Submission on "Review of the KiwiSaver Default Provider Arrangements Discussion Paper" (Discussion Paper)

18 September 2019

Introduction and summary

1. This is a submission on behalf of **Nikko Asset Management New Zealand Limited** (Nikko).

2. We do not seek confidentiality for our submission.

3. Nikko is a new entrant to retail (including KiwiSaver), but an established fund manager for wholesale and institutional clients. We have been named Morningstar Fund Manager of the Year for the last two years.

4. In *summary:*
    a. We agree that there needs to be a change to the investment mandate for default funds to better cater for the portion of the default customer base that cannot, or will not, make an active choice of fund;
    b. However, changing the investment mandate to better allow for customers who stay in default funds for the long term does not mean that encouraging active decision making should no longer be a key plank of the default policy. We believe that active decision making, engagement, confidence in financial markets and financial well-being are all linked and therefore should continue to be encouraged; and
    c. The broader KiwiSaver market is workably competitive and, with the exception of the inert default customer base, is flourishing. We therefore urge the Government to be extremely cautious of making some of the more extreme changes contemplated by the Discussion Paper because of the potential to harm the broader market.

The broader KiwiSaver market is a New Zealand success story

5. It is worth remembering that the default is scheme is a part of a broader KiwiSaver market, which in totality is flourishing. The FMA's "KiwiSaver Report 2018" records that the FUM for the market has grown to approximately $50 bn and has in total 2,837,656 members, of which 2,405,877 are active members.

6. On the supply side there are about 25 KiwiSaver providers, including several disruptive new entrants. The market is generating a diverse range of different offerings to choose from including; ultra-low cost offerings, passive or active options, tiered pricing, climate friendly funds and special interest funds such as Sharia compliant funds. Switching between funds is easy thanks to the IRD mechanism.

7. It is also worth remembering that there is a very high level of scrutiny on fees in this market with the Sorted Tool / Smart Investor enabling direct comparison of funds on the basis of fees and private websites that compare fees. There is also frequent reporting by the regulator, a KiwiSaver Fund Tracker and significant commentary in the media about offers, fees and topical issues. All these are having their effect. In addition, there is no price across the whole KiwiSaver market that has not been tested for its reasonableness by the FMA.

8. Our main concern with the Discussion Paper is that it points to a number of levers that Government has at its disposal that go above and beyond normal commercial levers; they are akin to a monopolist with market power. Government could literally take hundreds of thousands of customers from one provider and give them to another, it can change laws and it can tender books of customers at lower cost than the market can because it faces no distribution costs in acquiring default customers. While these levers have the positive potential to improve the lot of default customers, they also have the potential to create distortionary effects in the broader KiwiSaver market if used unwisely because they are potentially so potent.

9. In particular, it would be easy to envisage Government condensing down to one or two default providers, who because of their scale and lack of distribution costs would be able to offer terms that would squeeze out the rest of the market more generally. While such a differently structured

market may in the short term deliver greater efficiencies through its consolidation, the loss would be all the innovations and variances that are currently occurring by the disruptors (and the innovation is occurring mostly at the fringes).

10. To take Nikko as an example, we are an extremely small player in KiwiSaver at this stage. However, we have rolled out New Zealand's first true digital advice tool to help customers select funds that are right for them. The evolution of tools of this nature could have a transformative effect on financial services over the next five to ten years. Therefore if Government was to implement policies that deterred entry and innovation as a result of market consolidation, the cost could very well be the delay of extremely valuable developments for New Zealand that would easily outweigh the value of potentially lower fees in the short term. The current diversity of offers would also be reduced.

11. Overall, while we agree that there are legitimate issues to address in the context of the outcomes that members are seeing in default KiwiSaver, this should not be at the expense of the broader market and its diversity. We urge against some of the more extreme forms of intervention being considered and instead recommend that Government creates a default policy to complement the broader market. We are pleased that the Discussion Paper provides some awareness of this issue by including promoting innovation, competition, and value-for-money across KiwiSaver as "criterion 5", but we do not consider that taking into account impact on the greater part of the market has been given the level of prominence that it deserves .

