Ministry of Business, Innovation & Employment

Review of KiwiSaver Default Provider Arrangements

Discussion Document

November 2012

MBIE-MAKO-3295467

Request for comments

The Ministry seeks written submissions by email to investment@med.govt.nz or posted to Review of KiwiSaver Default Provider Arrangements, Investment Law Team, Ministry of Business, Innovation and Employment, PO Box 1473, Wellington.

If you would like to meet directly with officials then please make your request at an early date. Submissions should be provided by 24 December 2012.

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1. Purpose

Background

1. KiwiSaver was launched in 2007 as a voluntary work-based savings initiative designed to encourage a long-term savings habit and asset accumulation in individuals for their retirement.

2. One of the key features of the design of KiwiSaver is auto-enrolment of employees. When an employee enters into the workforce for the first time, or starts with a new employer, and if they are not already a member, they are automatically enrolled into KiwiSaver. This means that a 'default' arrangement of some sort must be provided for those employees who do not actively select a KiwiSaver provider.

3. Six default providers (AMP, AXA, ASB, Mercer, OnePath, and Tower) were originally appointed for a seven year term. In that time, AMP has taken over AXA's New Zealand business. The original 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, we think it is an opportunity to consider whether these default arrangements remain appropriate. There are several reasons for this:

   - Experiences with the scheme – The current arrangements were designed to achieve a set of objectives based on information and judgements accumulated before the introduction of KiwiSaver in 2007. It has been over five years since KiwiSaver was established and membership uptake has far exceeded initial estimates. We now have both statistical and survey data on member activity as well as data on fund performance and fees, all of which provide a useful evidence base for analysing policy options.
   - 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 Markets Development Taskforce[1], the Savings Working Group[2] 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.
   - International experience – A number of other countries (including Sweden, the United Kingdom and Australia) have also 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 which is relevant to this review.

[1] Capital Markets Matter: Report of the Capital Market Development Taskforce, December 2009, p. 46
[2] *Saving New Zealand: Reducing Vulnerabilities and Barriers to Growth and Prosperity: Final Report to the Minister of Finance, January 2011, s.7.3.4*

Objective of the review

4. The review sets out to answer the following broad questions:

    - What should be the objectives of the default product? In particular, should this differ from the original objectives in light of experience with KiwiSaver?
    - What is the design of default schemes that best achieves these objectives? Given that the design has significant impacts on the fees and returns of default KiwiSaver members, and on broader competition within the KiwiSaver market:
        i. What are the most appropriate institutional arrangements and how do these achieve objectives in relation to fund performance, fees and competition?
        ii. How should investment mandates in relation to asset allocation and investment products be designed for default schemes?
    - If new default arrangements are considered necessary, what is the best way to manage the transition process, and what are the implications for existing default providers and members of default schemes?

5. Possible future changes to KiwiSaver settings are out of scope of the review, for example first home withdrawal, compulsion, and transferability between providers.

Objective of the discussion document

6. The purpose of this discussion document is not to state a preferred position, but to consult with relevant stakeholders and consumer groups in order to determine the design that delivers the best outcomes for default members. This includes decisions around institutional architecture and the investment approach that best achieves this. The default product also helps set industry standards and benchmarks. In this regard it is important to all KiwiSaver members.

7. As a means of providing context for the questions that we have asked, the discussion document reflects the research and analysis we have undertaken so far.

8. With over five years' experience of KiwiSaver, both industry and consumers have a lot more knowledge and information with which to inform this review process. KiwiSaver has become the central pillar of many New Zealanders' retirement savings and dominates our retail managed funds sector. Therefore we think it's an opportune time to reflect on what we have learnt from the experience to date and what we could do to improve upon it.

9. The document canvasses three key areas through chapters 2 - 4:

    - Chapter 2 discusses the objective of the default fund, particularly in the context of investor behaviour and risk/return trade-offs.
    - Chapter 3 considers options for the investment approach of the default fund.
    - Chapter 4 looks at the impacts of fund size, scale and fees on final accumulation balances, including institutional architecture questions – notably, how many default providers there should be.
    - Chapter 5 looks at other issues that need to be taken into consideration when reviewing the default product.

2. Objective of the default fund

Why have a default product?

10. As the design of KiwiSaver includes the auto-enrolment feature, the scheme needs to include a default option for those members who do not, or are unequipped to, make a choice as to which fund and/or provider they will invest in.

11. In thinking about the membership of the default base, we have taken account of the following:

    - The purpose of the default is to provide an investment option for those members who do not choose.
    - While there may be a subset of default members who have actively chosen to be in the default, we cannot assume that. These members can equally choose not to be in the default and transfer to non-default products.

12. In many respects the Government's role regarding the default product is as a de facto investment adviser. It must make decisions as to the appropriate investment approach for a cohort of members who have not revealed their preferences.

13. The key issue discussed in this chapter is the objective of the default fund. In particular, should it focus on capital preservation or long-term retirement income maximisation?

The default product was designed to be a short-term 'parking space'

14. When KiwiSaver was first launched there was a desire to promote confidence in KiwiSaver (and in the benefits of saving more generally) by reducing the likelihood of capital loss in the initial years of the scheme. As a result, the default was originally envisaged as a transitional 'parking space' where members resided temporarily before they made an active choice. Consequently, the investment approach has been conservative; focussing on capital preservation and relatively low fees, rather than a longer term focus on maximising retirement income and lifetime earnings. It was assumed that market forces would work to encourage members who would benefit from a more growth-oriented approach to move out of default funds.

15. Below we give some of the arguments for keeping the status quo, and some counterarguments for changing the objectives – and therefore the design – of the KiwiSaver default product. There are a number of factors that need to be taken into account in making this decision. Some are empirical, others more philosophical. Making a decision to change the objectives of the default product depends on the weight that is placed on different criteria.

The experience with KiwiSaver so far

16. As at 31 March 2012 there were 1.9 million KiwiSaver members of which 447,274 members were in one of the six default funds. 178,000 members are in their employer-chosen scheme and approximately 165,500 of these are in the default option of that scheme.[3] Appendix One of this document sets out some of the data we have on KiwiSaver member activity across a variety of scenarios. The key findings of relevance here are:

    - Nearly half the eligible population is enrolled in KiwiSaver but growth is slowing. This may impact on decisions around the optimum institutional delivery architecture and the Crown's ability to negotiate on price.
    - The default funds comprise the single largest fund type in KiwiSaver.
    - Excluding those aged 17 years and under, 42% of default members are non-contributing while only 31% of active-choice members are non-contributing. This is useful when thinking about what influences consistent contributions.
    - 38% of all current members entered via automatic enrolment. The proportion of auto-enrolled members who opt-out has dropped from 35% in 2009 to 6.2% in 2012. This suggests a broadening acceptance of KiwiSaver.
    - 37% of all KiwiSaver members have entered via the default option and a further 13% through their employer chosen scheme.
    - Of those initially in the default option, 31% have moved to another provider and 8% have moved to another fund with the default provider they were placed with. When default members move, they tend to move to a fund with a balanced investment strategy. Of those that have remained in the default, 55% have been there for over 3 years and 36% have been there for over 4 years. The evidence in Table A7 suggests that when a cohort of KiwiSaver members enter the default, over time fewer and fewer switch out of the default.
    - Almost half of the current default members are aged between 18 and 35 years of age. This group is the most likely to have used the first home withdrawal option.

Evidence from investor behaviour – many KiwiSaver members join the default product, and they may remain in it for a long time

17. Experience both here and overseas tells us that, over time, a significant proportion of the population will, for a variety of reasons, gravitate to the default option and remain there.

[3] Figures presented here for employer-chosen scheme membership is as at 30 June 2012. We have assumed that around 5% of the 250,000 members initially allocated to an employer-chosen scheme have switched to a non-default fund within that scheme. The 5% figure is based on the switching decisions of members allocated to default providers.

