Westpac New Zealand Limited / BT Funds Management (NZ) Limited

Submission to the Ministry of Business, Innovation and Employment on the Review of the KiwiSaver Default Provider Arrangements

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1. Background

1.1 This submission to the Ministry of Business, Innovation and Employment (**MBIE**) is made on behalf of Westpac New Zealand Limited (**WNZL**) and BT Funds Management (NZ) Limited (**BTNZ**) in respect of the Review of KiwiSaver Default Provider Arrangements (**Consultation Paper**)**.** WNZL and BTNZ's contact for this submission is:

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2. Introduction

Objective of the Consultation

2.1 Westpac welcomes the opportunity to provide feedback to MBIE regarding the Consultation Paper, and fully supports MBIE's stated objective behind the review, namely to enhance the financial well-being of default members, particularly at retirement. Westpac considers that this objective should apply both up to and throughout retirement.

Key matters for consideration

2.2 MBIE has outlined a range of options in relation to the current default provider settings. These options could result in significant change to the KiwiSaver default provider scheme. It is very important that sufficient time is allowed (a) to communicate with members to ensure that they understand the changes; and (b) for providers to implement these changes in a way that provides minimal disruption for members. This will ensure that trust and confidence in the KiwiSaver scheme is retained.

2.3 An important pillar of trust and confidence in the KiwiSaver default scheme is stability and this is impacted by continual change. The uncertainty that constant regulatory change creates for members should also be taken into account as part of the consultation.

2.4 We make the following points in relation to the Consultation Paper:

a) In our view, the best way to enhance the wellbeing of default members in retirement is to move to a balanced mandate. This provides the best balance of investment risk returns and simplicity for default members to understand and for providers to implement.

b) The focus should not simply be on the lowest fees, given the range of differences in approach to investment and the resulting differences in investor outcomes. Instead, the criteria should allow for a reasonable range of fees. When assessing fees, all fund fees should be taken into account and not just those in default funds. This is to ensure that default providers do not have a ‘loss-leading’ position for their default fund and higher fees in their other funds which has a potentially adverse impact on investor outcomes.

c) During the previous appointment round for default providers, individual providers were evaluated according to technical criteria and pricing proposals. Providers who met the criteria set by MBIE were appointed. Westpac does not consider that there is any reason to justify a move away from this approach. It ensures transparency in the appointment process as well as maintaining competition between providers. Any significant change in the number of providers appointed will result in disruption for members and risks significantly undermining the trust and confidence that they have in KiwiSaver.

d) Westpac is supportive of responsible investment practices, and integrates ESG factors into its investment decision making process. We consider that default provider arrangements should be used to achieve objectives in relation to responsible investment to a limited extent, including disclosure on a limited basis. Any mandatory requirements above the requirement to exclude investments in companies that operate in sectors deemed inconsistent with New Zealand law may be difficult to implement consistently across providers given the differences in size and nature of default providers.

e) The criteria for New Zealand’s capital market development is inconsistent with other criteria in the Consultation Paper. Whilst Westpac recognises the importance of New Zealand capital markets and supports their ongoing development, the primary objective is to enhance the financial position of default members. This does not necessarily align with an objective to enhance New Zealand capital markets. We consider that a specific requirement to enhance the focus on enhancing New Zealand’s capital markets in the KiwiSaver regime could negatively impact financial outcomes for members.

f) If an existing default provider is not reappointed, their default members should be transferred to other default providers. This is the least disruptive option and the most likely to ensure that trust and confidence in KiwiSaver is maintained. Default providers and Inland Revenue should ensure that this is clearly communicated to members to avoid any confusion.

Contribution Rates

2.5 While not within the scope of the Consultation Paper, Westpac supports a review of default contribution rates. We consider that a higher default contribution rate would have a significant impact on improving the financial well-being of members.

3. Our response

3.1 Our specific responses to the Consultation Paper’s questions are set out in the attached Appendix.

Appendix 1

Submission template: Review of KiwiSaver default provider arrangements

Westpac New Zealand Limited / BT Funds Management (NZ) Limited

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

Feedback on discussion paper

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

We support the main objective identified, which is to enhance the financial well-being of default members. However it should be made clear that this objective applies up to, and throughout, the retirement phase. We suggest a change from '*at* retirement' to '*in* retirement'. This aligns with the purpose of the KiwiSaver Act 2006 which is "…to increase individuals' well-being and financial independence, particularly in retirement…".

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

We note the following points in relation to the individual criteria:

Criterion 1: Paragraph 14 refers to considering all potential sources of income for default members. It would be useful for MBIE to expand on how they consider this would work in practice as default providers do not have access to this information. There would be significant cost implications in obtaining this information from members.