Our view of what a default KiwiSaver scheme should seek to achieve

12. If our proposition that the broader KiwiSaver market is workable and competitive is accepted, we believe that an ideal default offering would provide a good baseline service with fairly vanilla terms.

13. This would mean that on one hand there is space for the wider market to compete for customers in default funds (in different ways e.g. on price, on different kinds of fund, on service etc) and potential reasons why those customers would choose to switch; but on the other hand if customers do remain in the default funds the outcome for those customers would be respectable.

14. There may even be value in pegging some of the default KiwiSaver terms to metrics in the KiwiSaver Fund Tracker, so that as the market moves the default terms also move.

15. As noted above, an undesirable outcome would be to create default funds with terms that the market cannot compete with as a consequence of Government using its unique levers that are akin to market power (e.g. mandating fees that cannot profitably be competed against by small scale providers, or any provider that faces distribution costs). Such an outcome would effectively deter members making choices and, as noted above, would have a chilling effect on the broader market.

The link between active decision making and investor confidence

16. As noted above we agree with changing the investment mandate of default funds so that if members do stay in them for the long term the outcomes are reasonably good for them.

17. However, just because policy changes are being considered which aim for better outcomes for customers who stay in default funds for the long term, this does not mean that encouraging active decision making should no longer be a key plank of the policy.

18. We note that on pages 12, 23 and 30 of the investor confidence survey recently published by the FMA[1] confidence in financial markets, regulation etc was the lowest for investors in KiwiSaver among all product types, whereas investors in managed funds was the highest among all product types.

19. What is particularly interesting about this finding is that a KiwiSaver fund is a managed fund but with some extra regulation and a contribution regime added to it.

20. Unless one is to believe that the additional layer of regulation is undermining investor confidence, the only objective difference between being a member of a manged fund and being in a KiwSaver fund is that you cannot enrol in a managed fund without making an active choice.

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[1] "Attitudes towards New Zealand's financial markets – Investor confidence research" (May 2019) https://www.fma.govt.nz/assets/News-releases/190723-FMA-2019-Investor-Confidence-Survey-for-publication.pdf

21. Therefore there is a clear correlation to us between members not making active choices and members having less confidence in markets and investments generally. If Government wishes to promote confident participation in financial markets (which is at the very heart of the Financial Markets Conduct Act 2013) and the broader financial well-being of New Zealanders then continuing to promote financial education and active decision making is critical.

Employers could play a greater role in encouraging active decision making

22. We believe that there is space to include employers more in educating their staff and encouraging active decision making (provided they have reasonable protections for their good faith efforts). This is particularly for staff with more than 20 employees that could reasonably be expected to have some capability in this regard.

23. In some ways employers are better placed to lead educative efforts than providers because their ability to make contact and communicate with their staff is greater than the ability of default providers to remain in contact with default members in many cases.

24. Options might include:

    a. Requiring employers to discuss KiwiSaver with staff when they join work or hold education sessions about KiwiSaver; and/or
    b. Requiring employers to select a default provider for the business and explain the choice to the staff.

25. We believe that involving employers more in the selection of superannuation providers is common in other jurisdictions, such as the UK.

26. In the face of such a policy, we believe that KiwiSaver providers would have incentives to actively compete to be the provider of choice for many employers and the market would see a greater level of variance of offering such as special pricing or bespoke terms for certain kinds of business.

27. We believe that employers could embrace this model because it would be a way for them to confer benefits on their staff without having to spend money of their own. For example, an employer with

a large blue collar workforce may not easily be able to raise the average wage of workers directly (due to the number of workers), but may be able to negotiate a very favourable default offering with rebates or lower fees as an alternate benefit.

28. As a final observation, there is potentially a legislative basis for involving employers more in the purpose statement to the KiwiSaver Act 2006:
"….provides for schemes … to facilitate individuals' savings ***principally through the workplace****"* [emphasis added].

