Financial Services Council
Growing and protecting the wealth of New Zealanders

Financial Services Council
of New Zealand
Level 33, ANZ Centre,
23-29 Albert St, Auckland 1010
P: +64 9 985 5762
E: fsc@fsc.org.nz
www.fsc.org.nz

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Financial Markets Policy
Building, Resources and Markets
Ministry of Business, Innovation & Employment
PO Box 1473
Wellington 6140
New Zealand

BY EMAIL: defaultkiwisaver@mbie.govt.nz

Submission: KiwiSaver default provider arrangements

This submission is from the Financial Services Council of New Zealand Incorporated (**FSC**).

The FSC is a non-profit member organisation and the voice of the financial services sector in New Zealand. Our 50 members comprise 95% of the life insurance market in New Zealand, and manage funds of more than $47.5bn. Members include the major insurers in life, disability and income insurance, fund managers, KiwiSaver, professional services and technology providers to the financial services sector.

Our submission has been developed through consultation with FSC members, and represents the views of our members. We acknowledge the time and input of our members in contributing to this submission.

The FSC's guiding vision is to be the voice of New Zealand's financial services industry and we strongly support initiatives that are designed to deliver:

- strong and sustainable customer outcomes
- sustainability of the financial services sector
- increasing professionalism and trust of the industry.

Our key comments

Our members support the suggested objective for the review of default provider arrangements, and the general direction of the customer-focused proposals for investment mandate reform. We would go a step further: the review would also benefit from an ancillary objective that is to clarify – for a mature KiwiSaver environment – the purposes for having default providers.

While fees are extremely important, we urge the review to consider them as part – but not the primary or sole factor – of provider choice. We would prefer fee principles that providers must meet, rather than prescribed fees or caps or similar.

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We recommend that default status be available to any provider that satisfies the criteria.

Although responsible investment and capital market development are strongly supported concepts across our member-base, we consider that conflating these objectives with default provider arrangements risks confusing the review's purpose and driving outcomes that do not maximise the review's objective or the efficiency of the KiwiSaver system.

Whatever direction the review takes, we encourage you to minimise the amount of choice that becomes mandated for KiwiSaver members to consider. The more complex the baseline decision making, the less likely it is that customers will feel able to make active choices. A significant advantage of New Zealand's KiwiSaver system is its simplicity: every new layer of requirement diminishes that.

We believe there is untapped administrative and logistic opportunity in better leveraging off the IRD's central role in KiwiSaver, that could have a marked positive impact for customers in terms of lower KiwiSaver costs and greater system efficiency.

We would encourage you to consider our recently published KiwiSaver 2050 report, which we enclose with this submission.

I can be contacted on 021 0233 5414 or richard.klipin@fsc.org.nz to discuss any element of our submission.

Yours sincerely

Richard Klipin
Chief Executive Officer

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OBJECTIVES AND CRITERIA FOR THE REVIEW

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

We support the main objective of the review being to "enhance the financial well-being of default members, particularly at retirement" and recommend replacing "at" with "in" retirement, so that it considers the period of retirement and uses wording consistent with the KiwiSaver Act.

We suggest that an ancillary objective should be to clarify – for a mature KiwiSaver environment – the purposes for having default providers.

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

We rank the criteria as follows:

[1] Better financial position for KiwiSaver default members, particularly at retirement

[2] Trust and confidence in KiwiSaver

[3] Low administration and compliance costs

[5] Support development of NZ's capital markets that contribute to individuals' well-being

[4] Promote innovation, competition, and value-for-money across KiwiSaver

Although fully supporting the development of capital markets, we caution that a focus on it as part of the review risks confusing the purpose of default provider arrangements. Accordingly we would prefer that criteria to be removed.

INVESTMENT MANDATE

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

We agree with the problem definition.

While the intent may have been for the default fund to be a parking space, this is not how it is being used or viewed by members who are not actively choosing funds that are better suited to their risk appetites and investment timeframes. This places a large number of members in a low growth option with decades to run until retirement eligibility.

Although a conservative option may benefit some members, it is likely to be suboptimal for many members. So a move away from a "parking space" purpose is justified and indeed beneficial for many default members.

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We would support initiatives by industry and Government to also consider active choice members who are in conservative funds where that is not necessarily the best option. There is an opportunity for further education of and engagement with KiwiSaver members (not just default members) about the right fund choice, and for the provision of more information and guidance to support that educative objective.