Criterion 2: We agree with the point made at paragraph 16 which is that if individuals have trust and confidence in KiwiSaver, they are more likely to join, remain in and keep contributing to KiwiSaver. However we consider that trust and confidence in the short-term should be balanced against improving the long-term financial position of members.

An important pillar of trust and confidence in the KiwiSaver default scheme is stability and this is impacted by continual change. The uncertainty that constant regulatory change creates for members should also be taken into account as part of the consultation.

Criterion 3: We agree with this criterion.

Criterion 4: Westpac recognises the importance of New Zealand capital markets and supports their ongoing development. However we consider that this criterion is inconsistent with the purpose of the KiwiSaver regime which is to increase individuals' well-being and financial independence, particularly in retirement. There are more appropriate avenues for addressing the development of the New Zealand capital markets. KiwiSaver fund managers should focus on their duty to maximise the financial outcomes for their members. Please see our detailed comments under question 28.

Criterion 5: While we agree that innovation, competition and value for money are important aspects of the KiwiSaver regime, these should be balanced with the objectives of trust and confidence and enhancing the financial well-being of default members. We also note that these considerations are at odds with the prescriptive nature of the default fund regime. The more prescriptive the nature of the default fund regime, the less capacity there is for innovation and competition in this sector.

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

We agree with the problem definition. Whilst default member engagement remains important, shifting the investment mandate can result in better financial outcomes for members who remain in the default fund. Experience indicates that the current settings are delivering sub-optimal outcomes resulting in comparatively low long-term returns for members who remain in default funds.

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?**

Any changes to the investment mandate options should apply only to default members who have not made an active choice. Members who actively choose to remain in a default fund have made this decision based on their own assessment of fees and risk profiles.

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

If a life-stages option is adopted, it would be important for the stages and ages to be prescribed by regulations, to ensure that there is consistency across default providers.

We also consider that a life-stages option would be complex and costly to implement which is inconsistent with the purpose of having a low-cost retirement savings regime for members (see our response under question 10).

A nursery period may be warranted if a life-stages option is adopted. This would provide the opportunity to engage with members regarding the funds and any other investment goals they may have. However there are associated costs with this option.

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

If a balanced investment mandate is adopted, the mandate should be to invest 50% in growth assets with a suggested investment range of +/-15% around the benchmark weight to growth assets. This range allows managers some discretion and reduces the homogenisation of the products. It also allows for operation in 'normal' fund conditions where volatility within underlying funds may result in breaches of the ranges and would reduce the need to establish a separate default fund that would operate in a more restrictive ranges than the general fund range.

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

We have no comment as we do not support a growth mandate.

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

We have no comment as we do not support a conservative mandate.

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?**

Issues in relation to first-home buyers and other people making early withdrawals are significantly mitigated by the fact that these members are considerably more engaged early on in the savings journey. There is very high awareness about using KiwiSaver for a first home purchase among members which means that these members are more aware of fund choice.

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

As stated in question 5, it is important that there is consistency across fund providers in the number of funds and asset allocation if a life-stages option is chosen. This may restrict the use of existing funds, and increase establishment costs as providers may have to create new funds.

There would be significant upfront cost in building new systems, developing the funds, and updating disclosure for members. There would also be an increased level of communications required to existing members at the transition to the new investment mandate and on an ongoing basis (for example, leading up to and at each change in the life-stages). Given the complexities involved, ongoing management costs would also increase.

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?**

Westpac supports a move from a conservative investment mandate to a balanced investment mandate. We consider that this is the simplest and best option to deliver the objective of a better financial position for default members, and maintain trust and confidence in KiwiSaver.

While life-stages would also be a good default option if an entirely new regime was created we believe it is very complex to transition from the current arrangements without impacting significantly on the trust and confidence of members.

We also note that in Australia, default investment strategies tend to be balanced in nature[1].

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 consider that at present, the fees generally represent reasonable value for money. We note that there are different cohorts of default providers in terms of longevity and size and this will potentially affect the value offered by individual providers. We believe that the range of fees across the 9 funds is currently quite broad (in advance of the current review). This needs careful consideration or too great a focus on fees will simply necessitate passive index based solutions which may not be in all members' best long term interests.

When assessing fees, the fees of all the core funds (conservative, balanced and growth) in the provider's offer and not just the default fund should be taken into account. This is to ensure that default providers do not have a 'loss-leading' position for their default fund and higher fees for other funds with potential implications for member outcomes.

