with freedom to pursue the best returns possible for a given level of risk/fund type. *Requiring* managers to invest in the local market may, at various times, *require* them to invest in an already overvalued market, reducing members' returns. To do so runs against the stated overall objective of the review. This investment risk is particularly relevant given the small number of listed assets in Aotearoa New Zealand, and the relative size of KiwiSaver already.

Additionally, Criterion 4's suggestion of private investment explicitly contradicts Criterion 3 (keeping fees as low as possible).

Further, given this review is focused specifically on *default* members, we believe that item 22 misallocates the responsibility of developing a strong capital market to those least capable of taking the inherent risks associated with such a goal.

3. **What is your feedback on the problem definition for the investment mandate? Is a move away from a "parking space" purpose justified?**

We would support, in principle, the idea of moving away from treating default funds as a 'landing pad' for new members. However, we note the following issues:

- Default conservative funds are, on average, considerably cheaper than other conservative offerings.[1] For a member who should be in a conservative fund, it may be that the default option represents the best outcome for them.
- Conservative funds are also appropriate for some groups who may otherwise be misallocated under a life-stages model, such as first home buyers and the self-employed.
    - First home buyers will use their funds for a house deposit in the short to medium-term, making cyclical market volatility a concern.
    - Self-employed New Zealanders are potentially highly exposed to economic fluctuations, which may make taking greater risk with their KiwiSaver inappropriate i.e. needing financial hardship withdrawals due to business failure.

We could support moving away from parking space on the proviso that default providers be required to establish more accurately (than simply basing fund type on age) the appropriate investment option for the member. This may require significant efforts to engage members, including the use of appropriate triggers.

4. **Should the investment mandate options (and other options, for example in relation to fees) apply only to default members who have not made an active choice, or should they also apply to members who have made an active choice to stay in the default fund? Why or why not?**

[1] For a breakdown of KiwiSaver fees by fund type over time, see our forthcoming article "Economies of Scale: The Case of KiwiSaver Fees" (2019), forthcoming in the *Pacific Accounting Review*, co-authored by Aaron Gilbert, Ayesha Scott and Shuohan Xu.

No, members who have actively chosen a conservative default fund, should be entitled to remain in a conservative fund regardless of their life stage or a generic risk assessment. We note, as stated above, default conservative funds are cheaper than non-default conservative funds, and therefore active default members should be assumed to have made an informed decision.

5. **If a life-stages option is adopted, what "stages" should apply and to which age groups? Should there be a "nursery" period?**

We have no particular views on this. We note there is a case for not treating a soon-to-be-retired person as suitable for a conservative fund, given the 30-year life-expectancy in retirement. However, there is currently a dearth of research into how people decumulate their savings during retirement. The current assumption is that people spend equally over their remaining years. However, at least anecdotally, this doesn't appear to be the case with many newly retired individuals spending on big-ticket items such as cars and holidays. A significant downturn in the market just before retirement could potentially reduce savings at the same time as spending increases, and when combined with the effect of compounding returns, could dramatically reduce the amount a retiree can withdraw annually going forward. More thought needs to be given to this gap in the literature.

In the event where the fund can actively engage with the member *before* assuming a fund type, we support the concept of a "nursery period".

6. **If a balanced investment mandate is adopted, what range for growth assets should be applied?**

We have no view on this issue.

7. **If a growth investment mandate is adopted, what range for growth assets should be applied?**

We have no view on this issue.

8. **If a conservative investment mandate is adopted, what range for growth assets should be applied?**

We have no view on this issue.

9. **If a life-stages, growth, or balanced option was adopted, how should we mitigate the potential issue in relation to first-home buyers and other people making early withdrawals?**

As stated above, we support a life-stages model, if providers are required to actively engage with members to determine whether the predicted fund type adequately represents an appropriate fund type.

We note item 60 that the review categorises default first home buyers as a small portion of total membership based on historical information. However, given the current house deposit requirements and housing affordability, we argue this statement may significantly underestimate the number of current default members planning on buying a house.

10. **What would be the administrative costs to providers of choosing a life-stages option?**

We have no view on this question.