18. Experience with longer-established schemes shows a trend over time towards the default. Of almost 12 million Australians who currently hold a superannuation account, approximately 80 per cent have their compulsory superannuation contributions paid into a default superannuation fund.[4] In Sweden, when the Premium Pension was introduced in 2000, 67 per cent made an active choice. By 2005, this had declined to just 8 per cent of new enrolees.[5] In the UK, in 2007 the National Association of Pension Funds annual survey found 84 per cent of defined contribution schemes offered their members a default fund and 91 per cent of all members in these schemes have left their money in the default fund.[6] Recent empirical evidence from the US has found that where there is auto-enrolment in pensions schemes a large cohort of those auto-enrolled go to the default.[7]

19. This propensity to gravitate to the default is common in retirement saving schemes and has also been the subject of studies in a range of situations where there is a default setting (for example, organ donation decisions, car insurance plan choices, consent to email marketing). In addition, behaviours such as inertia, procrastination and poor risk assessment are often exhibited by investors, particularly when faced with complex financial decisions.[8]

20. So, while in an ideal world the best outcome would be that all investors are fully informed and sufficiently knowledgeable to make an active choice of superannuation scheme provider and fund, the reality is very different. Decisions around investing are hard. The subject matter is complex and requires a level of research, time and commitment that is beyond many people. And while a large and active market of financial intermediaries does exist, anecdotal evidence suggests the account value threshold often set by advisers before offering advice serves to exclude many KiwiSaver members with small balances.

21. Finally, while investment in financial literacy and financial education programmes may help in transitioning some members to products more suitable to their individual circumstances, there is no evidence to suggest that such programmes can be expected to reach all, or even most, of these individuals.

[4] http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/government_response/key_points.htm#mysuper

[5] http://www.sweden.gov.se/content/1/c6/05/22/65/077d40e8.pdf, page 36. The launch of the PP was accompanied by a comprehensive communications campaign as well as including all working citizens. The profile of new members is now predominantly younger people, similar to what we would expect with KiwiSaver.

[6] 'Building personal accounts: designing an investment approach – A discussion paper to support consultation May 2009' Personal Accounts Delivery Authority, page 33.

[7] The Importance of Default Options for Retirement Savings Outcomes, John Beshears, Choi J., Laibson D., Madrian B, NBER, January 2006, pages 8-15.

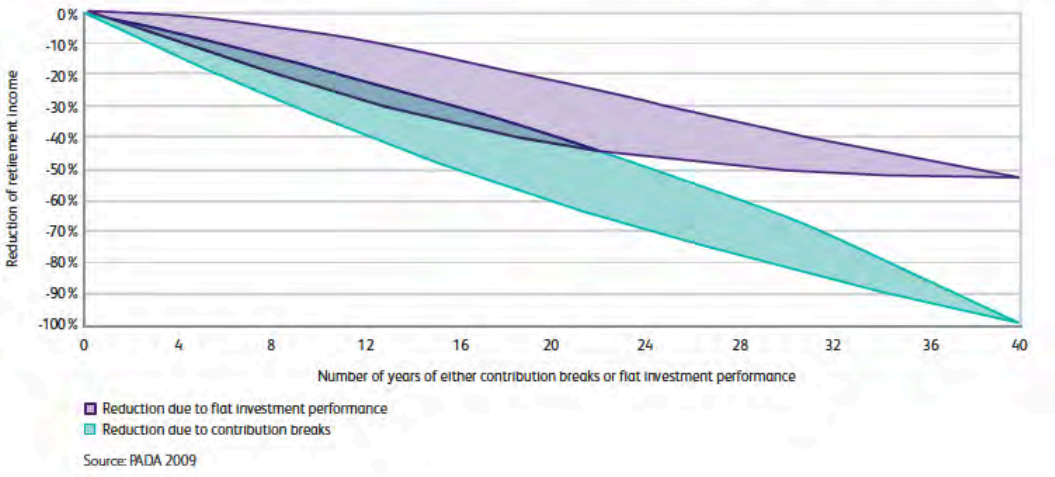
[8] See, in particular, work Barberi, Bernartzi, Beshears, Choi, Kahneman, Laibson, Thaler et al

Why it might be better to stay with the status quo

22. The current design of the default product takes a short-term investment approach, consistent with an expectation that members would move to a fund better matched to their investment horizon. There are a number of benefits with the design.

- The current default product is comparatively easy to design and monitor.
- The current default product also reduces the risk that default enrolees suffer short and medium-term capital loss – if members are focused on short-term, rather than final, outcomes volatility may discourage saving.[9] Persistency of contributions can have more of an influence than investment performance in ensuring that members' savings are maximised at retirement. Therefore, encouraging members to keep contributing is an important consideration.[10] The graphic below, courtesy of UK's Personal Accounts Delivery Authority (PADA), demonstrates this.[11] Conversely, the tendency towards inertia means that risk and loss tolerance may well be higher in practice for default members. The contribution holiday statistics for KiwiSaver members (refer Appendix One, Table A2) reveal that a higher percentage of default members are currently taking a contributions holiday (42%) than active choice members (31%). This suggests that performance is not a principal influence, given that the default funds have produced consistent positive returns to date.

Figure 3.1 Reduction in expected retirement income due to contribution breaks or flat investment performance



- Conservative funds have tended to outperform funds with a balanced or growth investment mandate over the last five years – a period dominated by the financial crisis and, consequently, high volatility in markets. However, this trend is beginning to reverse in line with long-term expectations.[12]

[9] Additionally individuals treat gains and losses asymmetrically, that is, they dislike a loss more than they like a gain of equal magnitude. (Barber and Odean 2001; De Bondt 1998; Goetzmann and Kumar 2008). Investors are reluctant to realise their losses, and they keep loss-making positions in the hope that they will recover their original investment. (Benartzi and Thaler 1995; Gneezy and Potters 1997; Odean 1998; and Rabin and Thaler 2001).

[10] 'Building personal accounts: designing an investment approach – A discussion paper to support consultation May 2009' Personal Accounts Delivery Authority, pp 33-35

[11] Ibid, page 36.

[12] http://www.morningstar.com.au/s/documents/KiwiSaver%20Survey%2030-09-2012.pdf

- Finally, a proportion of investors prefer low-risk investments, or their circumstances are such that the current default mandate is suitable for them – for example, members planning to withdraw money to purchase a first home, or those nearing retirement.

1. Are there other arguments in favour of the current default arrangements? If so, please explain.
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.

Risk and return trade-offs

23. There are a number of counterarguments against the hypothesis discussed above.

24. Studies have shown that asset allocation decisions have a significant influence on an investor's expected return and its variance.[13] Over time, growth assets such as equities are expected to outperform less volatile assets, given their greater risk and the premium generated by that risk. In any given period there may be instances where this does not occur due to the greater volatility of growth assets.[14]

25. Conservative mandates are typically expected to lead to lower returns over the long-term and are more susceptible to erosion of value through inflationary risk. They may also lead to members saving inadequately for their retirement (shortfall risk). Capital preservation strategies, in effect, trade off investment risk for inflation risk. However, they are less likely to experience short-term volatility.

26. To reiterate, the objective of KiwiSaver is to encourage a long-term savings habit and financial asset accumulation by individuals who are not in a position to enjoy standards of living in retirement similar to those in pre-retirement. Based on the experience with KiwiSaver default product enrolments to date, the experience of other jurisdictions, and research by behavioural economists, we expect there to be a large and persistent group of savers remaining in the default product, even though it may not be appropriate to their own circumstances and risk preferences. This forms the basis of a hypothesis that shifting the KiwiSaver default product towards a longer term, more growth-oriented investment objective will deliver better outcomes for default members.

3. Financial advisers / providers – What is your experience with risk/volatility and member behaviour in response to it?

Why it might be better to change

27. Alongside a decision about a short-term versus long-term approach, Government must also evaluate what level of short-term risk and volatility it is willing to impose on default members. As noted previously, the Government's role regarding the default product is as a de facto investment adviser. A higher weighting of investment in growth assets is expected to generate greater volatility in returns, including possible periods of capital loss, but over the long-term investors are expected to achieve a higher level of retirement savings overall compared to a capital preservation approach.

[13] 'Lifestage Investment Options in Default KiwiSaver Schemes', Paul Newfield and Heathcliff Neels, Mercer, June 2009

[14] Appendix two provides further analysis of returns for equities and bonds.

28. Some might question whether it is appropriate for Government to expose default members to a greater degree of short-term risk and volatility, regardless of the expectation of improved returns over the long-term. Conversely, capital preservation is expected to provide consistent and steady returns, but there is a greater likelihood of capital erosion through inflationary effects.