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

Investment mandate options should apply only to default members (ie who have not made an active choice). If it can be identified that a member has made an active choice to stay in the existing (conservative) default fund, that active choice should not be overruled unless the member makes a further active choice.

As noted above, we would support initiatives by industry and Government to consider active choice members who are in conservative funds where that is not necessarily the best option.

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

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

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

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

The range should remain the same as currently, as many members currently in conservative funds are there because they consider those investment settings to be appropriate for them.

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

For first home buyers, the risk of shorter investment horizons being inappropriate for some KiwiSaver investment mandates is mitigated by the fact that, typically, they tend to be more engaged in KiwiSaver decision making.

We support the provision of information, guidance and financial literacy initiatives by industry and Government to boost member understanding of these issues.

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

We anticipate significant upfront costs in building a new system (or modifying existing systems to apply for default members), developing the fund, and updating disclosure for members. Cost include for example

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systems to analyse the member's age and allocate them to the appropriate fund, disclosure documents, training staff and advisers, and modifying online portals / apps for fund choice.

In addition, increased level of communications would be required for existing members at the transition to the new investment mandate and on an ongoing basis (leading up to and at each change in the life-stages).

Overall, the costs associated with the fund would increase.

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

Most of our members prefer a balanced investment mandate.

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

There is more to KiwiSaver choice than fee comparison. Overt focus on fees risks incentivising behaviour that does not put customer interests first, leading to underfunding (for example) of education, servicing and risk management.

The imposition of lower fee requirements for default members may, through cross-subsidisation between default and non-default members, result in increased fees for non-default members. This risk is accentuated by the additional resourcing and administrative requirements associated with default members such as member education, locating members with no current address and additional reporting.

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

Under 18s have made an active choice or had an active choice made for them. They are not default members (but may have chosen to invest in a default fund). The policy question is less about default arrangements and more about protection of savings for people in certain categories (under 18, low income, low balances). While aspects of this policy may be addressed by default provider arrangements, broader solutions – including taxation policy and Government contribution – may also be relevant.

Percentage-based fees help ensure fairness across balances. While lowering fees will have some impact on retirement outcomes, other factors may be as important.

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

Government mandated fee arrangements are problematic and unlikely to benefit customers. In particular, we note that:

- A Government-set fee could have a significant impact on competition (note criterion 5), benefiting larger providers because of their efficiencies of scale.

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- If a life-stages option is adopted, it should allow for the apportionment of differential investment costs to those invested in each fund.

- When assessing fees, the fees of all core funds and not just the default fund should be taken into account, so as to ensure against cross subsidisation.

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

Fees should be assessed together with (ie not in isolation of) other factors in the procurement process. That's because of the inherent relationship between fees on the one hand, and the combination of investment style (ie active management etc) and investment mandate (ie conservative, balanced, life-stages) on the other. To promote competition and innovation that will benefit customers, the package should be assessed as a whole.

On the options, we comment as follows:

Option 1 – We do not support Government setting a fee. Setting a fee range or capping fees is likely to drive providers to the maximum fee and could also limit the number of tenders received, even though some providers who may not tender, may offer a better retirement outcome because of their investment performance.

Option 2 & 3 – Although these may provide better retirement outcomes for default members, continuing to focus on reducing default fund fees means further cross subsidisation of default members, which negatively impacts active choice members. We support the status quo.

Option 4 – We consider that a locked in retirement savings product is unlikely to encourage under 18s to develop a savings habit.

Option 5 – We do not support this option. Given the large number of default members with balances under $10,000, this is akin to suggesting a free default option, which would result in cross subsidisation by active choice members.

Option 6 – Eliminating or reducing default member fees may be a viable option for both members and providers, however, this is also likely to result in further cross-subsidisation. Prohibiting fixed fees will increase the likelihood of cross-subsidisation.

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NUMBER OF PROVIDERS

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

There has been limited impact, if any, on innovation because of the restrictive basis of default fund scheme requirements.

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

Default status should be available to any provider that satisfies the criteria.

In general, the costs and benefits you identify are appropriate. We note, however, that factors like "concentration of risk" and "higher [regulatory] monitoring costs" should be considered in the context of the current regulatory environment, which is significantly more comprehensive than when KiwiSaver was introduced.

We note that provider numbers are partly dependent on the approach taken to other consultation questions. For example, if the life stages option is chosen, significant investment would be necessary. That might require scale not available to some providers.

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

Should be done on a periodic basis if chosen so that industry are not perpetually dealing with reallocation of members from previous default schemes.