However, we take umbrage with the statement in item 67 that "the risk of actual losses remains low". We assume this is referring to people having less at retirement than they contributed, but it is not clear. A growth fund, with 80% in equities suffering a 45% decline in market value (as per the reduction in the NZX during the GFC in 2008, where Aotearoa New Zealand suffered a smaller decline than many global markets) would reduce a member's balance by 36%. While this would technically be a 'paper' loss, media reporting on recent market jitters[2] has highlighted the potential for investors to make significant mistakes by trying to move into a lower risk portfolio after or during falls. Doing so would lock in losses and remove the possibility of investment gains post-downturn. Additionally, for anyone needing to withdraw money early, such as financial hardship withdrawals or first home deposits, this would represent a real loss.

Losses would potentially compromise existing investor trust and confidence in KiwiSaver.[3] We note the NZ general public still has significant distrust of stock markets as a result of the 1987 market crash, and as yet KiwiSaver has not seen a wide-scale and significant downturn (KiwiSaver was very young at the time of the 2008 crash).

11. **What is your feedback on the different options? Do you agree with our assessment of the costs and benefits of the option? Which option do you think is best and why? Is there another option that we have not considered that would be better than the options discussed?**

We support a life-stages approach, provided there are exceptions for members where a lesser risk portfolio would be appropriate (such as first home withdrawal, significant volatility in other wealth such as small business owners).

We note that for Criterion 2 the document highlights the 'benefits' of better long-term returns while ignoring the potential risks of a significant downturn, particularly in light of the poor investment knowledge of New Zealanders. We also do not support the benefit under Criterion 4 as we do not believe this should be a criterion.

12. **What is your feedback on the level of value that KiwiSaver default members get for their fees? What are the costs that are within and outside a provider's control? To what extent are fees too high?**

We support all efforts to reduce the fees members pay. It is worth remembering that returns are uncertain while fees are guaranteed, and higher fees result in far greater reductions in eventual savings than the simple difference in the total fees.

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[2] See, for example, "KiwiSavers could face their toughest year in 2019" by Tamsyn Parker in the NZ Herald (3/1/19) https://www.nzherald.co.nz/personal-finance/news/article.cfm?c_id=12&objectid=12179312; or, "Choppy markets: What you should do with your KiwiSaver" in the NZ Herald (12/10/18) https://www.nzherald.co.nz/personal-finance/news/article.cfm?c_id=12&objectid=12141406; among others.

[3] Trust was mentioned as an issue across focus groups in our study of KiwiSaver disclosure, findings can be found in the report "What Kiwis' Want", available from https://acfr.aut.ac.nz/__data/assets/pdf_file/0005/168080/KiwiSaver-Readability-Stage-2-IND-REPORT-Final-v2.0.pdf

Of particular concern is the significant differences in the fees charged by default providers for essentially the same service, as shown in Table 1. As default members do not select their provider, their eventual retirement savings are being affected by their random allocation to a particular provider, with a person potentially tens of thousands worse off at retirement by being allocated to a higher fee provider.

We note for current default providers, who are all managing a conservative portfolio, the variable costs should be relatively low as they are predominately invested in cash and fixed interest investments. Notably, recent entrants to the market, such as Simplicity, have managed to offer considerably lower fees than existing providers, even for funds that are more heavily growth-orientated. One aspect of this is the argument of passive vs active management. Passive management *should* offer considerably lower fees than an active approach. The recent change by BNZ to passive management and the near halving of fees on some of their funds is a good example. We would argue that given the preponderance of academic evidence showing no value in active investment[4], and the extremely limited impact active management would have on a conservative fund anyway, providers should be focusing on low-cost passive strategies.

A forthcoming paper of ours in the *Pacific Accounting Review* provides insights into the issue of economies of scale raised in item 81. There is no evidence of economies of scale in terms of assets under management, but there is evidence of economies of scale with regards to the number of members a provider has (Gilbert, Scott and Xu, 2019). The findings show a 1% increase in member numbers for a fund with more than 50,000 participants, will result in a 0.9% increase in the total fees. To maximise the fee reduction, the funds need more members. The result appears to be driven by being able to spread the fixed costs associated with running a KiwiSaver fund (i.e. the infrastructure around managing member communications etc.) over more members. The cost of investing itself appears to be fixed.