29. In terms of broader economic impacts, better investor outcomes and increased investor asset accumulation translate into benefits for the wider economy as a whole, including better retirement outcomes (and so possibly reduced welfare costs), and improved access to capital for New Zealand's listed entities.

30. It is also not possible to know exactly what the risk preferences of individuals are when making this judgement and they certainly will not all be uniform. So, whatever decision is made, it will not suit a subset of default members.

31. In weighing up these considerations and in making these decisions, we think it is both important and helpful to refer back to the overarching objective set out at the start of this discussion document. That is, what is the design that will deliver the best outcomes for default members? Two key components of the design are the investment approach and the institutional architecture, both of which are examined in the next two chapters.

4. Are there other reasons to change from the current settings that we have not considered? If so, please clarify.
5. As an organisation, what indicators do you use to assess a client's risk tolerance?
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 make a first home withdrawal and, if so, when?

3. Investment Approach

Investment strategy

32. The current design of the default product is focussed on capital preservation and relatively low fees. The alternative is a focus on maximising retirement income and lifetime earnings. A strategy of capital preservation is generally achieved by implementing a conservative investment approach. The existing terms of appointment require the default funds to implement a conservative investment strategy with 75 to 80 per cent invested in fixed interest and between 15 and 25 per cent in growth assets.[15]

33. If this design is maintained, an alternative, lower cost, lower risk option would be to remove the allocation to growth assets altogether. OECD modelling, however, shows that under this strategy lifetime risk is not reduced whereas lifetime returns are.[16]

34. As discussed in the previous chapter, the decision as to what the objective of the default product should be is one that ultimately rests with the Crown. Ministers must weigh up the risk/return trade-offs and make a judgement on those.

35. In this chapter, we look at a range of other investment strategies that are consistent with an objective of retirement income maximisation.

36. If retirement income maximisation is the agreed objective then the next choice is what the appropriate asset allocation should be. Several studies have shown that asset allocation (the proportionate allocation of a portfolio's capital between different asset classes) is more important than selecting individual assets within asset classes, and can provide up to 80 per cent of the long-term returns of portfolios.[17]

37. In very simple terms there are three broad types of investment strategies under this objective:

    - *Aggressive investment strategies* – primarily invest in growth assets, but may have some limited exposure to low-risk assets; and
    - *Balanced investment strategies* – seek to strike a balance between growth assets and low-risk assets; and
    - *Life-cycle investment strategies* – seek to reduce the proportion of riskier assets (e.g. equities) as people get closer to retirement.

38. An aggressive investment strategy is expected to provide the greatest average asset accumulations, but has high exposure to market volatility and is vulnerable to market shocks. As people near the age of retirement, there is a greater risk that if the period over which they spend their retirement savings coincides with a downturn in the market, they will be forced to crystallise losses.

[15] On average this equates to (approximately) 38% cash; 26% international fixed interest; 15% New Zealand fixed interest; 6% in Australasian shares; and 12% in international shares.
[16] 'Assessing Default Investment Strategies in Defined Contribution Pension Plans', P. Antolin, Payet S. & Yermo J., OECD Journal: Financial Market Trends, Volume 2012 – Issue 1.
[17] See for example, '25 Years of Indexing: An Analysis of the Costs and Benefits', Pricewaterhouse Coopers and Barclays Global Investors, or; Ed Vos and Cayne Dunnett, 'Strategic and Tactical Asset Allocation in New Zealand', New Zealand Journal of Business, Vol. 18, No 2, 1996, pp123-142.

39. A balanced investment strategy has less exposure to volatility and market shocks but would also be expected to provide lower average returns than a growth fund. Balanced funds do not attempt to reflect the different risk preferences that savers may have depending on how close they are to withdrawing their savings (their investment time horizon).

Life-cycling

40. One of the features of KiwiSaver is that it is linked to the age of eligibility for New Zealand Super. As individuals plan their exit from the workforce their investment risk increases. The time available to them in which to make good investment losses, through either replacement savings or investment income, diminishes.

41. An increasing number of jurisdictions, seeking to better match asset exposures with individuals' risk tolerances (as proxied by their age, or length of time until retirement), have adopted some form of life-cycle fund (also referred to as life-stages or life-styling) as the default investment option. Countries we have reviewed with analogous schemes include the United Kingdom, Australia, Sweden, Chile, Mexico, and Peru. Similarly, 401K pension plans in the US usually have a life-cycle investment strategy as the default.

42. Life-cycle funds de-risk an investor's assets over time by transitioning the mix from high volatility growth investments, such as equities, to bonds and cash. Bonds and, particularly, cash have comparatively low volatility so that the risk to an investor of crystallising losses as they enter retirement is greatly reduced.

43. A significant amount of research has explored the properties of life-cycle funds and their suitability as a retirement investment option. Recent work by the OECD concludes that funds which match investment risk and return to investors' lifecycles are likely to be the most appropriate default product. [18] In particular, a life-cycle fund offers a greater probability of increased asset growth than a conservative fund, better aligns participants' age-based risk profiles (where investors have elected to not directly reveal their risk preferences through an active choice of fund) with their asset exposure than a single strategy does, and offers a mitigation strategy against market shocks.

44. However, outcomes are also dependent on what assumptions are made about desirable combinations of risk and return, the future performance of different asset classes, and the precise design of the life-cycle fund. In some situations the OECD research found that a fixed portfolio strategy (such as a balanced fund) gives similar or better returns with a similar risk level (although it is more exposed to market shocks at the point of decumulation) and without the additional complexity of a life stages product. In other situations, life cycle funds (for example, 90 per cent equities with an "average multi-shaped function" glide path) gave higher returns and less risk than a fixed portfolio of 50 per cent equities.

[18] 'Assessing Default Investment Strategies in Defined Contribution Pension Plans', P. Antolin, Payet S. & Yermo J., OECD Journal: Financial Market Trends, Volume 2012 – Issue 1.

45. Life-cycle funds are an efficient means for managing large numbers of individuals, where assessing individual risk tolerances are impossible. Cohorts of default members are transferred across to a lower risk fund upon reaching a set age. Traditionally there has been little scope for a fund manager to adjust asset allocations based on an individual's savings and circumstances or to respond to market conditions – although in KiwiSaver if an investor is concerned about this they can always switch to a non-default fund. Life-cycle funds can also be administratively burdensome and costly.

46. There are a variety of approaches taken by fund managers in implementing a life cycle investment strategy, the difference being largely in whether the strategy is organised around a single fund or several funds. We examine two of the more common approaches below and invite submissions on any other variations.

7. Are there other issues around risk and investment strategies that we should be taking into consideration?

Standard life-cycle funds

47. In many life-cycle funds, the switching is generally performed automatically using a fixed formula based on how close an investor is to retirement. The units of a higher-risk fund are sold and units of a lower-risk fund are bought at pre-determined dates. For example, at age 45 an investor is switched from a growth fund to a balanced fund. Or, if the investor is contributing regularly, the transition may be at least partly made by putting their new contributions into lower risk assets via a lower risk fund.

8. Is a traditional life-cycle investment approach appropriate for a default fund and if so, why?
9. Do you have any concerns with life-cycle funds? (Note: we address withdrawals for first-home purchase below)

Target date funds

48. Target-date funds are similar to 'traditional' life-cycle funds but offer greater flexibility for an investment manager to manage the fund to reflect both the age-based risk profiles of the members, and market conditions at any given time. An investor is placed in a single fund corresponding to their expected retirement date (in the case of KiwiSaver, the age of eligibility for NZ Super). For example, someone expected to retire in 2030 would be placed, in the '2030' fund. The fund then changes its asset allocation (and hence its risk profile) gradually over time to less volatile assets in the period leading up to 2030. The de-risking occurs within the fund. This is instead of moving an investor's savings from units in a higher to lower risk fund.

49. When the UK's PADA went out to consultation on this issue in 2009, the response was overwhelmingly in favour of target date funds. A couple of the advantages of this approach noted were:

- Investors would find it relatively easy to match their fund to their expected retirement date.
- Target-date funds focus members on the outcome and draw attention away from short-to-medium term volatility.
- Without having an impact on the members' unit holdings, such funds can more easily accommodate tactical asset allocation and adjustments to the investment strategy in response to market conditions.