We also note that regulatory change has an impact on costs for providers which should be weighed against the benefits for members.

[1] Source APRA 2012

The current fees charged by default providers vary markedly, ranging from approximately $38 to $89 for a member with $10,000 invested. This variation is significant and a continuation would result in significantly different retirement outcomes for default members.

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

Under the KiwiSaver Act, under 18s should not be defaulted into a default fund.

We agree that a default provider's fixed monthly fee will have a larger effect on those with low balances. It is important that everyone is treated equitably and that the fixed monthly fees are reasonable. We note that as members' balances increase over time, this impact will reduce.

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?**

We do not consider that the government setting a fee is the right solution given the differences in scale, style and models of different default fund providers.

If the government sets a fee, the highest weighting in determining the fee should be based on the average amount of funds under management. A hypothetical Total Cost to Company ratio should be used and the individual provider should determine how they set fixed and variable fees within that ratio.

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?**

All 'core' funds of a provider should carry a reasonable weighting in any fee assessment. While the default fund fees are important, they should not be priced less than other fund fees as a 'loss leader' for the reasons explained at question 12 above.

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?**

The default model has reduced fees for members. However we do not consider that there has been any significant impact from the number of providers in the default market in terms of innovation. As stated above at question 2, the prescribed basis of the default fund regulatory landscape allows limited scope for innovation.

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?**

It is important to treat current providers fairly. If a smaller number of providers is to be selected, the number and size of opportunity needs to be committed to in advance and it needs to be equitable for all providers.

KiwiSaver default providers selected in 2014 have had significantly lower volume of members and assets and consequently less scale from which to drive value and recover costs. Moving to a smaller set number is a significant departure for providers and members and the impact on trust and confidence needs to be considered.

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

If a “minimum requirements” approach is taken, this should be done a periodic basis. This would ensure that any reallocation and communications would have a broader reach and impact than if there was just a single default provider appointment.

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

Implementing responsible investment principles generally comes with increased costs as a result of the additional research and monitoring required. This may be in the form of employing external consultants to manage exclusions screens, obtaining external endorsements and accreditation, implementing Environmental Social and Governance (ESG) assessments of investments, and stewardship activities in the form of company engagements (activism) and proxy voting. These affect underlying costs which in turn are a component of pricing which affects returns.

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

In the long term, we expect that responsible investment practices should be beneficial to returns for members. However, we note that research is generally mixed on this depending on whether the focus is on ESG integration or exclusions. For example, studies have shown that individual companies that have strong ratings on relevant and material sustainability issues deliver stronger performance than those firms with poor ratings on such issues[2]. On the other hand, research has also shown that negative screening and exclusions can materially impact future performance[3].

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

Default provider arrangements should be used to achieve objectives in relation to responsible investment to a limited extent. This includes requiring providers to have a framework for responsible investment and disclosure in accordance with our response under question 23.

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?**

Default members would expect their provider to act in their interests at all times and to do so in a responsible manner. However, this is balanced with the fact that investors generally want the highest possible returns. We also note that default members have a range of levels of engagement and different views in relation to responsible investment.

23. **Our experience is that default members have not engaged in the responsible investment aspect of KiwiSaver despite increased publicity around responsible investing in the KiwiSaver market. We do not consider that there is a high level of understanding from default members around responsible investment. 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?**

As a general comment, we do not consider that default member engagement is driven by a lack of information. The very nature of a default member is that they do not engage or make active choices.

At present, the regulations that prescribe what is set out in the Product Disclosure Statement (PDS) are currently restrictive and other than a basic minimum standard this would prevent further information about responsible investing from being included.

A simple option could be for default providers to confirm whether or not they integrate ESG factors into the investment decision making process, exclude certain sectors or companies from their

[2] Harvard University. Khan,Mozaffar and Serafeim, George and Yoon, Aaron, SSRN, "Corporate Sustainability: First Evidence on Materiality," March 9, 2015
[3] Russell Investments. Leola Ross and Miao Ouyang. "Negative screening and performance consequences: How much is too much?"

portfolios, or possess an external accreditation (for example UN-Principles for Responsible Investment (UN-PRI) signatory) in the PDS.

However we consider that there is value in making space available to engage with default members on other aspects of the proposition, rather than just core disclosure and a common prescriptive form of disclosure may assist with comparability.

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

As outlined above in question 22, default members have a range of expectations depending on their personal interests and values. We believe that most providers are excluding investments in companies that operate in sectors deemed either inconsistent with New Zealand law or that may be subject to global treaties for which New Zealand is a signatory.

