In Confidence

OFFICE OF THE MINISTER OF FINANCE

OFFICE OF THE MINISTER OF COMMERCE

The Chair
Cabinet Economic Growth and Infrastructure Committee

Future KiwiSaver Default Provider Arrangements

Proposal

This paper seeks Cabinet decisions on future KiwiSaver default provider arrangements for when the existing terms of appointment expire on 30 June 2014. It seeks key decisions on the investment approach for default funds, criteria for selecting new default providers, and transitioning default members between existing and new default providers. These decisions will form the basis for a tender process.

Executive Summary

1 KiwiSaver requires 'default' funds because new employees are automatically enrolled without actively selecting a provider. Auto-enrolled members are currently allocated to one of five default providers and enrolled into that provider's default fund. They remain in the providers' default fund until they actively choose a new fund or provider.

2 The existing default providers were appointed following a competitive tender process. Their obligations are set out in each default provider's terms of appointment, which are due to expire on 30 June 2014. This paper seeks key decisions on future default provider arrangements, including the investment approach for the default funds and criteria for selecting new default providers.

3 These decisions will affect many New Zealanders and are likely to attract significant public interest. Around 780,000 (37%) of the current 2.1 million KiwiSaver members initially entered KiwiSaver through allocation to a default provider. Over 450,000 (23%) remain as default members (that is, they have not subsequently chosen a new fund or provider).

Key decision 1: Investment approach for default funds

4 KiwiSaver default funds must invest in accordance with the approach stipulated in the default provider's terms of appointment. The current default arrangements require default funds to invest under a conservative mandate, which means that growth assets such as shares and property must be within a 15-25% range.

5 While we have considered a number of options, we propose that KiwiSaver default funds should retain the existing conservative investment mandate. The associated lower volatility of returns better preserve members' capital, supporting confidence in KiwiSaver and the development of a savings habit.

Key decision 2: Criteria for selection of default providers

6 We propose that the selection criteria used in 2006 should apply to the forthcoming tender as it has provided well-governed and competently managed investment funds that provide a high level of care and diligence. We also propose an additional requirement to provide investor education and impartial financial advice to encourage members to make an active fund choice.

7 In deciding the number of default providers, we consider that there be a limited number of default KiwiSaver providers. This will ensure competitive tensions in the tender process, and provide leverage in fee negotiations.

8 We do not have sufficient information at present to set an actual or maximum number of providers. Therefore, we recommend that Cabinet delegate authority to the group of approving Ministers to determine the maximum number of default providers.

Key decision 3: Transitioning between existing and new providers

9 We propose in principle that existing default providers that are reappointed would retain all or some of their current default members, but if a current provider is not reappointed, their default members would be transferred to the new default providers. The current default design places requirements on the default providers over and above other providers. These additional requirements will expire along with the expiration of the term of appointment. Therefore, existing default members would no longer have the protection of the instrument of appointment which specifies fees and reporting obligations if they are not with one of the new default providers.

Next steps: Tender process

10 The decisions in this paper will form the basis for the forthcoming tender process. We propose that further decisions on details of the tender be delegated to a group of approving Ministers being the Minister of Finance, the Minister for Economic Development, the Minister of Commerce and the Minister of Revenue. Other Ministers could be co-opted on an as needs basis.

11 It is expected that the procurement process will be completed, and the new default providers announced in the first half of 2014.

Background on KiwiSaver default arrangements

12 KiwiSaver was launched in July 2007. A key design feature is auto-enrolment of new employees without requiring consent or active selection of a KiwiSaver provider. People who enter into the workforce for the first time, or start with a new employer are automatically enrolled into KiwiSaver unless they actively opt out. Most auto-enrolled members are allocated to a default fund, as are those who opt-in to KiwiSaver via their employer. Once enrolled, they remain in the default fund to which they have been allocated until they actively choose a new fund or provider.

13 Around 780,000 (37%) of the current 2.1 million KiwiSaver members initially entered KiwiSaver through default allocation to a default provider. Over 450,000 (23%) remain as default members. Six default providers (AMP, AXA, ASB, Mercer, OnePath, and Tower) were appointed for a seven year term in 2007, following a competitive tender process. Since then, AMP has taken over AXA's New Zealand business and Tower's investment business has been acquired by Fisher Funds Limited.

14 The term of appointment is due to expire on 30 June 2014. While the default provider contracts could simply be re-tendered on their current terms, Cabinet agreed in November 2012 to release a discussion document to consult on whether these default arrangements remain appropriate [EGI Min (12) 25/1 refers]. There are several reasons for not simply rolling over the existing terms and conditions:

(a) **Experiences with the KiwiSaver default arrangements:** The current arrangements were designed based on information accumulated before the introduction of KiwiSaver in 2007 and with objectives that were particular to the establishment period. KiwiSaver is now well established. The size and structure of the market is known, and more is understood about the behaviour of members.

(b) **Recommendations for change by several government-initiated reviews:** In recent years there have been specific recommendations for changes to the default provider arrangements. For example, the Capital Market Development Taskforce, the Savings Working Group and the Prime Minister's February 2009 Job Summit all recommended that default arrangements be altered to better suit long-run investment needs by either adopting a life-cycle or balanced investment strategy.

(c) **International experience:** A number of other countries (for example Australia, Sweden and the United Kingdom), along with the OECD, have been considering what might be the most appropriate default fund arrangements for automatic enrolment or compulsory savings schemes. Although each has different policy settings with characteristics unique to those countries, their experience and review processes have contributed to a body of research that is relevant to KiwiSaver default arrangements.