Finally, based on item 85(c), we believe fees *could* be lower for Kiwisaver members. However, it is almost impossible to determine the actual costs of running a KiwiSaver fund independently, and therefore without greater transparency by providers it is difficult to support this belief.

13. **Is it a problem that fees disproportionately affect those on low income and under 18s? Why/why not?**

The problem as articulated is misidentified. The issue is low balances, which are more common with low-income members and under-18s. Low balances are disproportionately impacted by the fixed fee compared to those accounts with higher balances, resulting in lower returns. Other jurisdictions have implemented strategies that limit the level of fees charged on low balances, essentially protecting balances up to a threshold amount.

14. **If the government sets a fee, what should the fee be set at for the different investment mandate options? What considerations, methods or models could be used to determine the fee? What should be the balance between fixed and percentage fees?**

[4] See Frijns, B. and Indriawan, I. (2018), "On the ability of New Zealand actively managed funds to generate outperformance in their domestic equity allocations", *Pacific Accounting Review*, Vol. 30 No. 4, pp. 463-481. https://doi.org/10.1108/PAR-10-2017-0079

We do not support the government fixing a fee, but instead, believe that fees should be a key criterion used in the selection of the default providers.

15. **What fee arrangements would best promote the objectives of the review? What is your feedback on the fee options? Do you agree with the costs and benefits identified? Which option (or the status quo) do you prefer and why? What other approaches or models could be used to reduce fees?**

We advocate for Option 2, whereby fees become one of the selection criteria. One option to ensure some similarity in fees would be to select the providers who came within a certain percentage of the cheapest selected provider. For instance, Table 1 identifies KiwiWealth as the cheapest provider ($96). Excluding the providers who are too much above the threshold would ensure better consistency.

16. **How has the number of providers in the default market affected innovation, competition and value-for-money in the default market and in KiwiSaver more generally?**

As we highlight in our answer to question 12 above, the only evidence of economies of scale relates to the number of members. Having 9 providers for just over 500,000 members has resulted in small member numbers on average, with an advantage for those who have been default providers since inception. Subsequently, there are less economies of scale available overall, on average. A few larger (based on member numbers) providers would offer better cost reduction, and in turn value for money.

Regarding competition, there is (at best) limited evidence of competition in the KiwiSaver market, especially in the default market. Default members are largely disengaged and therefore unlikely to respond to competitive efforts by other providers. The extreme differences in fees currently offered (for what amounts to the same basic service) is a prime example of a lack of competition.

17. **Do you agree with our assessment of the costs and benefits of the different approaches for the number of providers? Can you provide us with evidence that might help us quantify the size of the costs and benefits? What option do you prefer and why?**

We would dispute the importance placed on competition in both the benefits and costs. Competition requires members to switch to get better service and/or lower fees. As default members are disengaged, it is pointless to be concerned with competition until such time as members become more engaged.

18. **If a "minimum requirements" approach is taken should this be on a period-based or rolling system, and why?**

No opinion on this question.

19. **Are there higher investment costs for responsible investing? If so, how likely are these costs to contribute to lower net returns?**

The area of responsible investing (RI) is rapidly evolving. Previously, to engage in RI required funds to undertake their own investment research so that they could screen them for undesirable companies. Doing additional research imposed additional costs. Exchange Traded Fund (ETF) providers, however, are now offering index ETFs with ethical screens at relatively low cost. It is therefore not a *requirement* that funds incur additional costs for ethical investments.

20. **How does responsible investment affect returns? Does it increase or decrease returns, and to what extent?**

This is an incredibly complex question. To date, the academic evidence is extremely mixed. Studies have concluded it decreases, increases or has no impact on returns, dependent on benchmarking and time period. It is also worth noting that the mechanism by which RI influences returns is not well understood.

21. **Should the default provider arrangements be used to achieve objectives in relation to responsible investment?**

No. To do so is a distraction from the objective of KiwiSaver. Members are currently free to incorporate RI if they elect to by choosing a more responsible fund, in the event they make an active investment decision.

22. **Would default members want their funds to be invested more responsibly? If yes, is the same true if responsible investment means potentially limiting future returns?**

We would assume that if members had a strong preference for responsible investment they would have actively chosen a RI fund. From that basis we would say no, default members have shown no interest in RI, and that would likely be even more the case if it impacted returns.

