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growing and protecting the wealth of New Zealanders

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Review of KiwiSaver Default Provider Arrangements
Investment Law
Ministry of Business, Innovation and Employment
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Review of KiwiSaver Default Provider Arrangements

The Financial Services Council (**FSC**) appreciates the opportunity to make a submission on the Ministry's Review of KiwiSaver Default Provider Arrangements.

The default fund is intended to provide an investment option for those savers who, for whatever reason, do not choose a specific investment option. With the brilliance of hindsight we can say that KiwiSaver, including the default arrangements, has been remarkably successful:

- More than 2 million New Zealanders have engaged in long-term saving
- 10,000 people, with many more to come, have been able to make a deposit on a first home in a market requiring five times average earnings for a first home compared with three times for their parents' generation
- Increased long-term savings have enabled NZ-based fund managers to invest more in fast-growing New Zealand companies, some yet to be listed
- Despite the worst investment environment for 50 years no KiwiSaver has lost money
- KiwiSaver default fund investors are paying lower fees than they would in Australia or in other products, even given the low balances of many KiwiSaver accounts at this stage

FSC is a strong supporter of KiwiSaver and FSC members manage a substantial part of KiwiSaver funds under management. We are trusted by 2 million New Zealanders to help grow and protect their wealth. Of the six KiwiSaver default providers, five are FSC members (while ASB Bank is not an FSC member, Sovereign Ltd is part of the same Commonwealth Bank group and ASB does contribute to our policy development).

A list of FSC members is included at the end of this submission.

Our comments are general in nature and focus on those parts of the discussion document which deal with the objective of the default fund and its investment approach. We do not intend to comment on the 'default scheme architecture' and the appropriate number of default providers. FSC member companies will make their own submissions on that aspect of the review.

Our responses to the specific questions posed in the discussion document are at the end of this submission.

In the past year FSC has undertaken a major research project which recommends expanding saving through increasing contributions to and membership of KiwiSaver as a means of funding the gap between the desired age of retirement and a later age of eligibility for New Zealand Superannuation. Those proposals also have the potential to provide much higher incomes for retirees, to reduce the cost of providing New Zealand Superannuation and to increase capital investment in New Zealand but, to achieve that 'triple win' situation, it is essential for KiwiSavers to maximise their investment earnings.

We have also recently prepared a report on the potential benefits of KiwiSaver to the New Zealand economy if coverage and contribution rates are increased. A copy of that report will be available on our web site in the New Year www.fsc.org.nz.

Key Submission Points

- KiwiSaver is the most effective means available for improving saving levels in NZ and increasing the pool of local capital for investment
- KiwiSaver should be treated as long-term savings, despite the facility for first home withdrawals
- Maximising the sum accumulated over the full term is more important than short-term capital preservation, although a conservative option should be available for those who are close to withdrawing funds for a first home purchase or want less risk close to retirement
- The net return over the lifetime of a KiwiSaver's membership is more important than the level of fees
- Either life style or target date funds would provide a better result in the long term than the conservative investment option, which has growth assets limited to a maximum of 25%. However, life style is probably to be preferred given the limited scale that could be achieved if multiple default providers were required to have target date funds, and the impact on fees
- We recommend a working group to design an amendment to default providers' instruments of appointment to allow a life style fund as the default option.

Objectives

The long-term objective of the KiwiSaver scheme should be to enable New Zealanders to supplement New Zealand Superannuation and achieve a comfortable level of income in retirement, about twice the level of NZS. The objective of the default architecture should be to put those KiwiSavers who are not actively engaged into the portfolio that would give them the highest income and 'least regrets' at the time of retirement.

Ease of entry and the fact that new entrants do not have to make decisions about investment style have to be major reasons for the success of KiwiSaver.

The fact that new entrants have gone into the default fund does not mean that they are necessarily cautious, merely that they have not chosen a preferred option.