15 The terms of reference for the default review were announced in Budget 2012. It is also an action of the Building Capital Markets Business Growth Agenda which notes that the Government is reviewing the default fund mandate to ensure it is in the best interests of investors.

Experience with the default arrangements to date

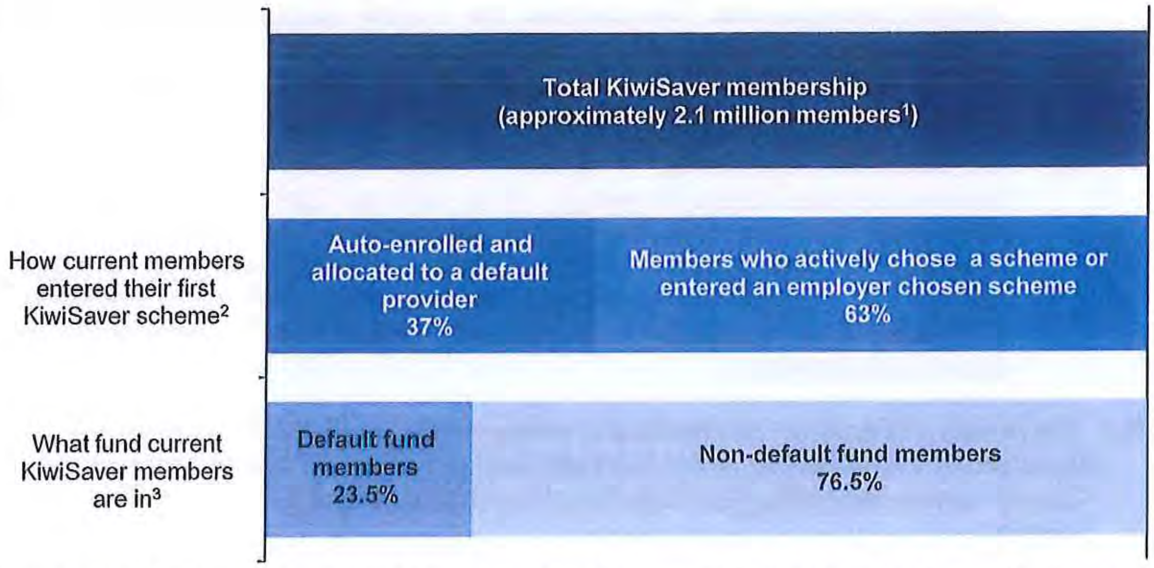
16 Figure 1 demonstrates how members enter KiwiSaver and how that decision (or non-decision) can be altered over time. It shows that 37% of the current KiwiSaver members were initially enrolled in a default fund. 36% of those who were initially enrolled in a default fund subsequently made active choices to move to another fund or scheme.

17 450,000 (23%) KiwiSaver members remain in the default fund to which they were allocated. The default funds (excluding members who have opted into a default fund) collectively represent the single largest KiwiSaver fund type by funds under management of $2.9 billion (23% of total KiwiSaver funds under management), as at March 2012. This is estimated to have increased to around $3.5 billion today.

18 As KiwiSaver account balances become more significant, and with the introduction of the new KiwiSaver reporting rules that allow members to more easily compare funds under the KiwiSaver (Periodic Disclosure) Regulations 2013, members may become more engaged with KiwiSaver and more likely to actively select the most appropriate fund for themselves.

19 Based on overseas experience and trends to date, there will likely continue to be a large group of default members. However, about half of New Zealanders eligible to join KiwiSaver have done so and the number of default members entering KiwiSaver is much lower than it was during the early years. That said, there would be a significant influx of new members into default funds if the Government was to decide to carry out a one-off automatic enrolment of all employees.

Figure 1: KiwiSaver auto-enrolment and default fund membership



Source: IRD, KiwiSaver statistics and adminstrative data & Financial Markets Authority, Annual KiwiSaver Report 2012.

Key decision 1: Investment approach for default funds

Background

20 KiwiSaver default providers must invest the default funds in accordance with the investment approach stipulated in the terms of their appointment. The Government specifies this investment approach.

21 When the current default providers were appointed in 2007, the Government chose a conservative investment mandate for default funds. This limits default funds' investments to mainly fixed interest and cash with a small (no less than 15 per cent and no more than 25 per cent) allocation to growth assets. Those terms of appointment are due to expire on 30 June 2014. Consequently, the Government must again choose an investment approach for default funds.

Future investment approach for default funds

22 The future investment approach for default funds is a contentious issue that directly affects hundreds of thousands of New Zealanders. Officials have consulted widely on this issue and there are a range of strongly held views within and between Government agencies, the KiwiSaver industry and other stakeholders about whether to retain the conservative approach or change the approach.