23. **To what extent is it a problem that default members do not have information about whether their investments are made responsibly? Would having more information make a difference to the behaviour of default members? What alternatives might there be to more/standardised information to address responsible investment concerns?**

The key problem with default members is that they are unwilling or unable to engage with KiwiSaver. Providing additional information is likely to enhance decision apathy in those who already feel overwhelmed. Members who simply do not want to engage with their retirement savings provider are unlikely to be concerned by the lack of information on RI. Therefore, making additional information mandatory is unlikely to positively influence default member behaviour.

However, simplified and standardised information[5] on exclusions may be of benefit to members of non-default funds (see our report, What Kiwis' Want[6] for evidence of an appetite for disclosure of this nature). The information should be easy to access and understand, perhaps a standardised list of industries with the fund managers identifying which of these are excluded. Additional information should be easily comparable between funds and fund managers.

24. **Do providers' current responsible investment exclusions meet what default members would expect?**

We have no opinion on this.

[5] See our report "Short and Sweet or Just Short? The Readability of Product Disclosure Statements" for a summary of what simplified and standardised information might look like. Available from https://acfr.aut.ac.nz/__data/assets/pdf_file/0017/108152/Short-and-Sweet-or-Just-Short_Ind-Report-26_Oct.pdf

[6] https://acfr.aut.ac.nz/__data/assets/pdf_file/0005/168080/KiwiSaver-Readability-Stage-2-IND-REPORT-Final-v2.0.pdf

25. **If this option is adopted, what industries or sectors should be excluded? Should the government instead adopt an international exclusion standard or certification regime? What would be the costs associated with an exclusion or certification regime?**

We do not advocate for this option. There is currently no real agreement on what should and should not be included in a RI fund. Currently, most funds exclude a few common industries or investments, like weapons manufacturers etc. Previously when questionable investments have been brought to the public's attention, fund managers have been quick to correct the situation. Therefore we see no need for mandatory exclusions.

26. **If this option is adopted, what form should standard disclosure take? For example, should all providers be required to provide a statement listing all excluded companies by sector?**

We would support a standardised and comparable list of ALL sectors, with funds and fund managers identifying those that are excluded from the fund. It should be simple and easy to compare between funds.

27. **What is your feedback on our assessment of the costs and benefits of the responsible investment options identified? Which option (or the status quo) do you prefer and why?**

We disagree option 2 will increase costs in a meaningful way. A standardised disclosure document provided *online* would cost little to produce and would likely be changed only rarely.

28. **What limitations or problems exist in relation to New Zealand's capital markets? How could the settings for KiwiSaver default providers be amended to support the development of New Zealand's capital markets? How do the liquidity and pricing rules affect default provider investment in alternative New Zealand investments?**

We strenuously object to adding requirements for KiwiSaver (in particular, KiwiSaver default funds) to support the NZ capital markets. To do so takes away from KiwiSaver's purpose and potentially undermines the main objective of KiwiSaver, maximising members retirement savings.

KiwiSaver funds, both default and non-default, are already investing in the local capital market. However, without additional listings of companies onto the stock exchange, there is a limit to how much money can be invested without overpricing stocks and artificially inflating prices.

Forcing funds to maintain specific NZ-based investments could result in forcing funds to purchase overvalued securities, resulting in reduced returns for investors (undermining Criterions 1 & 2).

Additionally, mandating alternative investments for default funds will undermine Criterion 3. Private equity investment requires considerably more staff and resources to seek out and develop opportunities. Funds will either have to acquire this expertise directly or use external managers. Either way it is reasonable to expect this would add to the fees charged to members. Additionally, a 0.5% requirement would result in very small amounts of capital being invested, $46 million in total spread over 9 managers currently. An amount such as this would do little to assist the local capital markets but would result in lower retirement savings due to higher fees.

29. **How could the default settings be used to develop New Zealand's capital markets? What parts of New Zealand's capital markets are most in need of development?**

See Question 28.