The discussion document has identified that only 39% of entrants into the default option of their scheme have since moved. The balance may remain in the default fund for the duration of their membership. The implications of that include:

- They are likely to accumulate less in investment earnings than if they were in a fund with more growth assets
- They will in effect have paid more for each dollar of pension than their peers who take up a more aggressive option
- They may in future conclude they were steered into a fund that was too conservative and hold the Government responsible for their lower earnings.

The number of KiwiSavers remaining in default funds may be inflated by the unusual investment conditions over the five years since KiwiSaver started in which conservative funds have performed comparatively well. The numbers have probably also been influenced by a level of quite legal "gaming" of the KiwiSaver scheme, where some individuals have used it to maximise returns by making the minimum investment necessary to obtain the incentive benefits without continuing contributions.

The FSC agrees that one of the reasons for the popularity of the KiwiSaver scheme is that entrants do not need to think about investment choices and in this respect the default funds serve an important purpose. However, we consider that the rules around asset allocation in the default funds operated by default providers need to be revised to allow new entrants to default into an appropriate investment portfolio according to their stage of life, with a higher allocation of growth assets for the long term.

The current investment approach for the default funds

The default funds operated by the default providers are permitted a minimum of 15% and a maximum of 25% in growth assets.

Members can move out of the default funds and make an active investment choice at any time. The discussion document notes that members were expected to remain in the default funds for only a short period and were expected subsequently to make an active choice to move to a fund that better matched their risk profile.

In our view, with the benefit of hindsight, we can now conclude that there are likely to be 3 different courses of action:

- A substantial proportion of people in the default funds will never have the interest or confidence to make an active choice of investment
- Some will take more interest once their savings grow and they can see higher comparative earning rates in different investment options
- Others will have a short-term view and will prefer to stay with the conservative approach as they save for a first home withdrawal and will then consider a more growth-oriented strategy for future saving

FSC is strongly of the view that KiwiSavers should be encouraged to maximise their returns to the greatest extent possible without undue risk. It can be expected that, with increasing longevity after age 65, retirement ages will move out. If the age of eligibility for NZ Superannuation moves closer to 70 the option for KiwiSavers to choose retirement at age 65 and fund the gap by drawing down their accumulation would be an attractive feature. KiwiSavers will also need investment in growth assets post-retirement and that is an issue for decumulation products.

The FSC research behind our report *Pensions for the Twenty First Century: Retirement Income Security for Younger New Zealanders* (see www.fsc.org.nz) calculated likely pensions from KiwiSaver fund balances at age 65 using relatively modest expected net return rates of 3% and 4%pa. Using the same base assumptions, further calculations (see Attachment 1) using 3% and 5% rates of return (real, net of tax and fees) indicate that the additional 2% over a 45 year working life results in an extra 30% in available pension at age 65 for a male on the median wage and an extra 24% for a female on the median wage. This means that someone on the male median wage would receive $325,000 less in their retirement pot if they were to stay in a conservative default fund compared with a more aggressive fund that earns 2% more over 45 years. For a woman on the median wage, potentially $205,000 would be left on the table by sticking with the default option. For someone on the minimum wage throughout their working life, $179,000 would be left on the table. These are all significant sums that would make a major difference to a retiree's retirement life style.

Appendix Two of the discussion document notes that the long-term return on NZ equities since 1900 has exceeded 5%, while the return from bonds and bills has been less than 3%. As an additional illustration we have attached (Attachment 2) a copy of Appendix 5 from our report showing Goldman Sachs research on total return by asset class in Australia over the past 25 years to the end of 2009.

Additional work done for us by Infometrics (to be released in the New Year) indicates that a balanced portfolio would have approximately 3.5% more in NZ equities than a conservative portfolio currently has. The impact of that on the New Zealand stock market would be an injection of approximately $52 billion additional investment by 2060.

In an ideal world savers would receive professional advice from a financial adviser to help them choose the investment option that is most appropriate for them. However, the reality is that it is not cost-effective for advisers to provide advice to people with very small balances, which applies to most KiwiSaver new entrants. Once their balances grow they are likely to be more receptive to advice and also more of a business proposition for the advisers.