Options for the default fund investment approach

23 We have considered three main options for the default funds investment approach. They are:

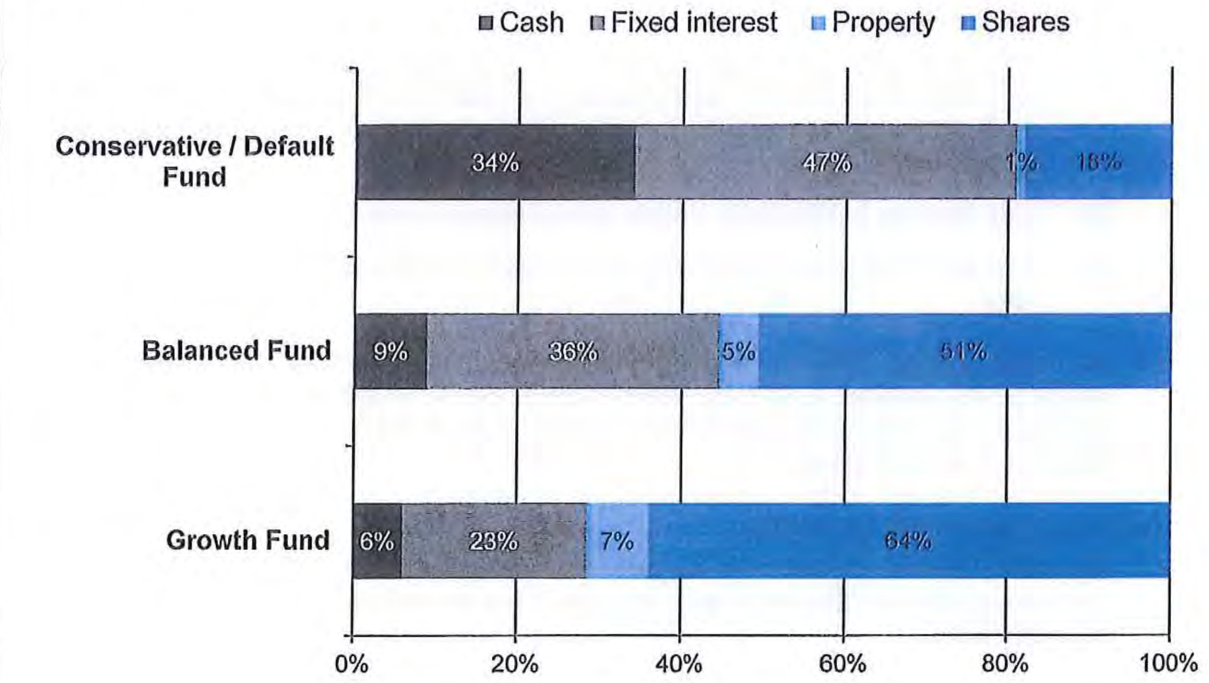
(a) **Conservative** – Funds invest a small amount in growth assets (15-25%) and the rest in less volatile fixed interest assets and cash.

(b) **Balanced** – A higher asset allocation to growth assets (around 50%). Growth funds invest an even higher proportion in growth assets. Growth funds are not considered as a separate option here as the arguments for or against changing the default fund investment approach to balanced applies similarly to growth funds.

(c) **Lifecycle** – A lifecycle investment approach starts younger people in a growth fund and progresses them though to a conservative asset allocation as they get closer to retirement. The rationale for lifecycle funds is that investors with longer investment time horizons are generally recommended to adopt asset allocations with higher risks and returns.

24 Figure 2 below shows the asset allocation for typical conservative (the existing default funds), balanced and growth KiwiSaver funds

Figure 2: Asset allocation of typical KiwiSaver funds



Source: Morningstar New Zealand Multi-Sector Market Indices, March 2013

25 In weighing up the above options we have based our recommendation on:

(a) The purpose of KiwiSaver, the objectives of the default fund, and who the default funds are designed for

(b) Best practice investment principles

(c) Risks to the KiwiSaver brand and to individual members.

The purpose of KiwiSaver, the objectives of the default fund, and who the default funds are designed for

26 The purpose of KiwiSaver, as set out in the KiwiSaver Act, is to encourage a long-term savings habit and asset accumulation by individuals who are not in a position to enjoy standards of living in retirement similar to those in pre-retirement.

27 When KiwiSaver was established in 2007, the default funds were intended to provide stable returns and build public confidence in KiwiSaver. The default funds provided a temporary 'parking space' for default members who had not yet made an active choice. Thus the Government chose a 'conservative' investment approach.

28 An alternative objective would be for the default funds to try to be, in themselves, an appropriate long-term investment option for a larger group of KiwiSaver members. This would suggest an investment mandate designed to achieve higher average investment returns for most default fund members.

29 The design of default funds has the most impact on KiwiSaver members who are not actively engaged in decision-making about the appropriate KiwiSaver fund for them. Other members are (by definition) able to make a decision about whether a default fund is appropriate for them and switch funds.

30 There are a number of reasons why KiwiSaver members may fall into this disengaged group. For example:

(a) Difficulty with, and inexperience in, understanding relatively complex financial products: there are a large proportion of KiwiSaver investors for whom KiwiSaver is their first experience with investing in asset classes other than bank deposits or residential housing.

(b) Indifference, particularly if retirement appears a very long-way off.

(c) A lack of time to make investment decisions and a general bias towards the status quo.

31 As noted earlier, 36% of members that were initially enrolled in a default fund have subsequently shifted out of the default funds. Some KiwiSaver providers have reported that there are also members of the existing default funds who have made a conscious decision to remain there.

Best practice investment principles

32 Standard investment theory suggests that growth assets are expected to outperform income assets over the long term. However, growth assets experience greater volatility in the short term.

33 Those investing over a long time period – in a KiwiSaver context, those who are a long way from retirement – are generally recommended to have a significant asset allocation to growth assets. Those with shorter time horizons are more vulnerable to short-term volatility, and so are generally recommended to have a more conservative asset allocation with a greater share of income assets.

34 There are also investment strategies, called 'lifecycle' strategies, in which a person's mix of growth and income assets adjusts over time as they get closer to retirement. The asset allocation in these strategies starts out with a high proportion of growth assets and gradually shifts to a high proportion of income assets. Modelling by the OECD and others has suggested that these strategies outperform fixed portfolios in raising average returns whilst constraining variation in account balances at retirement. This has led to their popularity in retirement savings schemes overseas.