10. Is a target date investment approach appropriate for a default fund and if so, why?
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?
12. Financial advisers / providers - Are there issues with, or barriers to, capturing age data? If so, please elaborate..

50. We have summarised the investment approaches in the following table:

Investment approach summary table			
Investment approach	**Key features**	**Pros**	**Cons**
Conservative (Status quo)	Fixed allocation fund focused on capital preservation. Predominately invested in low risk assets such as fixed interest and cash.	Low volatility so less vulnerable to market shocks and periods of capital loss.	Expected to deliver a lower investment return than other strategies over the long-run. More vulnerable to inflation risk.
Balanced	Fixed allocation fund which seeks to strike a balance between growth assets and low-risk assets.	(Compared to conservative) Greater exposure to higher growth assets so can accumulate excess average returns over the long run.	(Compared to conservative) Greater volatility so greater risk that an investor needing to access their savings may be forced to crystallise losses if the market is in a down cycle. Potentially higher fees due to higher degree of active investment management (unless passive approach is adopted).
Aggressive	Fixed allocation fund with asset growth objectives. Likely to be predominately invested in riskier assets such as equity.	(Compared to conservative and balanced) Provides even greater exposure to high-growth, riskier assets than either conservative or balanced investment strategy. Expected to deliver higher returns over the long-run.	(Compared to conservative and balanced) As above, but higher exposure to market volatility and increased vulnerability to market shocks. The increased risk is particularly acute if an investor needs to liquidate assets at a pre-determined time, forcing the crystallisation of losses if it occurs in a market downturn. Potentially higher fees due to higher degree of active investment management (unless passive approach is adopted).

Traditional life-stages	A life-stages funds approach to asset allocation seeks to reflect how far an investor is from their expected retirement date. Investors are systematically moved from a higher risk fund to another lower-risk fund (or a portfolio of lower-risk funds) over time. For example, an investor aged 25 may have 100% of their investments in an aggressive fund. When they reach age 50, 40% of this investment is switched into a conservative fund, and at age 60 it is all transferred into a cash fund.	Provides a mechanism to better reflect an investor's age-based risk profile. Reduces risk in a systematic fashion in order to best ready an investor for retirement.	Higher fees than a straight conservative investment approach but likely to equate to a similar level of costs as a balanced investment approach. Early investment phase is subject to greater volatility and increased vulnerability to market shocks. Pre-set dates for changing asset allocations may result in crystallisation of losses along the way. Administratively complex.
Target date funds	Target-date funds are similar to traditional life-stages funds, but an investor is placed in a single fund corresponding to their expected retirement date. The fund then changes its asset allocation (and hence its risk profile) over time. This is instead of moving an investor's savings from units in a higher to lower risk fund. For example, someone expected to retire in 2030 would be placed, or could choose to invest their contributions in the '2030' fund. The asset allocation in this fund would be changed over time to less volatile assets in the period leading up to 2030.	Retains the same advantages as a traditional life staged fund but is easier to coordinate with asset allocation strategies that are more tailored to an investor's age-based risk profile. Target date funds offer a 'set and forget' option, shift investor focus onto outcome and away from short-medium term volatility, and are a relatively straightforward proposition to communicate to investors.	As with traditional life-cycle funds, the fees are likely to be higher than for a conservative fund. They are less complex to administer than traditional life-cycle funds. However, NZ may have insufficient population and/or number of default members to make such a proposition economically viable.

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.
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?

First home withdrawal

51. The design of KiwiSaver allows members to withdraw their own, and their employer's, contributions (including any returns earned) to purchase a first home. This means that this cohort of members may have a set of risk preferences that are potentially misaligned with a long-term investment focus.

52. Between July 2010 and September 2012 around 9,300 members have used the first home withdrawal option, of which the majority were aged under 35. Less than one per cent of all KiwiSaver members aged under 35 have used the first home withdrawal.

53. For a period of time, these savers have a short investment time horizon (perhaps only a few years) contrary to what their age would suggest. Under a life-cycle or other long-term investment approach they may be invested in assets that don't reflect their current risk tolerances. A market downturn prior to their withdrawal could mean they have a smaller deposit for their first home than if they had invested conservatively – although, they are just as likely to have a larger deposit. [19]

54. One approach to mitigating this exposure to volatility risk could be to encourage those intending to use their KiwiSaver savings to help fund a deposit (through, for example, a public marketing campaign) to opt into a conservative fund. There is, however, a risk that they remain in a conservative fund even once they have purchased their home.

55. Another approach, if a life-stages investment strategy is adopted, is to structure a life-cycle or target-date fund to better reflect the initial short-term investment horizon of many members of KiwiSaver in the 18-35 age group. For example, a fund could be structured to follow a cycle of Conservative – Growth – Balanced – Conservative. This has the added advantage of establishing investor confidence in the initial years of accumulation. While the member account balances are small, the return has relatively little impact. Cementing investor confidence was a primary consideration when designing the NEST scheme in the UK. Consequently, their funds' investment strategies are based on this approach.

56. An alternative, if using target-date funds, would be to ask new members at sign-up time if they plan to make a first-home withdrawal. If they do, their first target date could be when they expect to make that withdrawal. After the first-home withdrawal is made, they could set a new target, their expected retirement date. This does, however, rely on members engaging in the process which, for a large number of default members, may not be feasible.

57. Last, a further consideration is when members contact their providers to withdraw their savings for a first home purchase. There exists an opportunity for providers to connect with those members and provide advice as to what the most appropriate investment strategy for their risk profile should be following their home purchase. It may be that members who have actively saved and planned for a first home purchase are likely to be more financially aware and engaged.

[19] The current profile of default members (as at 31 March 2012) has around 47 per cent aged between 18 and 35, the age group most likely to be considering using their KiwiSaver for a first home purchase (FMA KiwiSaver Report for the year ended 30 June 2012).

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?
16. To what extent do you think the first-home withdrawal facility should influence the design of the default product? Please explain.
17. What, in your view, is the best approach to deal with members intending to use their KiwiSaver for a first home purchase?

Passive versus active management

58. In the next chapter we discuss the impact that fees can have on a saver's final accumulation for retirement. One way to achieve lower fees is to use passive funds rather than active funds. Our research suggests that for markets that are well-functioning and highly efficient (for example, the US large cap market and the sovereign bond market), there is little benefit to be gained from an active investment approach. Active managers rarely out-perform the index consistently.[20] In addition, passive management minimises the risk of underperformance relative to the benchmark index and reduces variations in outcomes across a selection of managers. Increasingly, exchange traded funds provide a very low-cost mechanism for investing into a variety of asset classes that have otherwise been comparatively expensive.[21]

59. However, there are some markets for which a passive approach is not appropriate, for example, direct investment into less liquid, alternative asset classes such as property, commodities, infrastructure and private equity. Active management fees in these classes do, however, create a very high hurdle to delivering out-performance once fees are deducted.

60. Markets such as the New Zealand equities market operate somewhere in-between. Opinions differ as to whether active or passive management is best in such markets.

18. Do you agree with our analysis of active versus passive investment management? If not, why not?
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.

Alternative assets

61. From our initial discussions with providers, we understand that there is some investment already into unlisted alternative assets such as property. However, for a number of reasons, there is a lack of KiwiSaver investment into alternative asset classes such as venture capital and private equity. Reasons include high fees, high risk, lack of performance track record and relative illiquidity. Furthermore, until funds reach significant scale of funds under management, the two to three per cent usually allocated to alternative asset classes will be too small a quantum to warrant the extra resources required in terms of specialist capability in research, analysis and due diligence.

62. Outside of KiwiSaver, the same reasons for reluctance by fund managers to invest in these alternative asset classes appear to apply equally to other retail managed investment schemes.

[20] Refer Malkiel, Cremers & Petajisto et al.
[21] For example, the Schwab U.S. Mid-Cap ETF has an expense ratio of 0.07% https://www.schwabetfs.com/summary.asp?symbol=SCHM

20. In your view, do you consider the rationale listed above to be accurate? If not, why not?
21. Do you have any suggestions or proposals as to how the asset classes might be made more attractive for KiwiSaver investment?

Summary

63. Growth asset investment strategies will increase fund complexity; we expect life-cycle or target date funds would be the most complex and – all else equal – the most expensive for the Government to oversee and monitor. A more rigorous and detailed framework for assessment (compared to what is presently required) would be needed to ensure that investors' funds are appropriately managed in a product that varies the asset allocations for different groups of investors. Complexity also increases with investment in a greater diversity of asset classes.