Is regulatory messaging unhelpful for active decision making?

29. It is an objective truth that a person who made an active choice to invest in growth orientated strategy at any stage over the last ten years would have done far better than a person who had remained in default KiwiSaver, even if that person had selected the highest fee fund option and the worst performing manager for the strategy. Therefore picking the correct investment strategy is clearly the highest priority thing that an investor in KiwiSaver should have (setting aside any non-financial goals such as pursuing a particular ethical ideology).

30. Against that context, the regulatory messaging that participants are required to provide in the form of the risk indicator is potentially unhelpful in terms of helping them to choose the right asset base. Growth assets are required to be described as "higher risk" assets in the "risk indicator", which can make members believe that they are at risk of losing their money if they invest in these assets. However, the so called "risk indicator" is a reflection of short term volatility, rather than true long term risk as most people would understand it. The probability that a well-diversified portfolio of shares will be worth less than investments in the "lower risk assets" over a long term investment time horizon (which is what most people investing for retirement should have) is extremely low and this critical point is not conveyed.

31. Given that the risk indicator is so central to KiwiSaver disclosure, this could well be having a detrimental impact on people with low levels of confidence and deterring them from making appropriate choices. We consider that there is merit in reconsidering the risk indicator, and potentially some of the other aspects of the PDS and Fund Updates that are ultimately confusing for investors, such as the market index requirements.

32. Further, a great deal of the focus of the PDS (and of public sector messaging) is on the downsides (like fees) and risks of making investments. Whereas it is just as important to convey the benefits of investing in products like KiwiSaver that objectively make people better off. This is particularly the case for a customer base that may lack confidence.

33. To illustrate the point, we have set out below the headings for the various sections of the PDS in the order in which they appear and have highlighted; in red all the headings with negative connotations, in yellow the headings that are administrative or completely neutral, and in green the headings that have positive connotations or that refer to benefits:

1 Key information summary
2 How does this investment work?
3 Description of your investment option(s)
4 What are the risks of investing?
5 What are the fees?
6 What taxes will you pay?
7 Who is involved?
8 How to complain
9 Where you can find more information
10 How to apply

34. About half the headings have negative connotations and none of the headings have positive connotations.

35. It would be useful to have some form of official publication to sit alongside the PDS that provides information about the benefits of KiwiSaver and the importance of selecting the right kind of investment strategy to balance out the PDS. There appears to be no appetite to pursue such a document although the concept has been raised from several different quarters, including academic with no commercial vested interest.

36. Finally, although there have been some educative efforts to encourage people to engage more with KiwiSaver (we commend the FMA videos targeted at younger women for example) there appears to be far more attention being given to fees by public sector agencies, than the issue of customers not selecting the correct investment strategy, even though objectively selecting the correct investment strategy is more important. In fact for customers who particularly focus on this low fee message, remaining in default funds (wrongly) appears to make sense because they are in a low fee option.

37. Therefore we feel that regulatory messaging has not always been helpful for investors with lower confidence and lower levels of financial literacy for encouraging best decision making.

We support use of Lifestages and balanced fund as potential options – Government does not necessarily need to prescribe the parameters of those funds – in fact it is helpful if fund managers could put default customers into existing non default generic KiwiSaver funds that are appropriate

38. We consider that either life stages or balanced funds would be funds that investors could responsibly be enrolled into and left in for the long term. (We see no reason why Government could not select some balanced and some life stages funds to be default funds at the same time.)

39. Whichever type of strategy Government chooses, it is probably not necessary for Government to commit itself or the market to granular parameters for the different kinds of funds. Instead it should be open to considering some variances in offers that are reasonable through its tender process. We would suggest that the quality of investment and the amount of actual management are however, matters that should be considered very carefully. It is possible to put together a low cost balanced fund that has the veneer of meeting Government's objectives but which almost certainly would not generate good returns for investors, for example a fund that ultimately has a significant portion in cash.