Summary of arguments for each investment approach

35 The main arguments in favour of a conservative mandate are as follows:

(a) KiwiSaver is meeting the aims of encouraging savings for retirement and that there is nothing to indicate that the fundamentals of the scheme are flawed.

(b) There is potential for erosion of investor confidence and damage to the KiwiSaver brand if members' experience short term negative returns. This risk will increase as members' account balances become larger. A conservative investment approach minimises this risk as conservative funds tend to have consistently stable and positive but relatively low returns.

(c) The Government should take a risk-averse approach to investing on behalf of those who do not make an active choice for themselves, given that the individual circumstances and risk preferences of this group are likely to differ.

(d) The conservative investment option is most consistent with the idea that the default fund is a temporary 'parking space' while members consider the best provider and fund for them.

36 The main arguments in favour of a balanced mandate are:

(a) To provide higher long-term returns than a conservative mandate. It is also easier to administer than a lifecycle investment approach. In addition, it is closer to the recommended investment approach for the median default fund member (aged 36-40 years old).

(b) To extend the downward influence of the default funds fees on non-default fund fees. KiwiSaver provider fees, particularly those charged under the existing default arrangements, are cost competitive when benchmarked against other domestic retail funds and Australian superannuation funds. Some of this has been attributed to the role the default funds have played in establishing a market benchmark for fees. By changing the investment approach to balanced, thereby increasing the proportion of growth assets in default funds, the downward influence of the default product on fees would be widened to a larger part of the KiwiSaver market.

(c) Balanced and growth funds are generally used as defaults in other countries, including Australian superannuation schemes. Of non-default KiwiSaver funds, balanced funds have the largest pool of funds under management (and growth funds have the second most members, after cash funds).

37 The main arguments in favour of a lifecycle investment approach are:

(a) To improve retirement outcomes for members who remain in default funds. Under a life-cycle investment strategy members are less likely to be worse off and are more likely to be better off than in either a conservative or a balanced fund.

(b) Lifecycle strategies better adapt to the investment time horizons of individual members. No single investment strategy will be appropriate for all default members and whatever selection is made it will not suit everyone; however, this problem is likely to be more pronounced where a single investment mandate is prescribed for all. Lifecycle strategies set asset allocations that take into account individual members' ages and likely time until retirement.

Recommendation

38 Having considered the arguments above, we recommend that the KiwiSaver default funds retain the status quo conservative investment approach.

39 The conservative approach is the most consistent of the three options with the two main purposes of default funds, which are:

(a) To provide stable returns and build confidence in KiwiSaver

(b) To treat default funds as a 'parking space' for members while they consider the best fund type to suit their particular circumstances.

40 We also propose that additional requirements be placed on default providers to provide investor education and impartial financial advice, including actively contacting default enrolled members on investment strategy decision choices. This new requirement should reduce the percentage of fund members who are inappropriately in a conservative fund.

Key decision 2: Criteria for selection of default providers

Selection criteria for new default providers

41 The selection of default providers should ensure a well-governed and competently managed investment fund that provides a high level of care and diligence. In 2006, the criteria for selecting default providers were based on a number of weighted evaluation criteria. These criteria fell into the following groups:

(a) Provider's proposed scheme meets minimum legislative and tax treatment requirements – e.g. can be registered as a KiwiSaver scheme and qualifies as a portfolio investment entity for tax purposes

(b) Security and organisational credibility – e.g. appropriate governance and financially sound

(c) Organisational capability – e.g. experienced senior management and sound risk management policies

(d) Proposed product composition of default funds – e.g. ability to deliver a complete solution through own provision and outsourcing, and offers a suite of non-default KiwiSaver funds

(e) Administration capability – able to meet the specific administration requirements of KiwiSaver (e.g. integration with Inland Revenue's systems) and meet the implementation date

(f) Investment capability – able to offer a simple conservative fund, e.g. investment strategy, selection process for sub-managers

(g) Competitive fee levels – willingness to offer competitive and transparent fees, compared to other providers and industry benchmarks.

42 We consider that the requirements listed above should form the main criteria for any tender process and recommend that these be incorporated into the tender framework. They have served default members well in ensuring the provision of a well-governed, competitively priced fund.

43 Default providers should also be required to offer education and advice to members. Criteria could include an ability and willingness of the provider to provide investor education and impartial financial advice; including resources to actively contact default enrolled members to ensure they are invested appropriately. We propose that the details of this additional requirement, and all other requirements, be determined by the approving group of Ministers.

44 The approach taken in the original tender was to consider a provider's ability to meet or exceed the above criteria alongside the fees they proposed to charge. We recommend that this approach continue to be applied in the tendering of the default providers.

Fees for default funds

45 Fees charged by the current default providers are specified in their terms of appointment, which were set following negotiations in the competitive tender process in 2006.

46 Currently, default fund fees comprise an annual percentage-based fee (around 0.5% of each member's account balance) and a fixed administration fee (generally $3.00 per member per month). Members may also be charged fees for member-specific decisions, such as switching funds. Fees are deducted for members' account balances.

47 In general KiwiSaver provider fees are regarded as cost competitive against other domestic retail managed funds and retail Australian superannuation schemes. Regulations on KiwiSaver periodic reporting that came into force in July 2013 will promote greater comparability. However, a percentage-based fee does not necessarily reflect the costs of running a fund (because of economies of scale) or reward performance.

48 Submitters were invited to comment on the use of fixed fees, tiered fees and performance fees in a default fund. A fixed fee was regarded as unworkable, particularly as it is standard industry practice to charge percentage-based fees. It is difficult to align a fixed fee with the commonly used approach of sub-contracting out at least part of the investment management functions to specialists.