64. These funds may also incur higher fund management fees. If not offset by better earnings, higher fees would have a negative impact on members' balances. Requiring more passive, lower-cost management of funds may provide a mitigating factor, along with the Crown negotiating fee discounts during the tender process.

65. Additionally, a shift to a growth asset strategy of any kind would increase the variation of investment outcomes among default members allocated to the various default funds, unless they were all invested in identical securities (which implies a single manager).

66. In summary, decisions around investment approaches are not clear-cut. There are several considerations to take into account:

    - Determining the appropriate risk / reward profile for individual investors, and a judgement about the level of short-term risk the Government should assume on behalf of individuals, as opposed to the long-term risk of low investment returns;
    - Choosing among the options will inevitably involve a trade-off for Government between minimising the risk of loss against improving average retirement saving outcomes for those who remain in the default scheme; and
    - No single investment strategy will suit all members.

22. Are there any other key considerations? If so, please explain.

4. The role of scale and fees

Pension market characteristics and KiwiSaver

67. In pension markets the supply side is often characterised by potentially large fixed costs and economies of scale, while on the demand side investors' participation is characterised by soft-compulsion and influenced by inertia.[22] Scale economies can be generated in functions such as collection of contributions, record keeping and marketing.[23] The combination of low investor responsiveness to fees and investor inertia can lead to uncompetitive markets (and higher than necessary fees)[24] and, in a model of increasing funds under management (FUM), an ability to generate substantial economic rents.

68. There may also be other negative outcomes – with highly inelastic demand, price changes do not affect quantities consumed very much but can elicit large monetary transfers from consumers to firms.[25] Therefore, options for lowering fees and/or increasing risk adjusted expected returns are important considerations when thinking about how the default product might be improved.[26]

The role of scale and fees

69. There were six default providers appointed in 2007. The terms of appointment require that they report on the default product quarterly to FMA and the Default Provider Review panel. The fees they may charge are specified along with the investment strategy they must adhere to.

70. Based on our initial discussions with stakeholders, we estimate that if a similar tender process were run again, then there would be at least 10 to 12 providers who would meet the existing criteria.

71. However, economies of scale in funds management can substantially drive down costs and, consequently, fees. The level of fees charged is important because it has a significant impact on savings outcomes. For example, 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 their final retirement funds. Fees of 1% will have a 20.79% cumulative effect for the same earner.[27] There is some evidence to suggest that higher fees do not typically translate into higher performance or higher returns.[28]

[22] New Policies for Mandatory Defined Contribution Pensions, Gregorio Impavido, Lasagabaster E. and Garcia-Huitron M., The World Bank 2010, pp 37, 11.
[23] For example, without marketing costs, the minimal efficiency scale of Chilean pension funds declines from 2 million contributors to about 150,000 contributors (Impavido, 2010), pp 20-26.
[24] Impavido, page 70.
[25] Impavido, page 46.
[26] Impavido, page 2.
[27] 'Making auto-enrolment work', Department for Work & Pensions, October 2010, page 69.
[28] See work by Malkiel, Cremers and Petjisto.

72. Using data from the FMA, the average balance was $6,530 in a default fund as at 31 March 2012.[29] Assuming an administration fee of $2.50 per month and a 50 basis points investment management fee (the lower end of fund fees and not including any in-fund costs), annual fees total around $62.50 per member. On this basis, the total annual fee revenue generated by default members is around $28 million, and growing. Split across the existing six providers, this equates to just over $4.67 million per annum each in fee revenue. This is over and above these providers' other product offerings. An MBIE estimate suggests the projected fee income generated from default members over the next 10 years could be $400 – $500 million.[30]

73. Establishment costs for a KiwiSaver scheme vary across providers and scheme profitability will be driven to a large degree by utilising existing infrastructure. This is where the banks have a significant competitive advantage in leveraging off a ready-made distribution network. Approximately two-thirds of all KiwiSaver funds are now with the banks. However, a number of small boutique KiwiSaver funds have launched since inception in 2007. This would suggest barriers to entry can be overcome. The ability to out-source back office functions and concentrate on the core investment management function has enabled smaller players to participate in the market.

74. The design of KiwiSaver enables members to easily switch providers. This feature facilitates a robust and competitive market in KiwiSaver providers for those members who elect to actively choose their provider.[31] However, there is no competitive default provider market as such because members are sequentially allocated a provider so they have not made a choice. They are randomly allocated to a provider via the Inland Revenue interface. Therefore, the notion of providing 'choice' by having a number of default providers may be largely redundant, outside a spreading of concentration risk across several providers rather than just one.

75. Outside of the default provider 'market' itself, however, default products can bring competitive pressures to bear on non-default products through benchmark setting in the market for fees, and for governance.

23. Do you agree with our analysis of the existing KiwiSaver market and the role of scale and fees? If not, why not?

76. A second issue in considering the number of default funds is the ability of funds to meet the standards required and to honour commitments in the event of employee fraud, breach of limit breaks, remedying of pricing errors or similar. There is a trade-off between requiring a provider to have sufficient size and scale with 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. Although, even where these institutions have the resources, it does not necessarily follow that they will stand behind funds they operate in the event of problems.

[29] FMA KiwiSaver Report for the year ended 30 June 2012. $2.9 billion divided 447,274.
[30] Growth of funds under management based on Treasury forecasts and assumptions that default funds maintain a 23% share and fees are static at 50bps.
[31] See also MED's Report on KiwiSaver Supply Side Evaluation 2010, http://www.med.govt.nz/about-us/publications/publications-by-topic/evaluation-of-government-programmes/kiwisaver-supply-side-evaluation.pdf/view.

77. We think a balance needs to be struck between an efficient fee structure, while at the same time ensuring that service and performance are not compromised. This is where considerations around what is the right number of default providers intersect with mechanisms available to reduce fees charged to investors.

78. A further complicating factor is that, while investors may benefit from negotiated reduced fees, it can be difficult to align performance with fees. For example, active fund managers may underinvest in investment management capability if there is sufficient downward pressure on fees. Ideally the default product should be structured in a way that on-going performance, relative to market performance, is linked to the on-going appointment of a default provider. In general, in managed funds there is an inherent misalignment between investor interests (which are to maximise risk-adjusted investment returns over the long-term) and fund manager interests (which are to increase funds under management, usually best achieved through a focus on short-term gains rather than the long-term investment profile that their members may have).

79. Because of features specific to KiwiSaver (auto-enrolment, the Crown contribution), we consider that there is both an obligation and an opportunity to seek better alignment of these interests for better investor outcomes overall. We think valuable brand equity accrues to a product and a provider through the awarding of default status. It gives, in effect, an implicit government 'stamp of approval' which equates to a value-add for that provider. If the default product is offered by a commercial enterprise with a range of other retail offerings, then that increase in brand equity will have spill-over benefits for those other products and the organisation as a whole.

80. Should the Crown then try and leverage the brand equity contribution it has made for the benefit of investors, for example by requiring fund managers to sharpen their pencils on fees in return for the added status of being named a default provider. Some possible options are:

- *A fixed fee* – Some research suggests that fixed fees are superior to fees based on a percentage of FUM because of the large fixed-cost component to pension funds. Therefore one option may be to require a default provider to charge a single investment management fee to a fund irrespective of FUM. A fixed fee would also better align the incentives of managers with investors' long-term investment objectives by removing the incentive to increase management fee revenue through increased FUM.
- *A tiered fee* – A variation on the above is a tiered fee structure whereby the percentage fee steadily reduces as FUM increases.
- *Consider separating the administration functions from the asset management functions* – A further option is to separate the investment management function from back office administration functions and seek economies of scale through centralising the latter through a tender process. This is the approach that Sweden has taken with their default product, resulting in very low fees (as a percentage of FUM) that are continuing to trend downwards as FUM grows and economies of scale increase.[32] New Zealand has gone part-way in this model with Inland Revenue managing employer and employee inflows from payroll.

[32] http://secure.pensionsmyndigheten.se/download/18.2c8f793e1335aaf986a8000282786/OR+engelsk+2010.pdf

24. Please outline what you consider to be the pros and cons of the options suggested above. Please detail your preference and why.
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.