30. **Should default funds take an active role in helping develop the New Zealand capital markets? Would this support the purpose of the KiwiSaver Act and the accumulation of retirement savings by default members?**

No. KiwiSaver has already resulted in considerable new investment in the NZ market. Efforts to enhance and grow the local market should be considered separately and not as part of a review of KiwiSaver.

31. **To what extent is the management of default funds currently located in New Zealand or carried out by New Zealand entities?**

We have no opinion on this.

32. **What is your feedback on a New Zealand-based management option? If this option is adopted, which part of the investment process do you think should be based in New Zealand to help develop New Zealand's capital markets? What type of mechanism would best give effect to this requirement?**

We have no opinion on this option.

33. **What is your feedback on a targeted investment requirement? If the option is adopted, what market should be targeted by an investment requirement (eg early stage companies)?**

We do not support this idea. It is likely to increase costs to members, undermining Criterion 3.

34. **What is your feedback on our assessment of the costs and benefits of the options to develop New Zealand's capital markets? Which option (or the status quo) is best and why? Is there another option that would be better than the options discussed?**

We support the status quo, we feel this offers the best opportunity to advance Criterions 1,2,3 and 5, which in our opinion are the only criterions that should be considered.

35. **What is your feedback on the problem definition for the transfer of members? What other problems are there in relation to the transfer of members?**

We agree with the problem definition.

36. **If default members are transferred from providers with more members to providers with fewer members, how should we decide which members are transferred?**

As we have articulated above, our research has shown that funds get greater economies of scale from having more members, not greater assets. As such, we would argue for a small number of default providers, no more than four. Each of the four providers would have a little over 100,000 members each. This would result in net inflows for most existing default providers, should they be one of the providers going forward, and would remove issues around reallocating from larger to smaller funds.

37. **If transfer option 1 or 2 were adopted, how should default members be given a choice to remain with their current provider for this option?**

Current members should be given the option to remain with a former default provider if they wish. This could occur in the same fashion as those who already have chosen their default fund (rather than being allocated to a fund). Funds would be able to contact members directly to discuss the change offering an incentive for funds to try to engage members.

38. **What is your feedback on the transfer options and the costs and benefits of the options? Which option (or not transferring at all) do you prefer and why? Is there another better option we have not considered?**

We would question the degree to which default members trust in KiwiSaver would be affected by a change in default provider. If members are given the opportunity to elect to stay with a current provider, this further weakens this argument.

We would also point out that while moving significant numbers of default members between funds may be costly, it is a one-off cost. Funds themselves should still be better off as they would, in most cases, have larger member bases to spread fixed costs over.

39. **What factors should the review consider in deciding transition timeframes?**

We have no opinion on this.

40. **Should active defaults be considered default members for the purposes of transfers? How should active defaults be treated and notified of any changes to default provider settings?**

No, active defaults should not be included in the transfer process as these represent engaged members who have made a choice.

41. **What is your feedback on the member education requirements that default providers should have in relation to default members, and how these should be enforced in the instruments of appointment?**

Default providers should be required to undertake efforts to engage default members. Educating them would be beneficial, and the FMA framework looks suitable in this respect, such that they can make informed choices on their KiwiSaver, even if that choice is to stay with a default provider.

Mandating requirements is difficult, however, as there is little strong evidence as to the best ways to engage members. We note the recent FMA/AMP series of trials based on behavioural insights is one of the few pieces of work done on engaging members. We would prefer that rather than mandating requirements like numbers of outbound calls, or number of staff educating members, that funds continue to detail their engagement efforts, and the success those efforts have had. These can form the basis of measuring future performance in future tendering rounds.

42. **What is your feedback on the other requirements that should apply to default members?**

We have no comment on this.

43. **Any other feedback?**

Member engagement should be given more prominence, both in the review and appointment of providers. If KiwiSaver members were suitably engaged, then many of the issues identified in this discussion document would become less important including the questions of costs, value-for-money, suitable fund type for defaults, and responsible investing. Engaged members, armed with clear information, would be able to decide for themselves if a provider was overcharging compared with their peers, whether the exclusions are broad enough or, in fact, too broad etc.

At present default providers are required to document their engagement efforts, but not actually undertake engagement efforts. We would argue that preference in the next round should go to those providers who can demonstrate a history of successful engagement efforts, or smart attempts to engage members.