49 A tiered fee was viewed by some respondents as potentially innovative. However, tiered fees add complexity and uncertainty. They also make it more difficult for comparisons to be made as funds under management increase or decrease. Similar arguments can also be applied to performance fees. They add complexity and, in open-ended funds with members moving in and out, can be inequitable.

50 However, performance fees can be a useful mechanism to align the interests of members with those of the provider manager. A mix of a base fee and a performance fee payable on performance over and above agreed objectives can help incentivise better investor outcomes. Several KiwiSaver providers currently charge performance fees. However, there are several disadvantages with performance fees:

(a) They reward outperformance but do not penalise under-performance. Therefore, they can encourage fund managers to take excessive investment risks.

(b) They add complexity, are difficult to align across funds and impair investors' ability to easily compare fees and performance.

(c) They generally encourage fund managers to focus on short term results at the expense of the longer-term goals associated with retirement savings products.

51 We consider that default funds have played, and will continue to play, an important role in setting the benchmark in the market for fees that are not 'unreasonable'. Therefore, it is important that the fees for default funds remain transparent and easy to compare. This is best achieved through simplicity. We recommend that the default provider tender require providers to price their fund based on only a percentage-based fee and a fixed administration fee that is aligned with the fund fees and membership fees as defined in the KiwiSaver (Periodic Disclosure) Regulations 2013.

Number of default providers

52 In order to obtain some degree of negotiation leverage over the fees charged by default providers, it was decided in 2006 to limit the number of default providers and undertake a rigorous evaluation process to appoint providers to the limited available positions. It was decided that there would be a limited number of providers, in order to create competitive tension around fees. The Government must again give consideration to the number of default providers it intends to appoint.

53 At one end of the spectrum, the limit on the number of default providers could be removed entirely. Under this scenario, default provider appointments would be made under a non-competitive process in which any provider could be appointed if they meet certain baseline criteria and fee levels. We expect that this scenario would likely result in a significant increase in the number of default providers, including reappointment of all existing default providers.

54 The advantages of not having a cap on the number of default providers are:

- To provide the greatest diversification of default providers
- To allow for a relatively simple and predictable appointment process
- To avoid costs to government and providers from having to reallocate existing default members
- To potentially be the least controversial approach from the point of view of the funds management industry as it would provide clear benchmark criteria to prospective default providers.

55 The main disadvantages are:

- Reduced competition for default provider status. This may lead to higher fees.
- Increased monitoring costs for the FMA. Default providers are subject to higher levels of FMA scrutiny than other providers.
- Increased administrative costs for Inland Revenue.

56 Under alternative approaches, a higher bar or greater competitive tension could be sought through a combination of increased capability and service requirements, lower required fees, or by retaining a cap on the number of default providers.

What consideration should be given to scale?

57 There is a trade-off between requiring a provider to have sufficient size and scale with adequate balance sheet backing to be able to honour commitments versus encouraging more innovative and cost efficient smaller providers. Minimum size and scale requirements invariably limit default provider appointments to large financial institutions such as banks and insurers.

58 Managed funds, including pension funds, can realise significant economies through scale and this influences fees. Fees charged, in turn, have a significant influence on net fund returns.

59 The consultation undertaken with stakeholders asked about the extent of scale economies to be found in the provision of KiwiSaver providers and the key drivers of those economies.

60 The ability to easily transfer between providers is a KiwiSaver design feature that ensures a competitive market outside of the default funds and encourages providers to actively compete for customers. However, the default funds exercise competitive pressures on the non-default funds by signalling a 'reasonableness' standard for fees. Many respondents noted that KiwiSaver providers' fees are generally much lower than those charged by Australian superannuation funds which generally have much greater scale.

61 The level of fees charged is important because it has a significant impact on savings outcomes. For example, a study by the UK Department for Works & Pensions concluded that for a median earner with a full savings history (40 years of saving at an annual income of $50,000), fees of 0.5% have a cumulative cost effect of 11.09% on final retirement funds. Fees of 1% have a 20.79% cumulative effect for the same earner.

62 In the New Zealand context, there will be a point at which funds reach minimum fund viability but this will also depend upon a provider's existing business. Respondents suggested that minimum fund viability is $20 million but that scale benefits become significant at $50-$100 million. However, there will also be a point at which funds become sub-scale and therefore are in danger of cutting costs in areas like compliance and governance.