The FSC is a strong advocate of professional advice and we would like to see more people making an active choice of investment option based on their risk profile. For those people who do not seek advice, the life cycle approach is likely to be a reasonable approximation of the strategy that would be recommended. It is also likely to produce the 'least regrets' outcome at retirement for those New Zealanders who would find it difficult to make an investment portfolio choice.

The recommended investment approach for the default funds

The FSC would like to see a working group established to design appropriate rules for an amendment to the default providers' instruments of appointment, enabling them to move current savers automatically from the conservative default fund into a life style fund. KiwiSaver members who said they were likely to purchase a first home in the next 5 years, or who wanted to retire in the near future, could choose to opt into a conservative fund.

Recent (as yet unpublished) public opinion research conducted for FSC by Horizon Research indicates that, while only 1.9% of KiwiSaver members have drawn on their funds for a first home purchase, approximately 60% of members who do not already own their own home intend to do so. As 50% of the working age population have already purchased their first home, it probably means 30% of all KiwiSaver participants could be expected to use the first home withdrawal and subsidy option sometime within the next 20 years. However, if only 30% of KiwiSavers are likely to be using the option, this may suggest that lifestages should be the usual default for all KiwiSaver investors unless they specifically indicate they intend to buy a first home within the next 5 years.

We believe the OECD paper[1] cited in section 3 of the discussion document provides a good starting point for further work.

The discussion document raises the issue of the management of growth assets incurring higher fees than a conservative portfolio. While we acknowledge that investment in growth assets does incur higher fees, we believe that the focus should be on net returns rather than the fees themselves

[1] "Assessing Default Investment Strategies in Defined Contribution Pension Plans", P. Antolin, Payet S. & Yermo J., (2010) OECD *Working Papers on Finance, Insurance and Private Pensions, No 2,* OECD Publishing.

(which must, in any case, be 'not unreasonable'). Research conducted for the FSC has shown that investment in a conservative portfolio over the span of a working life would require contribution rates to be higher than the contribution rate needed if funds were invested in more growth assets. In our view, the current rules for default fund investments are likely to penalise those KiwiSaver members who have least knowledge about investment matters. This may leave the Crown vulnerable to future legal action on the grounds that the default portfolio design was not in the best interests of the KiwiSaver members.

We consider, also, that the increased disclosure to be provided under the KiwiSaver (Periodic Disclosure) Regulations will offset to a great extent the increased complexity of monitoring more growth oriented investment strategies.

Finally, the discussion document asked for an insight into the issues that exist around decumulation. A series of slides from a presentation by FSC on decumulation identifying some of the issues can be found here:

http://fsc.org.nz/site/fsc/files/presentations/Presentation%20to%20RPRC%20Decumulation%20Symposium%20-%2030%20November%202012.pptx

We also believe that attention will need to be given to the possibility of a default decumulation product.

We would be interested in meeting with the review team to discuss the matters contained in this submission.

Yours sincerely,

Peter Neilson
CHIEF EXECUTIVE

Responses to Questions

1. Are there other arguments in favour of the current default arrangements? If so, please explain.
With the brilliance of hindsight we can say that KiwiSaver default arrangements were remarkably successful:

- More than 2 million New Zealanders have engaged in long-term saving
- 10,000 people, with many more to come, have been able to make a deposit on a first home in a market requiring five times average earnings for a first home compared with three times for their parents' generation
- Increased long-term savings has probably enabled NZ-based fund managers to invest more in fast-growing New Zealand companies, some yet to be listed
- Despite the worst investment environment for 50 years no KiwiSaver has lost money
- KiwiSaver default fund investors are paying lower fees than they would in Australia or in other products, even given the low balances of many KiwiSaver accounts at this stage

2. Default providers – Have you undertaken a programme of active engagement with default members to get them to make an active choice of fund? If so, please provide details including, for example, contact rates, transfer rates.
Individual FSC members will answer this question directly.