RESPONSIBLE INVESTMENT

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

Yes, there are additional costs associated with implementing a responsible investing policy, however, these costs vary depending on the level (and strategies) of responsible investing.

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

Mixed, but in the longer term responsible investing should lead to an improved return or lower risk if implemented in the right way. However, this would be highly dependent on the approach and cycle: for example RI research done when oil prices are high.

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

In general, our members consider that default provider rules should not include responsible investment. We would support disclosure of responsible investing approaches but not mandatory investing requirements. For example, default providers could confirm whether or not they have ESG integration, exclusions, or are PRI signatory in the PDS.

There are different approaches to responsible investing with exclusions being the most basic and not necessarily the most effective form of responsible investing. Responsible investing means different things to different people. Providers should be able to compete using varying approaches. For example, providers should be able to determine the level of responsible investing in their funds and ensure adequate disclosure so that members are aware of their approach to responsible investing.

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

Providers (whether default or not) that develop responsible investing solutions should be able to compete on the strength of their approaches. Imposing RI requirements across all default providers diminishes the competitive attractiveness of funds that make particular approaches to RI their point of difference. Default members can make an active choice if their default provider does not meet the RI criteria that are important to that member. Members should not be forced into responsible investing.

As noted above, responsible investing shouldn't limit future returns.

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

The very nature of a default member is that they do not engage or make active choices. It is unlikely that making more information available about the responsible investing status of their fund will impact the behaviour of default members.

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

There are a range of expectations depending on personal interests and values.

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

This question appears to imply that exclusions are the defining aspect of responsible investing, which is not the case. Policy should drive improvements in underlying issues: excluding sectors is a weak driver of change.

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

This could be done at a broad sector level rather than listing each company.

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

Our preference is Option 2, although we note the potential for increased costs associated with additional disclosure.

CAPITAL MARKET DEVELOPMENT

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

Limitations include high fees, low liquidity, poor quality, size and scale of KiwiSaver providers, skills and experience of analysts and portfolio managers/providers to select suitable private companies for investment.

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

Should be provider led and not mandatory.

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

Our members consider that default rules should not include capital market development. The primary purpose of KiwiSaver 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. It is focussed on the individual and not on supporting the development of New Zealand's capital markets as these two objectives are not necessarily aligned.

Investment managers have an obligation to consider the risk and return characteristics of all investments. Given the size of the opportunity, a mandated level of investment in New Zealand capital markets is likely to result in the acquisition of some inferior investments, which would not be in the best interests of members. We would also have concerns about the liquidity and pricing associated with these unlisted investments. Irrespective of the size of the mandate, it would be difficult for investment managers to make these investments knowing that under normal circumstances, they would not meet investment criteria.

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

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

We do not consider that this would have a direct impact on increasing investment into New Zealand capital markets and may even increase challenges and costs. Default funds and low fees encourage concentrated funds management, limiting the size and growth of the financial markets eco-system.

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

This is not supported.

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

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TRANSFER OF MEMBERS

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

We agree with the problem definition. Even if default members are notified in writing prior to any transfer taking place, there is still a significant percentage of default members we won't be able to contact because we don't hold up-to-date contact information. This will result in members being transferred with no idea who their new provider is.

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

This should be considered only in situations where the default provider is not reappointed.

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

Providers will need to write to members to request their confirmation to remain in the scheme (whether this means remaining in the default fund or switching to another fund). How providers do this should be determined by individual providers.

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

Moving members from one default provider to another, when their existing default provider has not lost their default provider status makes for a poor member experience and could negatively impact trust and confidence in KiwiSaver. It would also result in unnecessary administrative costs.

We support option 2 provided that existing default members are given the option to remain with their current provider. Option 2 will ensure that those existing default members who are truly disengaged or cannot be located, will continue to be protected under an instrument of appointment.

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

Timeframes will need to allow existing providers an opportunity to contact their default member base to give them an opportunity to remain in the provider's scheme.

It would be preferable to stagger the transition after 1 July 2021 to allow providers time to process new default members and properly onboard them.

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

No. If a default member has chosen to remain in the default fund, they are no longer a default member. Members in this category can be notified of the changes occurring, but shouldn't be required to take any action.

MEMBER ENGAGEMENT

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

This is potentially appropriate, however it takes time and resource. There should be key metrics to measure outcomes.

OTHER

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

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43. Any other feedback?

- There should be minimum earnings rate threshold before employees are put in a default fund.
- Contributions rates are out of scope but we think they should be reviewed.

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- Approach to default members on total remuneration contracts should be reviewed.