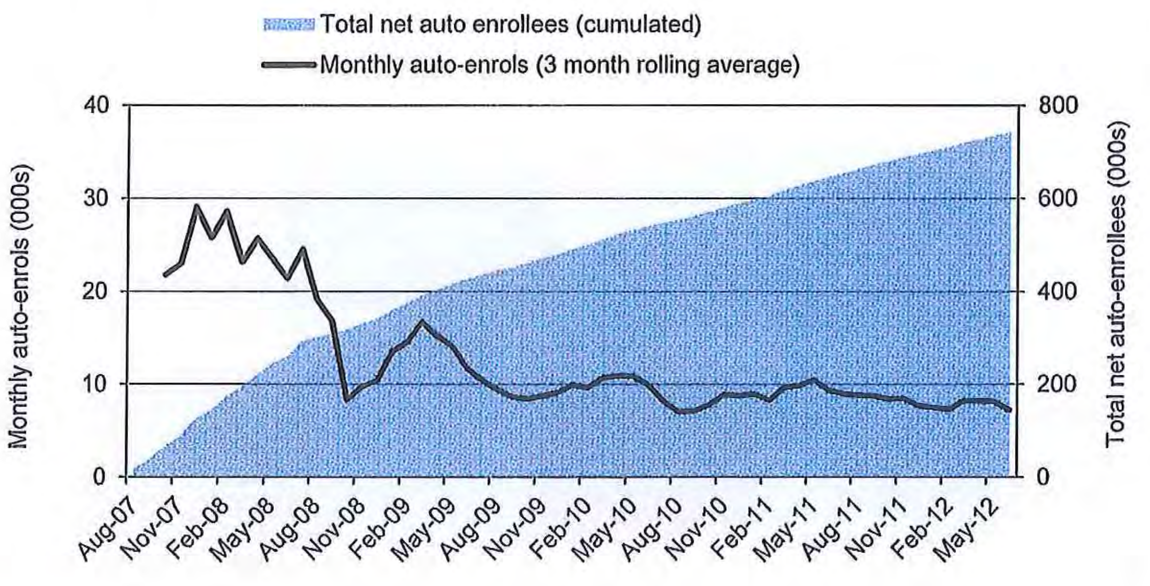
63 A recent Morningstar KiwiSaver performance survey estimated that the current default funds total $3.5 billion in funds under management between them with an average of $590 million per fund. This indicates that the default funds may increasingly benefit from scale economies as they grow larger. This also indicates that increasing the number of appointed default providers by a small number will not necessarily cause a loss in scale economies.

64 Having a reasonable spread of default providers also allows for diversification of provider risk. However, there are other considerations that need to be taken into account such as an increased workload and cost to the Crown in governance and oversight, as well as wider variances in performance across funds.

Future flows of new default members

65 Given that the future stream of new default members is likely to continue to decline (see Figure 3), it may be reasonable to reduce the number of default providers. The original six providers received an average of 2,500 new default members each month in the first three years of KiwiSaver (30,800 per year each). In the 12 months to June 2012, new default members have declined to an average of 440 per month (5,300 per year). This may suggest that the number of default providers should be capped.

Figure 3: Auto-enrolled member flows



Conclusions

66 We consider that it is essential for the selection process to be highly competitive. As was the case in 2006 and 2007, there should be a two-step process in selecting the default providers. First, bids should be judged against the qualifying criteria discussed in paragraphs 41 to 44 above. Fee issues should then be considered in order to provide leverage in fee negotiations. This tends to indicate that the number of default providers should be sufficiently high to avoid a tight oligopoly but not so high as to cause loss of economies of scale, excessive Inland Revenue administration costs and excessive FMA monitoring costs.

67 We do not have sufficient information at present to make that trade-off and propose a maximum number. Therefore, we recommend that Cabinet delegate authority to the group of approving Ministers to decide the maximum number of default providers at a later date once better information is available.

Key decision 3: Transitioning between existing and new providers

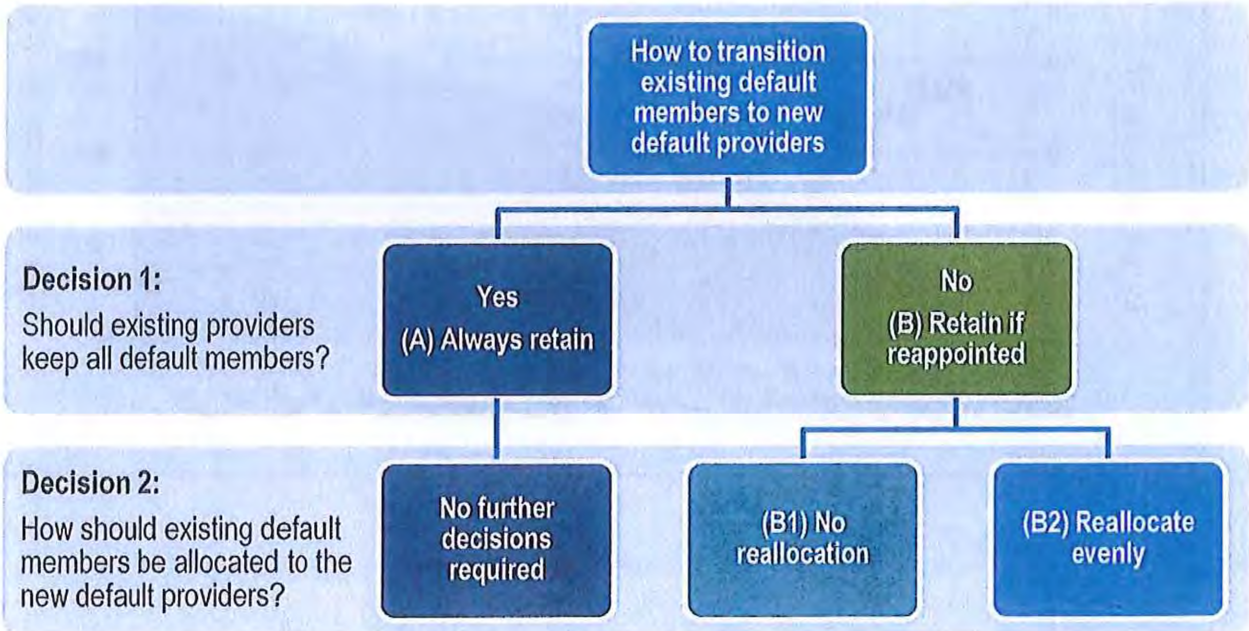
Options

68 Under a competitive procurement process, what happens to existing default members is an important determinant of how the process will operate and its outcomes. The decisions and options around this are outlined in Figure 4.