3. Financial advisers / providers – What is your experience with risk/volatility and member behaviour in response to it?
Our members will be answering this question directly in their submissions. It is well known that many investors tend to over-react to short-term fluctuations in the value of investments, to their long-term detriment. Typically, individual investors sell shares that have recently shown a sharp drop in value and join the bandwagon buying into shares towards the end of a price upswing. This behaviour is avoided by contractual long-term savings vehicles like KiwiSaver where investment continues throughout the cycle, and is an effective strategy for building wealth over time. Other behavioural quirks also make KiwiSaver a very effective means to help New Zealanders build wealth, provided the default mechanisms are well-designed.

4. Are there other reasons to change from the current settings that we have not considered? If so, please clarify.
FSC believes there are a number of reasons to change from the current settings that may not have been considered, namely:

- There is considerable public support for both universal coverage of employees in KiwiSaver and for a phased increase in contributions over time to 10%. The current settings for KiwiSaver are not compatible with contributions stepping up over time, by 1% a year (0.5% from the employee and 0.5% from the employer)
- The thinking about a KiwiSaver investor's portfolio is not sufficiently holistic. By 30 to 40 years of age the typical KiwiSaver will have a range of investments. That will include their education and training (a conservative investment) probably a home (another relatively low risk investment) and possibly bank deposits or term deposits (again, low risk investments). If those investments are very much weighted towards conservative assets, what justification is there for KiwiSaver also to be overweight in conservative investments?
- With life expectancy after age 65 increasing, it can be questioned why New Zealanders should be overweight in conservative assets from age 60 when their entitlement to NZ

Superannuation provides a low risk first tier of income and the protection of growth assets is needed to ensure their real incomes do not decline steadily after retirement.
- There would be economic benefits for New Zealand if default funds were more likely to be invested in high export and employment growth companies, which may be unlisted. However, this is likely to be incompatible with a conservative investment mandate.

5. As an organisation, what indicators do you use to assess a client's risk tolerance?
We will leave this question for our members to answer in their individual submissions.

6. Financial advisers / providers – Please explain the process you currently use to guide KiwiSaver active choice members into an investment fund that has the appropriate risk profile? What factors and weightings do you take account of, for example – age, gender, income, whether they intend to
We will leave this question for our members to answer in their individual submissions.

7. Are there other issues around risk and investment strategies that we should be taking into consideration?
The Infometrics report prepared for the FSC (to be published in the New Year) outlines the potential benefits for New Zealand of an expanded KiwiSaver scheme including moving the typical KiwiSaver portfolio from conservative to balanced. These benefits include:
- More capital for New Zealand businesses, in particular the fast-growing ones
- A modest reduction in interest rates which should have a flow on effect to a slightly lower NZ dollar
- A more resilient capital market during economic downturns
- More capital working with New Zealand employees, boosting productivity and wages

The quantity and quality of investment in New Zealand can be assisted by a default regime that better matches the long term interests of individual KiwiSaver investors by taking on a higher weighting of growth assets.

8. Is a traditional life-cycle investment approach appropriate for a default fund and if so, why?
We consider that a traditional life cycle investment approach for a default fund is most likely to ensure a 'least regrets' outcome for most KiwiSaver investors.

The current default arrangements, if continued, will result in many KiwiSavers leaving significant 'money on the table' after being placed in an inappropriate long term investment portfolio.

9. Do you have any concerns with life-cycle funds? (Note: we address withdrawals for first-home purchase below)
With any default arrangement the outcome will not be optimal for every participant but we can design arrangements that are the best for most and provide options for the exceptions to migrate to a better solution for them.

10. Is a target date investment approach appropriate for a default fund and if so, why?
When the FSC surveyed the public on whether they had a retirement date in mind, most people could nominate one. It is, however, unlikely that everyone's expectations will come to fruition as planned. Someone who re-partners later in life may find themselves having children living at home with them when they are in their 70s and at a time when some of their contemporaries are becoming great grandparents. As our core pension, NZ Superannuation, has an age of eligibility but does not require recipients to give up work to receive it, and with people in each generation living

on average an extra 2 years after age 65, it seems unlikely that any target date scheme will deal adequately with the variety of actual household situations.

As the discussion document highlights, having each provider required to operate several target date funds will make it more difficult to achieve economies of scale and therefore is likely to be more expensive.