Default scheme architecture

81. Given the impact of fees on investor outcomes, we think it is important to consider what the most efficient and effective model might be to help facilitate a reduction in fees and costs. The options for the delivery of the default product range from having just a few, to many, to all.

82. An approach taken by other countries such as Sweden and the UK are to have just one provider of default products. This was a suggestion made by the Savings Working Group who commissioned a high level analysis as to potential savings.[33]

83. This is not the Government's preferred option because there is a risk of incumbency as well as concentration of risk in one provider. The performance of a single default provider may be difficult to evaluate against other schemes, reducing the ability to monitor the provider and influence performance. The incumbent would have an advantage in future tenders because of likely high transition costs. These would also be incurred if a change is forced because of underperformance, leading to a high risk of creating a monopoly provider, and a greater likelihood that investors believe there is a government guarantee. (Although the KiwiSaver Act 2006 is explicit in stating that there is no Crown guarantee of any KiwiSaver scheme or investment product of a KiwiSaver scheme.[34])

84. An alternative approach could be based on the one that Australia is preparing to introduce next year. Australia will require all superannuation schemes to replace their existing default products with a new default product termed 'MySuper'. Those people allocated to a scheme by their employer and who then do not choose an investment option are put into the scheme's 'MySuper' product. The 'MySuper' product is intended to have low fees and strong governance. In addition, in acknowledgement of the role of scale, the superannuation scheme entity is required to "actively consider whether their MySuper product has access to sufficient scale to provide net returns that are in the best financial interests of members".[35]

85. The main issue with employing such an approach in the NZ context is an inability to generate scale economies with a comparatively small and highly diversified market of providers. A system involving many providers offering a default product will add complexity to the Crown's management in terms of governance and oversight of the default scheme. This complexity is further intensified if the investment mandate is switched from conservative to a balanced or life stages mandate. This increased complexity will likely add cost. Without controls, there is likely to be substantial variances in investor outcomes (such as in performance and fees charged) across 31 providers, particularly if the investment mandate is switched to a more diversified approach. If Government wishes to maintain a similar level of oversight and

[33] http://www.treasury.govt.nz/publications/reviews-consultation/savingsworkinggroup/pdfs/swg-report-jan11.pdf, pp 99-100

[34] Refer s. 205 (1) of KiwiSaver Act 2006.

[35] http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22legislation%2Fems%2Fr4708_ems_95b265c8-b160-4f44-8475-a9f661124806%22, page 2

governance as it currently employs across the default products, then there will be a significant increase in monitoring costs.

86. A possible solution to these issues might be to require all registered KiwiSaver schemes to offer a cheap default option with a highly prescribed investment mandate (and, potentially, fee caps), the purpose of the latter being to minimise variances in investor outcomes and ensure easier oversight than otherwise. The decision around default scheme architecture then becomes a trade-off between potentially more appropriate investment approaches and opportunities to leverage brand equity and scale for lower fees versus a more open set of qualifying conditions.

87. In summary, scale and fees are important determinants of investor outcomes – at least as equally important as the investment strategy. We see this as an opportunity to work with stakeholders to identify smarter ways to deliver better investor outcomes.

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.
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?
28. What are the key criteria you think the Government should employ in selecting default product providers?
29. What proportion of costs can be separated between asset/investment management and administration/back office functions?

5. Other considerations

88. Below we briefly discuss other issues that are related to the work here.

Financial Literacy initiatives

89. In an effort to better equip KiwiSaver members with the necessary tools to assist them in making an active choice, one of the criteria for any default provider could be a requirement on them to undertake a continued programme of financial education with their members. This could be done in a coordinated manner with other default providers or it could be contracted out to a third party provider.

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?
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?

Transition process

90. The term of appointment for the current default providers was for seven years. The KiwiSaver Act 2006 does not specifically state what happens to the members of a default KiwiSaver fund on expiry of the instrument of appointment. However, the transfer of members from one KiwiSaver default provider to another default provider is contemplated by the Act.

91. If current default arrangements were to change, this could mean either that some or all of the current default funds will no longer be default funds, or that some or all of them will have their mandates changed. Our concerns are around what might happen to those members' interests if their existing default provider was not reappointed.

92. In considering how the existing default members should be treated, we think there is a key principle to take into account. That is, all default members are entitled to be treated equitably and fairly. Therefore, decisions around scheme design and delivery should apply equally to future and existing members. Underpinning this principle are the following:

    - 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 expire along with the expiration of the term of appointment;
    - The term of appointment was time-limited (to seven years) and there is no provision for right of renewal; and
    - The default members were sequentially allocated across the six default providers via the Inland Revenue and not procured as a result of specific efforts of the default providers (such as marketing, branding, product development and performance).

93. The current default providers are required to report to FMA and the Default Provider Review panel quarterly. The fees they may charge are specified in the deed of appointment and they must submit a formal request for any increases in these. In addition, the default providers must adhere to the investment strategy specified in terms of the appointment.

94. As we discussed in Chapter 2, the behavioural characteristics of inertia, procrastination and poor risk assessment could leave default members vulnerable to opportunistic pricing by non-default providers. However, the KiwiSaver Act 2006 requires that KiwiSaver providers not charge a fee that is unreasonable.[36]

95. Any change in the investment approach also raises issues around how to treat the existing members of a default fund. As part of the Capital Markets Development Taskforce, a research report was commissioned from Mercer into the existing default scheme settings.[37] This report identified four options available in the event of a change to present arrangements:

- *Option 1:* Leave existing members in their current investment option (i.e. conservative);
- *Option 2:* Switch existing members into a new default fund – if the new default arrangement is a life stage fund then members should be placed based on their current age;
- *Option 3:* Issue existing members with an election form in an attempt to determine what they wish to do and leave those members who do not respond in their current investment option (i.e. conservative); or
- *Option 4:* Issue existing members with an election form in an attempt to determine what they wish to do and switch members who do not respond into a new default fund.

96. One of the things to consider is how the treatment of the existing default members will impact any proposed design changes. For example, if option 1 or 3 above is selected then this creates both scalability and cost issues for any new fund, particularly one that adopts a life stages approach. Another issue is around how any changes to the investment approach will work in with the investment statements all current default members have received, specifying their present investment asset allocation and risk profile. This may require legislation to provide appropriate protections for trustees and managers.

97. Ultimately though, as noted above, the reasoning behind the final decision as to what the investment approach and design of the default product should be in the future would be expected to apply equally to existing members. Therefore, any changes should be implemented across existing and future membership, implying option 2 or 4 above would be appropriate.

32. Please provide any comments or thoughts you might have regarding a possible transition process.

[36] KiwiSaver Act 2006, cl. 2 Schedule 1.
[37] 'Lifestage Investment Options in Default KiwiSaver Schemes', Paul Newfield and Heathcliff Neels, Mercer, June 2009.

Decumulation

98. The first cohort of KiwiSaver members who are eligible to withdraw their funds have come of age this year. There is now a source of data that, while small and not particularly representative, can provide us with an initial insight into withdrawal patterns and how these members transition out of KiwiSaver. While the Government is not contemplating changing existing decumulation arrangements, it will be interesting to observe member behaviour in this regard. For example, how many remain in KiwiSaver and how many shift into a non-KiwiSaver fund with the same provider? And how many withdraw the entire amount?

99. It would also be useful to get an insight into what issues exist around decumulation. Both the Capital Markets Development Taskforce and the Savings Working Group recommended that the Government consider options to facilitate the provision of a wider range of products, such as annuities, to help people manage their retirement savings.

100. Over time an increasing number of New Zealanders will approach retirement with significant KiwiSaver balances. At the moment there are few commercially available financial products designed to help individuals to optimally manage the decumulation of their savings. A question to be considered is whether there are regulatory or other barriers in place preventing the market from offering such products?

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?
34. Can you identify any barriers that exist to prevent a market developing in NZ for decumulation products?