69 The first decision is whether existing providers should keep all their current default members. The options are:

- **A. Always retain** – Existing default providers retain all their current default members, whether they are reappointed or not.
- **B. Retain if reappointed** – Default providers that are reappointed retain some or all of their current default members, but those that are not reappointed lose their default members.

Figure 4: Options for transitioning existing default members to the new default providers



70 Under option A (Always retain), the new default providers would be allocated a share of new default members, but current default members would remain with their original provider (whether that provider is reappointed or not).

71 Under option B (Retain if reappointed), further decisions would need to be made on how default members are to be allocated to the new default providers (i.e. whether the new default providers should each have a roughly even share of default members). The options are:

B1. No reallocation – Reappointed existing default providers retain all their members (regardless of how uneven this may be) and new default members are allocated to all the new default providers (including reappointed existing default providers).

B2. Reallocate evenly – The new default providers are allocated an equal, or near equal, number of the default members, regardless of whether they were an existing default provider or not. There are two sub-options for this, which have the effect of reducing the number of members needing to be transferred:

B2(i) Reappointed default providers keep most of their existing members, with only default members above their share reallocated to the new default providers.

B2(ii) Reappointed default providers retain all their current default members, and the flow of new default members be directed to only the new default providers (that are not existing default providers) until the number of default members with each new default provider is more equal.

72 A variant on the options above would be for default members due to be transferred to be issued with an election form in an attempt to determine what they wish to do. Those who did not respond, or who indicated they wished to be transferred, would be transferred to a new default provider.

Comment

73 Some existing default providers have asserted that the default members are their customers and should remain so. Against this:

(a) The current default design places additional requirements on the default providers over and above other providers because the Crown considered it necessary that they adhere to the highest standard of care. These requirements will expire along with the expiration of the term of appointment. Therefore, existing default members would no longer have the protection of the instrument of appointment which specifies fees and reporting obligations.

(b) The term of appointment was time-limited to seven years and may only be renewed with Ministerial approval.

(c) The default members were allocated across the six default providers via Inland Revenue and not procured as a result of specific efforts of the default providers (such as marketing, branding, product development and performance).

74 An important effect of this choice is on the procurement process itself. How default members are treated impacts on what is at stake – whether providers are bidding for rights to fees from a small number of members or a large number of members, and what incumbents stand to lose from making an uncompetitive offer.

75 On the other hand, transferring tens of thousands of members among schemes may be administratively costly and difficult for the Government, particularly Inland Revenue.

Recommendation

76 We propose in principle that default providers that are reappointed retain all or some of their current default members, but those that are not reappointed lose their default members (option B: (Retain if reappointed)). This would mean that existing default members would continue to receive the protection of the instrument of appointment which specifies fees and reporting obligations.

77 However, we propose that the decisions under option (B), on how default members are to be allocated to the new default providers, require further consideration and should be made by the group of approving Ministers after fully considering the effects on the tender process and the practicability and risks of the options.

78 In addition, it is important to recognise that some default members may have actively chosen to be in their current conservative funds. We therefore propose that any members who are to be transferred be issued with an opt-in election form. We propose that the details of this process be decided by the group of approving Ministers.

Transition timeframes

79 We propose that all new default members be enrolled with the new default providers from 1 July 2014.

80 For those existing default members who have not elected to remain with their current provider and are being transferred to the new providers, the transition would need to be phased so that it is orderly and does not cause any market distortions.

81 This timeframe depends, in part, on whether any change is made to the default fund investment approach, and how many default members are to be transferred to the new default providers. Therefore we propose that Cabinet delegate authority to the group of approving Ministers to determine this timeframe once further information about the future default arrangements are known.

Next steps: Tender process

82 We propose to follow a similar competitive tender process as was used to select the existing default providers. This process will be led by the Ministry of Business, Innovation and Employment, with oversight delegated to the group of approving Ministers. Given the potentially significant commercial benefits of being appointed a default provider, it is imperative that a transparent and robust selection process be undertaken. This will involve the independent evaluation of potential default providers against the criteria for selection.

83 The tender process will comprise five main stages:

- Stage 1: Registration of interest
- Stage 2: Request for proposal – issued to providers that are short-listed in Stage 1
- Stage 3: Due diligence – including appropriate stress testing of the potential new default providers systems and processes to ensure that they will be able to deal with expected member volumes and be operational by 1 July 2014
- Stage 4: Negotiation of fees
- Stage 5: Approval of default provider selection and confirmation of terms of appointment.

84 At each stage in the process there will be a short-listing of potential providers based on the previous stage. Stages 1-3 will narrow the pool of potential providers by imposing a mix of minimum capability requirements alongside consideration of likely fees. The resulting shortlist will be subject to a fee negotiation round in Stage 4, following which final appointments will be made.

Term of appointment

85 None of the submissions raised concerns with the current seven years. We consider there to be no need to set a shorter or longer term. Seven years appears to provide a reasonable period of incumbency for an appointed default provider while still being short enough to minimise complacency risks.

Next steps

86 Once Cabinet agrees on the key policy decisions required for the future KiwiSaver default provider arrangements, the approving group of Ministers will oversee the procurement process for selecting new default providers to apply from 1 July 2014.

87 As the first step, the approving group of Ministers will agree to a project plan which sets out milestones and decision points to complete the procurement process. This will include proposals for a project governance framework and other matters consistent with standard competitive procurement process.

88 We intend for the new default providers to be in place and available to accept new default members from 1 July 2014.

Consultation

89 The Treasury, Inland Revenue Department and the Financial Markets Authority have been consulted on the contents of this paper. The Department of Prime Minister and Cabinet has been informed.