11. Is there, in your view, a minimum scale requirement for implementing a target date investment approach? If so, what would the minimum size be?
We will leave this question for our members to answer in their individual submissions.

12. Financial advisers / providers - Are there issues with, or barriers to, capturing age data? If so, please elaborate..
We will leave this question for our members to answer in their individual submissions.

13. In your view, if we were to move away from a conservative mandate, which would be the more suitable investment strategy for a default fund – balanced, aggressive or life-cycle based? Please explain your response, giving consideration to costs and risks.
Given the likely circumstances of most default KiwiSavers a life cycle fund with an aggressive tilt during the majority of the period of investment is likely to provide the best (and 'least regrets') outcome for most at retirement.

These circumstances are likely to be:

- Most KiwiSavers will live on average longer than their parents and grandparents and will require growth assets to ensure they do not suffer a deep cut in living standards as they age
- As most funds cannot be accessed before age 65 it makes investment sense to use that investment horizon to include exposure to a significant proportion of illiquid investments with longer term superior earning potential
- As most default KiwiSavers will have investments in a number of lower risk areas (such as their training and their home) and will be underwritten by the taxpayer (NZ Superannuation) for the first tier of their retirement income, their KiwiSaver default fund should tilt towards the aggressive end of investment portfolios if their overall portfolio is to be "balanced". Those KiwiSavers who are close to retirement or about to make a deposit on a first home should elect a more conservative portfolio if that is their preference.

While aggressive strategies are likely to require higher fees for effective management, the focus needs to be on the net returns achieved after fees, not just the absolute level of fees.

14. Do you have other suggestions for an investment approach? For example, what about a balanced investment strategy with a switch to conservative/cash 5-10 years out from NZ Super eligibility?
We will leave this question for our members to answer in their individual submissions.

15. Is it reasonable to assume that some people in the default fund are there because they are intending to withdraw funds for a first-home purchase?
It is reasonable to assume that some people are in the default fund because they are intending to withdraw funds for a first home purchase, but it would be preferable to ask them rather than assume it and to require them to make an active choice for a conservative fund.

The FSC has commissioned surveys by Horizon Research on the intention of KiwiSavers or potential KiwiSaver members. Of those surveyed, some 50% had already purchased a first home and 60% of the balance (that is, 30% of all KiwiSavers or intending KiwiSavers) planned to use KiwiSaver balances to purchase a home. We did not ask whether people knew they were in a default fund but, if these results are indicative and 70% are not planning to take up that option, it may not be appropriate to put all KiwiSavers into conservative default funds for five years. We also have to be mindful that forming households and deciding to have children are not necessarily the same thing and timing may vary. For example, some families are quite young when they have their first child whereas professionals often delay having children and buying a home until their late 30s or early 40s. One default option that assumes home purchase in the first five years of membership may therefore not be appropriate.

A default into balanced or aggressive portfolios with an opt out for those who indicate they will retire or purchase a first home within the next five years may be a better solution for most.

16. To what extent do you think the first-home withdrawal facility should influence the design of the default product? Please explain.
We have covered this under question 15.

17. What, in your view, is the best approach to deal with members intending to use their KiwiSaver for a first home purchase?
We have covered this under question 15.

18. Do you agree with our analysis of active versus passive investment management? If not, why not?
Our own work has identified that, looking retrospectively, the best performing portfolio managers have been active rather than passive, although of course not all active managers have been or will be successful. The test really is whether the higher costs of active management will be more than offset by higher returns. While it is possible to describe the ideal portfolio retrospectively, it is not possible to pick it in advance.

19. What asset classes, if any, do you think would be best suited for a passive investment approach? What asset classes do you think should only be delivered via an active investment approach? Please explain your answer.
Given the time horizon for KiwiSaver investments, it would be a mistake not to have unlisted equities in the portfolio, which means the portfolio could not be totally passive. For at least the next 10 years it is hard to see how a passive investment management approach could be made compatible with lower fees without additional scale. That would require fewer providers and fewer options than currently available for those KiwiSavers who take an active interest in their investments and are prepared to switch providers, thereby incentivising providers to maintain or improve their investment management performance.