Summary List of Questions

1. Are there other arguments in favour of the current default arrangements? If so, please explain.
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.
3. Financial advisers / providers – What is your experience with risk/volatility and member behaviour in response to it?
4. Are there other reasons to change from the current settings that we have not considered? If so, please clarify.
5. As an organisation, what indicators do you use to assess a client's risk tolerance?
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 make a first home withdrawal and, if so, when?
7. Are there other issues around risk and investment strategies that we should be taking into consideration?
8. Is a traditional life-cycle investment approach appropriate for a default fund and if so, why?
9. Do you have any concerns with life-cycle funds? (Note: we address withdrawals for first-home purchase below)
10. Is a target date investment approach appropriate for a default fund and if so, why?
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?
12. Financial advisers / providers - Are there issues with, or barriers to, capturing age data? If so, please elaborate..
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.
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?
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?
16. To what extent do you think the first-home withdrawal facility should influence the design of the default product? Please explain.
17. What, in your view, is the best approach to deal with members intending to use their KiwiSaver for a first home purchase?
18. Do you agree with our analysis of active versus passive investment management? If not, why not?
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.
20. In your view, do you consider the rationale listed above to be accurate? If not, why not?
21. Do you have any suggestions or proposals as to how the asset classes might be made more attractive for KiwiSaver investment?
22. Are there any other key considerations? If so, please explain.
23. Do you agree with our analysis of the existing KiwiSaver market and the role of scale and fees? If not, why not?
24. Please outline what you consider to be the pros and cons of the options suggested above. Please detail your preference and why.

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.
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.
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?
28. What are the key criteria you think the Government should employ in selecting default product providers?
29. What proportion of costs can be separated between asset/investment management and administration/back office functions?
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?
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?
32. Please provide any comments or thoughts you might have regarding a possible transition process.
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?
34. Can you identify any barriers that exist to prevent a market developing in NZ for decumulation products?

Appendix One: Summary of KiwiSaver information

This appendix contains a selection of KiwiSaver statistics, most of which are publically available. The information relates to the year ended 30 June 2012 or as at that date, unless otherwise stated. For more detailed information, see:

- Inland Revenue's annual report on KiwiSaver and other research by the KiwiSaver evaluation group (2012 report to be released shortly).
  http://www.ird.govt.nz/aboutir/reports/research/report-ks/

- The Financial Markets Authority KiwiSaver Report
  http://www.fma.govt.nz/media/1242395/kiwisaver_report_for_the_year_ended_30_june_2012.pdf

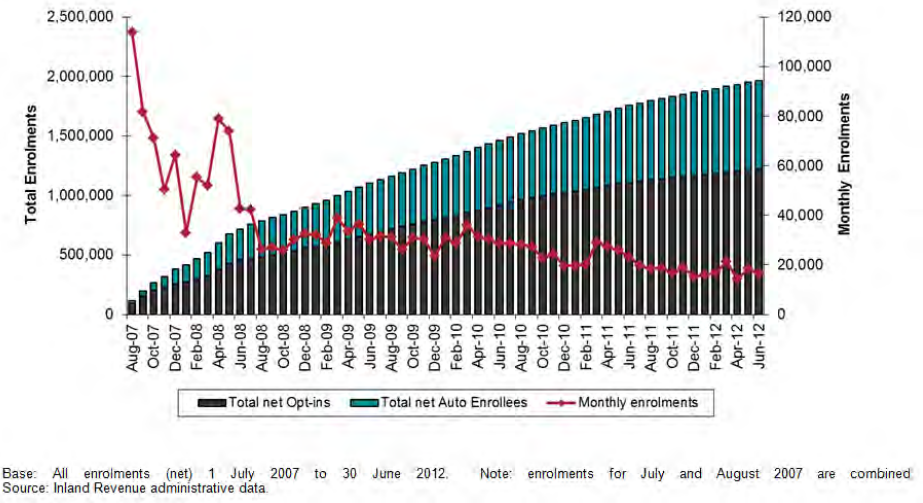
- Inland Revenue annual and monthly KiwiSaver statistics (continuously updated)
  http://www.kiwisaver.govt.nz/statistics/

Summary membership information

KiwiSaver has two million members but growth is slowing

In September 2012, KiwiSaver membership reached two million people. Net monthly enrolments have gradually declined from 40,000 in 2009 to around 16,000-20,000 per month recently. Total KiwiSaver membership may grow more slowly as the first group of members become eligible to withdraw their funds.

Total and monthly KiwiSaver enrolments



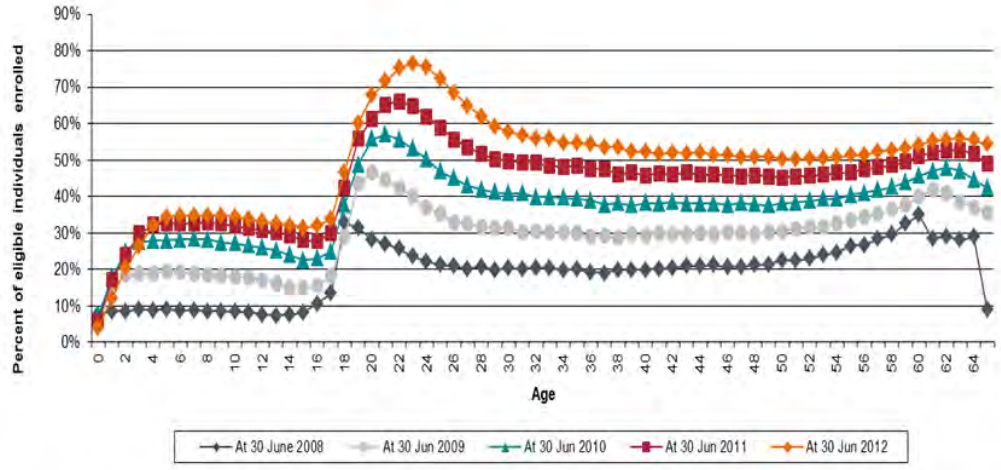
Base: All enrolments (net) 1 July 2007 to 30 June 2012. Note: enrolments for July and August 2007 are combined.
Source: Inland Revenue administrative data.

Source: IRD, KiwiSaver Annual Report, 2012 (draft)

Nearly half the eligible population is enrolled in KiwiSaver

In June 2012, around 49% of the eligible population is in KiwiSaver. This includes nearly 67% of the eligible population aged 18-24. The high membership rate of this age group is likely the result of young people entering the workforce for the first time and being automatically enrolled.

KiwiSaver reach into the eligible population



Base: All members at 30 June 2012. Eligible population are those eligible to join KiwiSaver (i.e. those who are New Zealand citizens or residents and under the age of 65 years), whether or not they have joined.
Source: Inland Revenue administrative data and Treasury long-term fiscal model for eligible population 2011/12.

Source: IRD, KiwiSaver Annual Report, 2012 (draft)

Contributions to KiwiSaver

Most members make contributions to their KiwiSaver account

In the year to June 2012, around 75% of members who are eligible for the member tax credit made some contributions to their account. Members are eligible for the member tax credit if they are aged 18 and over and are not yet able to withdraw their KiwiSaver funds (e.g. under 65 years old or have not been in KiwiSaver for at least 5 years).

The 414,000 non-contributing members are mostly those with no income and around 83,000 are on an active contributions holiday.[38]

Table A1. Proportion of contributing members (excluding members aged under 17), for the year ended 30 June 2012

	Members	% of members aged 18 and over
Maximum payment*	556,203	34%
Less than maximum payment*	675,661	41%
Received some member tax credit	**1,231,864**	**75%**
Total members aged 18 and over	**1,645,925**	**100%**

Source: IRD, Administrative data and MBIE calculations.
** The maximum annual member tax credit members are entitled for 2011/12 was $521.43.*

[38] Note that some of these 414,000 members may make contributions but may not be eligible for the member tax credit. For example, members based overseas are not eligible for the member tax credit, but may make voluntary contributions to their KiwiSaver account.

Similar proportions of default and non-default fund members seem to contribute to their KiwiSaver account

There is limited information on the proportion of default fund members that contribute compared to non-default fund members. Information from the FMA, which defines a non-contributing member as one who has not contributed to their KiwiSaver account in the two months to 31 March, shows no significant difference between the proportion of default fund members and non-default fund members that contribute.