90 This paper has taken into account the views of submitters who responded to the Review of KiwiSaver Default Provider Arrangements discussion document released in November 2012 as well as those who participated in stakeholder forums. Aspects of this paper have also been reviewed by an external peer review panel.

Financial Implications

91 There are no fiscal implications arising out of this proposal.

Human Rights

92 The proposals in this paper do not raise issues in terms of the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993.

Legislative Implications

93 There are no immediate legislative implications. However, regulations may need to be made at a later date.

Regulatory Impact Analysis

94 The proposals in the paper do not have regulatory implications.

Publicity

95 Subject to Cabinet's agreement to the proposals in this paper, we intend to issue a joint media statement announcing Cabinet's decisions. The Ministry of Business, Innovation and Employment will also publish a copy of this paper on its website, subject to deleting any information that is commercially sensitive. We also propose to write to the existing default providers to inform them of Cabinet's decisions.

Recommendations

We recommend that the Committee:

1 **Note** that the auto-enrolment feature of KiwiSaver means that a 'default' arrangement must be provided for employees who do not actively select a KiwiSaver provider.

2 **Note** that the existing default providers were appointed to a term of seven years which will expire on 30 June 2014.

3 **Note** that it will be more efficient for decisions on key policy and operational details in relation to implementation of the future default provider arrangements to be made from time-to-time by a smaller group of approving Ministers.

4 **Agree** that the group of approving Ministers should be those with responsibility for aspects of KiwiSaver or have a key interest in the default provider arrangements, being the Minister of Finance, the Minister for Economic Development, the Minister of Commerce, and the Minister of Revenue.

5 **Invite** the approving Ministers to co-opt other Ministers as necessary where any significant issues relating to their portfolios arise.

Key decision 1: Investment approach for default funds

6 **Note** that under their existing terms of appointment, the current default providers are required to deliver a fund that has a conservative investment approach.

7 **Agree** that the purpose of the default funds is to provide stable returns and build public confidence in KiwiSaver, which preserves members' capital while they consider the best fund type to suit their particular circumstances, rather than seek to maximise outcomes in retirement.

8 **Agree** that the investment approach for KiwiSaver default funds should remain conservative, including a 15-25% allocation to growth assets.

Key decision 2: Criteria for selection of default providers

9 **Note** that the 2006 tender requirements for default providers have served default members well in ensuring the provision of well-governed, competitively priced funds.

10 **Agree** that the following high-level criteria form the basis of the criteria for the assessment of a KiwiSaver provider's suitability to offer a default fund:

10.1 Investment capability:

10.1.1 A proven track record in investment capability and delivering funds management performance.

10.1.2 The ability to deliver the Government's specification for the default investment option and meet the standards required.

10.1.3 An ability to provide a full suite of KiwiSaver funds in addition to the default fund.

10.2 Corporate strength: The provider is a reputable organisation which has the financial capacity and infrastructure to maintain and enhance the proposition, while pursuing ethical standards that will not bring the KiwiSaver provider into disrepute.

10.3 Administrative capability:

10.3.1 The systems and process to undertake a large volume of transactions accurately and in a timely fashion.

10.3.2 Administration systems that are both scalable and flexible enough to adapt to frequent changes in legislation and provider features.

10.4 Track record and stability: A commitment from the organisation to the New Zealand market, to accept the mandate and carry it out to the best of its ability and at the fees negotiated or agreed.

10.5 Investor education and advice: The ability and commitment to provide investor education and impartial financial advice including to proactively contact default enrolled members to ensure they are invested appropriately.

11 **Agree** that the detailed criteria and any other additional criteria and requirements may be set by the approving group of Ministers.

12 **Agree** that providers be required to price their proposals on charging a percentage-based fee plus a fixed administration fee that is aligned with the fund fees and membership fees as defined in the KiwiSaver (Periodic Disclosure) Regulations 2013.

13 **Note** that there is insufficient information at present to set a maximum number of providers.

14 **Authorise** the group of approving Ministers to decide the maximum number of default providers, consistent with the policy objectives outlined in this paper.

Key decision 3: Transitioning between existing and new providers

15 **Agree** in principle that default members are to be reallocated in the event that their default provider is not reappointed, subject to providing those members with an opportunity to elect to remain with that provider.

16 **Authorise** the group of approving Ministers to determine how default members referred to in recommendation 15 would be reallocated to the default providers.

17 **Authorise** the group of approving Ministers to determine whether default members enrolled with a reappointed default provider should remain with that provider, or whether and how those members should be reallocated amongst default providers.

18 **Note** that the process for transferring current default members is set out in the current instruments of appointment and that the Financial Markets Conduct Bill, once passed, provides for regulations to be made to clarify this process in some circumstances.

Next steps: Tender process

19 **Agree** that a competitive tender process consistent with government procurement policies and practices be undertaken to appoint default providers from 1 July 2014.

20 **Agree** that all prospective default providers be required to undergo a due diligence process.

21 **Agree** that the new default providers be appointed for a term of seven years, expiring on 30 June 2021.

22 **Authorise** the group of approving Ministers to approve the new default providers following the tender.

Publicity

23 **Agree** that:

23.1 The Minister of Finance and the Minister of Commerce issue a media statement announcing Cabinet's decisions on these matters

23.2 The Ministry of Business, Innovation and Employment publish a copy of this paper on its website.

Bill English

Hon Bill English
Minister of Finance
31 / 7 / 2013

Hon Steven Joyce
Acting Minister of Commerce
1 / 8 / 13