Under our exclusions decision framework, BTNZ currently excludes investments in controversial weapons, assault weapons for civilians, whaling as well as tobacco.

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?**

In terms of the industries or sectors that should be excluded, we consider that providers should exclude investments in companies that operate in sectors deemed either inconsistent with New Zealand law or that may be subject to global treaties for which New Zealand is a signatory. The decision to make further mandatory exclusions should not be taken lightly as investors have a range of different views on this and it is inherently subjective. The likely long-term impact of exclusions on investment returns and risk should also be considered prior to incorporating further screens. We note that exclusions are easier for the larger default providers where investments are held by way of segregated accounts. It is more difficult for smaller providers to implement the exclusion policies. Many smaller KiwiSaver providers invest in pooled funds (eg BlackRock, Vanguard products) alongside other investors. Compliance with a centralised exclusions list may encourage smaller players to invest directly, which would increase quality concerns.

One option would be for default providers to sign up to the UN-PRI and disclosure of the ratings. The cost of this is around $15,000 per annum.

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?**

This should be done at a broad sector level, rather than requiring a statement listing all excluded companies. Company level exclusion lists are likely to differ slightly depending on definitions used in the screening process, which may cause investor confusion.

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?**

Our preference is for the status quo with a responsible investment policy included in disclosure documentation. This sets out whether a provider has ESG integration and stewardship policies, how they deal with proxy voting, and implementing exclusions by sector.

We also agree with the statement in paragraph 153 that there is tension between whether default KiwiSaver providers should focus on members' investment returns over responsible investment consideration, particularly where the default member is not making the choice for themselves.

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 consider that the criteria for New Zealand capital market development is at odds with some of the other criteria in the consultation. Whilst we are supportive of New Zealand capital markets and their ongoing development, all investment decisions are considered first and foremost in terms of their efficacy and contribution to increased returns, value and ongoing wealth for our members.

There are a number of limitations which exist in relation to New Zealand's capital markets. These can include low liquidity, limited choice, and comparative quality issues which can impact returns. Investing in private market (unlisted) opportunities will require a large degree of investment due diligence and monitoring which would result in higher fees for members. Due to the size and scale of KiwiSaver providers, there may be limitations in the capability of analysts and portfolio managers to select suitable private companies for investments.

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?**

We consider that this should be provider-led only rather than on a mandatory basis.

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?**

As above at question 29, we consider that it should be at a provider's discretion where the investments fit within the construction of the specific portfolio approach and requirements.

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

At present, the majority of all investment activities are controlled by a locally based team and all New Zealand assets are managed locally. For BTNZ, the selection for overseas assets is delegated to offshore based managers with mandates controlled by the New Zealand team. Activity and oversight is monitored by the New Zealand based team.

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 do not consider that this approach would have a direct impact on increasing investment into New Zealand capital markets. Instead, it would increase challenges and costs associated with accessing global markets to the detriment of fund members.

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 are not supportive of a targeted investment requirement.

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 have no comment here as we are not supportive of a targeted investment requirement.

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 for the transfer of members.

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 a general principle, default members should only be transferred in the case where the default provider is not reappointed. There will be difficulties associated with moving a group that is disengaged and there is the potential to result in further confusion which will lead to even less engagement. This would impact on trust and confidence in the KiwiSaver regime.

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?**

There should be a window for providers to communicate the implications associated with the changes and engage with these 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?**

Our preference is for Option 2 to be adopted. That is only members from those not appointed should be transferred. This would be the least disruptive option for members and providers.

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

There should be significant time allowed to engage with members in relation to any default fund change.

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?**

Active default members should not be considered default members for the purposes of transfers. If there are changes to the default fund settings, then these members should be made aware of the changes. However, they should not be required to reengage given that they have already engaged and selected a low risk and low cost fund.

We do note that there may be confusion if the name and nature of the default fund changes.

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?**

This is potentially appropriate, but we need to be mindful of the diversion of time and resource that this creates. Some key metrics should be in place to measure outcomes of this rather than focus on the specific communications and engagements. It is important that this is flexible and can be amended without undue process.

In terms of member education and engagement, the quality and amount of default member contact information is critical. In many cases the contact information received is incomplete (for example only a postal address) or inaccurate which presents difficulties in contacting these members.

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

We have no comment to make here.

43. **Any other feedback?**

We note that contribution rates are not within the scope of this review. However we think that it would be a useful exercise to review these. We would support a higher default contribution rate to ensure default members receive retirement benefits more in in line with their income before retirement.

Finally, the approach to default members on total remuneration contracts should be reviewed. Information in regard to choices and requirements of contracts should also be made clear to members during the initial joining period.