20. In your view, do you consider the rationale listed above to be accurate? If not, why not?
The rationale appears broadly accurate but probably underplays the reality that fund managers are now investing more in unlisted and illiquid equities as they are more comfortable with the long term horizon of most KiwiSavers. Secondly, although most of the KiwiSaver funds will not be paid out until the saver is aged 65, the fund managers know that at any time a KiwiSaver can decide to switch provider so they can have only a relatively small proportion of their portfolio in unlisted entities..

21. Do you have any suggestions or proposals as to how the asset classes might be made more attractive for KiwiSaver investment?
We will leave this question for our members to answer in their individual submissions.

22. Are there any other key considerations? If so, please explain.
This has been covered elsewhere.

23. Do you agree with our analysis of the existing KiwiSaver market and the role of scale and fees? If not, why not?
We will leave this question for our members to answer in their individual submissions.

24. Please outline what you consider to be the pros and cons of the options suggested above. Please detail your preference and why.
We will leave this question for our members to answer in their individual submissions.

25. Are there other possible approaches for reducing fees, for example a risk-sharing approach whereby fees are not charged on negative performance relative to market performance? Please detail any proposals you might have.
We will leave this question for our members to answer in their individual submissions.

26. Which of the two broad options for default providers do you consider the most appropriate (i.e. a limited number of qualifying providers (status quo) or all providers supply a default product? Please provide reasons and rationale for your answer.
We will leave this question for our members to answer in their individual submissions.

27. What do you regard as being the benefits and/or risks of having fewer providers? To what extent are these risks present if there are many providers?
We will leave this question for our members to answer in their individual submissions.

28. What are the key criteria you think the Government should employ in selecting default product providers?
We will leave this question for our members to answer in their individual submissions.

29. What proportion of costs can be separated between asset/investment management and administration/back office functions?
We will leave this question for our members to answer in their individual submissions.

30. What do you think are the pros and cons of requiring default providers to undertake financial education of their members? Are there other solutions that might work?
We will leave this question for our members to answer in their individual submissions.

31. Financial advisers / providers - Can you provide suggestions and cost estimates for a programme of engagement with default members to help them transition to active choice products?
We will leave this question for our members to answer in their individual submissions.

32. Please provide any comments or thoughts you might have regarding a possible transition process.
We will leave this question for our members to answer in their individual submissions.

33. Financial advisers / providers – What is your experience to date with those members eligible to withdraw their savings? Are there specific patterns of behaviour that you have noted?
We will leave this question for our members to answer in their individual submissions.

34. Can you identify any barriers that exist to prevent a market developing in NZ for decumulation products?
A recent presentation on these issues by the chief executive of the FSC can be found here:

http://fsc.org.nz/site/fsc/files/presentations/Presentation%20to%20RPRC%20Decumulation%20Symposium%20-%2030%20November%202012.pptx

List of FSC Members

FSC Members
Accident Compensation Corporation
AIA NZ
AMP Financial Services
ANZ Bank
Asteron Life Ltd
BNZ Insurance
CIGNA Life Insurance NZ Ltd
Fidelity Life Assurance Co Ltd
FNZ
Gen Re LifeHealth
Hannover Life Re of Australasia Ltd
Kiwibank Ltd
Mercer
Munich Reinsurance Co of Australasia Ltd
Partners Life
Pinnacle Life
Public Trust
RGA Reinsurance Co. of Australia Ltd
Sovereign Ltd
Swiss Re Life & Health Australia Ltd
TOWER New Zealand
Westpac Bank

Associate Members
Bell Gully
BNP Paribas
Bravura Solutions
Burrowes & Co
Chapman Tripp
Davies Financial & Actuarial Ltd
Deloitte
DLA Phillips Fox
Ernst & Young
KPMG
Kensington Swan
Melville Jessup Weaver
Minter Ellison Rudd Watts Lawyers
Morningstar Research Ltd
PricewaterhouseCoopers
Russell McVeagh
Trustees Executors Ltd