40. A simple change that might make being a default provider more attractive is if there were no requirement to offer specific bespoke "default funds" and if instead a default provider could enrol default customers into its standard balanced or life stages fund (but could identify those customers

who have not made an active choice), assuming that the fund is considered investment worthy. This would potentially reduce some administrative costs and help providers achieve scale.

Contributing members versus non-contributing members

41. A topic that the Discussion Paper is silent on is that of contributing members versus non-contributing members.

42. We note that of the 430,000 members of default funds referred to in the Discussion Paper, approximately 200,000 are non-contributing members. Given that this is about half the default customer base, we consider it worth better understanding who these people are and why they are not contributing and whether that drives differences to the approach that should be taken to the default KiwiSaver policy.

Some observations on costs

43. There is an incremental cost to serve every individual customer, regardless of balance size. For example as customer numbers increase, registry costs increase and staff numbers need to increase to on board and off board customers and to manage queries and communicate.

44. This has two implications for the Discussion Paper.

45. The first is in relation to low balance customers. Customers with very low balances are unlikely to cover their incremental costs to serve, let alone contribute to the common costs of managing a KiwiSaver fund. Further, low balance customers are often more service intensive than average customers because they are more likely to be mobile and therefore harder to communicate with and are also more likely to request hardship withdrawals, which is a labour intensive exercise as it requires liaison with a Supervisor.

46. There may or may not be good policy reasons why members on low balances should be further cross subsidised (e.g. because it is considered desirable to provide assistance to people with smaller balances). However, we would disagree with a suggestion that low balance members are somehow

being treated unfairly, being overcharged or not getting value for money given that many are already not covering their basic costs to serve and are being cross subsidised by higher balance clients.

47. The second implication is in relation to the notion of allocating large numbers of customers between providers. To suddenly switch a large book of customers away from one provider to another would potentially result in one provider having over-invested in staff and systems and the other provider scrambling to scale up. Therefore if the long term landscape is going to turn into one where vast volumes of customers are moved in one go between providers every few years, then that potentially becomes a very uncertain market to operate within. (This uncertainty is not only from a service provider perspective, but customers may become unsettled as a result of being passed back and forth between providers.)

Active default members should not be captured by the scheme

48. In various places the Discussion Paper asks how “active default” members should be treated. We believe that active defaults should fall outside of the scheme. To treat them otherwise would be to over-rule the decisions that they have made.

The “responsible investment” and “capital market development” aspects of the Discussion Paper should be uncoupled from the main debate about default KiwiSaver

49. The immediate problem to solve as far as default KiwiSaver is concerned are the returns default members have received as a result of being on the receiving end of conservative investment strategies for over ten years.

50. As far as the industry is concerned, there will be significant focus on the potential scale of the restructuring of the market by way of possible customer reallocation, over other issues.

51. We believe that an informed debate about responsible investing would be better discussed at a time when all the large players are not immediately concerned with the prospect of gaining or losing tens or hundreds of thousands of customers. There may also be value in making the discussion of “responsible investment” a matter for all KiwiSaver, rather than default KiwiSaver.

52. In making this suggestion, we are also taking into account that the Discussion Paper conflates responsible and ethical investment together, whereas the two concepts are quite different. We believe that an informed debate on this topic would involve properly unpacking the different concepts and the implications of those different concepts so that they can be understood by all parties.

53. As far as the capital market development proposals are concerned, we are sceptical as to whether this is a good idea to pursue at all because:

    a. As noted in the Discussion Paper the risk is that the pool of money required to be invested in alternative assets locally will be greater than the pool of credible investments. (Our impression is that there is currently no shortage of money looking for investments in alternative assets. The issue is shortage of good alternative investments.) Being forced to contend for a very small pool of credible investments would clearly not benefit members;
    b. The typical return curve for alternative assets, for example investment in a venture capital fund, is that they can lose money for several years in the initial phase as the failures come to light. It is only later that returns from the successful businesses overtake the losses. Therefore investors into alternative asset funds need to be in them for a reasonably long investment period and be sanguine in the face of multiple initial years of loss. Investors who are in funds because they lack confidence and who have not made an active choice are probably not the best audience for this kind of investment. Also open ended funds that have a continuous roll over of members as customers join the workforce or retire do not fit with the likely return curve as it will create windfalls for some at the expense of other members. Also if the intent is to retender and redistribute blocks of KiwiSaver members from time to time (as contemplated by the Discussion Paper), then small scale , long term, illiquid investments are inappropriate;
    c. The kinds of local investments contemplated by the Discussion Paper align far more with higher cost active management funds than the average cost vanilla funds that we envisage default to be; and
    d. In terms of repatriating capability, we believe that most businesses (like ours) will already have local investment teams and capability for the local markets and overseas teams for

global fund offerings. In order to make the best decisions, capability should be embedded in the markets they are investing in.

Some observations on the purpose statement to the KiwiSaver Act 2006 and on the proposed criteria for the review

54. We agree that the criteria for the review should be rooted in concepts that are embedded in the purpose statement to the KiwiSaver Act 2006, as that is the statutory context for the decisions being made.

55. Particular elements of the purpose statement that we see as being relevant are:

"…encourage a long-term savings habit and asset accumulation by individuals…" and
" *The Act aims to increase individuals' well-being and financial independence, particularly in retirement, and to provide retirement benefit",* and
"…provides for schemes … to facilitate individuals' savings" and
"…principally through the workplace.."

56. We note from the excerpts above that actual wording of the purpose statement to the KiwiSaver Act 2006 is broader than the extrapolation, which has become "criterion 1"[2]:

    a. The actual purpose statement refers to the circumstances of all individuals at retirement. Any decisions in respect of default KiwiSaver should also be considered in terms of flow through impacts into the broader market as a matter of course. Therefore the actual wording of the purpose statement captures criterion 5[3] as an equally important consideration as criterion 1 and our concerns about the impact of potentially extreme interventions on the wider market are relevant.

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[2] "Criterion 1: Better financial position for KiwiSaver default members, particularly at retirement". (Heading for criterion 1 discussion on page 8 of the Discussion Paper.)
[3] "Criterion 5: Promote innovation, competition, and value-for-money across KiwiSaver". (Heading for criterion 5 discussion on page 10 of the Discussion Paper.)

b. We also note that the actual purpose statement wording includes a concept of members being "financially independent", which has connotations of customers being empowered and capable of making their own decisions, which when coupled with the broader desire for confident participation in capital markets more generally, is a legislative basis for supporting our view that continuing to encourage active decision making should remain part of the objective for default schemes, even if the investment mandate is changed to accommodate members remaining for a longer period.

57. We have briefly discussed above why we consider that default KiwiSaver should not be used as a tool for capital markets development at a practical level. However, we note that even as a criterion in the abstract, it is out of step with all the others, in that all the others can clearly be linked to concepts in the KiwiSaver Act 2006. In our view the suggestions about developing capital markets would be at the expense of investors and their ability to save for the long term.

58. "Responsible investment" is similar to capital markets development in that in that it is not directly tied to the purpose statement to the KiwiSaver Act 2006, and indeed it is not even a criterion for the review in the Discussion Paper. This points to our view that the topic (while worthy of discussion in another context) cannot properly be unpacked and debated, while the very market structure is under debate.

Conclusions

59. The main problem with default funds is simple to solve and should have been solved several years ago when it became clear that there is a large group of disengaged customers that are hard to covert to active choices. The investment mandate has to change.

60. Other than changing the investment mandate to better cater for those who lack confidence to make an active choice or who are disengaged, the broader market is competitive and effective and therefore Government should be very cautious to intervene significantly.

61. Better allowing for customers to remain in default funds for the long term does not mean that investor education and active decision making should cease to be a goal. It is clear to us that the more engaged customers are in their investments the more likely they are to participate more confidently in financial markets generally. We also believe that there is scope for employers to play a larger role in encouraging active decision making.

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