Table A2. Contributing members by default and non-default fund, for the two months ended 31 March 2012

	Default		Non-default		Total	
	# members	% of default members	# members	% non-default members	# members	% total members
Contributing members	**255,054**	**57%**	**796,766**	**54%**	**1,051,820**	**55%**
Non-contributing members	**192,220**	**43%**	**666,171**	**46%**	**858,391**	**45%**
Total	**447,274**	**100%**	**1,462,937**	**100%**	**1,910,211**	**100%**

Source: FMA, KiwiSaver Report 2012

However, the non-default group includes a significant proportion of young people, many of whom earn no income. If we assume that all members aged 17 and under did not contribute, then the statistics suggest that non-default members are more likely to contribute.

Table A3. Contributing members by default and non-default fund, excluding members aged 17 and under, for the two months ended 31 March 2012

	Default		Non-default		Total	
	# members	% of default members	# members	% non-default members	# members	% total members
Contributing members	**255,054**	**58%**	**796,766**	**69%**	**1,051,820**	**66%**
Non-contributing members	**186,832**	**42%**	**359,294**	**31%**	**546,126**	**34%**
Total	**441,886**	**100%**	**1,156,060**	**100%**	**1,597,946**	**100%**

Source: FMA, KiwiSaver Report and MBIE calculations.

How people join KiwiSaver: auto-enrolment and opt-in

The auto-enrolment feature of KiwiSaver is highly influential

The auto-enrolment feature causes a significant number of people to join KiwiSaver. To date, around 38% of current members were automatically enrolled in KiwiSaver.

Table A4. Current members' KiwiSaver enrolment method, as at 30 June 2012

	Current members' enrolment method for their current provider	% of current members	Other enrolments	% of total enrolments
Opt-in via provider	**975,743**	**50%**		**43%**
Opt-in via employer	**247,950**	**13%**		**11%**
Auto-enrolled	**742,751**	**38%**		**33%**
Total current members	**1,966,444**	**100%**		
Opt-outs			255,935	**11%**
Closed accounts			32,227	**1%**
Total enrolments			**2,254,606**	**100%**

Source: IRD, KiwiSaver statistics and MBIE calculations.

The number of people affected by the auto-enrolment feature may be greater than this suggests. If we assume that all opt-outs were initially auto-enrolled (this is a reasonable assumption as it is unlikely that many people would opt-in to KiwiSaver only to then opt-out), then:

- The auto-enrolment feature may account for as much as 44% of total enrolments (33% + 11%, see above Table A4);
- Around 26% of all people who have been auto-enrolled chose to opt-out within the 8-week period; and
- The proportion of people who opt-out after being auto-enrolled appears to have declined significantly over the past four years from 35% in 2009 to 6.2% in 2012.

Furthermore, the influence of the auto-enrolment feature was shown in a 2011 study which found that, of all people who had opted-out of KiwiSaver at least once, around 32% had since become a KiwiSaver member.[39]

Most people choose their provider when they join KiwiSaver

Of current members:

- 50% initially entered KiwiSaver by choosing their provider;
- 37% did not make any choice and their employer did not have a preferred scheme, so they were allocated a default provider; and
- 13% did not make any choice and were allocated into their employer's preferred scheme.

[39] Inland Revenue National Research and Evaluation Unit (May, 2012). *KiwiSaver Evaluation: Opting-out and taking contributions holidays.*

Table A5. Current members' initial and current provider selection method, as at 30 June 2012

	Members' initial provider selection method		Members' current provider selection method		Default fund members*
	members	% of total	members	% of total	
Default allocated	734,008	37%	483,523	24%	447,274*
Employer chosen	249,381	13%	177,940	9%	
Active choice	992,703	50%	1,258,190	64%	
Involuntary transfer**	n/a	n/a	56,439	3%	
Total	**1,976,092**	**100%**	**1,976,092**	**100%**	

Source: IRD, administrative data

This data does not include members who have opted-out or members who have subsequently closed their accounts.

We do not know how many default fund members have made an active choice to remain in the default fund.

** This is based on the FMA KiwiSaver Report and is as at 31 March 2012 (other data in this table is for 30 June 2012). This figure is a lower bound estimate for total default fund members as at 30 June 2012.*

*** This includes members who have involuntarily transferred providers due to providers being wound-up or merged.*

How many default fund members exit their scheme and/or fund

Around 40% of members who are initially default fund members have moved out of the default fund[40]

By comparing the initial and provider selection method with the current default membership figure in the table above, we can infer how many members, of those who were initially default members, decided to move out of the default fund (either to another provider or to another fund with the same provider).

34% exited the default fund by transferring to another provider[41]

By comparing the initial and current provider selection method in the table above, we can infer how many initial default fund members decided to move out of the default fund to another provider. (See below for more information about how long default allocated members remain with the default provider).

5% of default fund members who are still with their default provider have exited the default fund by switching to another fund with the same provider[42]

In addition, by comparing this to the number of members currently in the default fund, we can deduce how many initial default members have switched out of the default fund and into another fund with the same default provider.

Therefore, provider transfers account for roughly 84% of total exits from the default fund and switches to other funds with the same provider account for 15%.

[40] Calculated as follows: 39.06% = (1 – (447,274 / 734,008)) x 100.
[41] Calculated as follows: 34% = ((734,008 – 483,523) / 734,008) x 100
[42] Calculated as follows: 4.9% = ((483,523 - 447,274) / 734,008) x 100

Most default fund members switch to a balanced fund

The table below shows the number of default fund members who have switched to another fund with the same default provider in 2011 and 2012. While the total number of members who decide to switch has changed substantially between the two years, the proportion of members that select each fund type appears to be reasonably constant.

Table A6. Default fund members switches to other fund within the same provider, years ended 31 March

	Members		% of inward switches		Value of transferred funds	
	2011	2012	2011	2012	2011	2012
Switches out of the default fund	**16,372**	**8,402**			($102.6m)	($49.6m)
Switches into other funds	**17,511**	**9,175**	**100%**	**100%**		
Conservative	2,880	1,545	16%	17%	$18.6m	$10.5m
Balanced	8,787	4,540	50%	49%	$52.3m	$23.2m
Growth	4,560	2,120	26%	23%	$24.9m	$12.0m
Cash	996	625	6%	7%	$5.6m	$3.2m
Shares	288	332	2%	4%	$1.2m	$0.7m
Fixed Interest	0	0	0%	0%		
Property	0	13	0%	0%		
Other	0	0	0%	0%		

Source: FMA, KiwiSaver Report, 2011 and 2012
Note: Switches out does not equal total switches into other funds because members can split their KiwiSaver over more than one fund.

Programmes to encourage default members to choose a fund are effective but limited

The Ministry has looked at data on provider transfers and fund switches by default fund members for each of the default providers. This suggests that all default providers have roughly the same proportion of default fund members transfer to another provider each year (this is about 8% of default members per year).

In addition, the data suggests that the number of default members that switch to another fund but remain with the same provider depends on the extent to which the provider has encouraged members to make an active fund choice. If a provider takes no action, it appears that less than 1% of default members transfer to another fund (a few hundred people per fund). Significant programmes to encourage default members to choose a fund appear to be able to increase this to over 10% of default members (several thousand people per fund). While this is a substantial increase, it is still a reasonably small proportion of default fund members.

Over half the members who entered the default fund in 2008 are still in the default fund over five years later

It is also important to consider how much inertia is created by the initial provider allocation. If members tend to remain with their initial provider, it suggests that the value of being a default provider is great. The table below shows indicates that default allocated members are more likely to transfer to another provider than active choice members.

In addition, we know that very few default members switch funds within the same provider (see above). Therefore, the table below is also indicative of the inertia of the default fund and suggests that a large group of members tend to remain in the default fund for at least several years.

Table A7. Inertia of initial provider, current members, year ended 30 June

		Current members' initial join method			
Year to 30 June that members joined KiwiSaver		**Active choice**	**Default**	**Employer nominated**	**Total**
2008	# joined*	282,717	312,909	96,329	691,955
	# still with initial provider	241,765	176,447	63,243	481,455
	% of joined still with initial provider	**86%**	**56%**	**66%**	**70%**
2009	# joined*	188,019	136,247	46,717	370,983
	# still with initial provider	152,181	89,332	31,888	273,401
	% of joined still with initial provider	**81%**	**66%**	**68%**	**74%**
2010	# joined*	205,597	98,587	35,487	339,671
	# still with initial provider	176,878	68,575	26,017	271,470
	% of joined still with initial provider	**86%**	**70%**	**73%**	**80%**
2011	# joined*	162,254	99,454	36,525	298,233
	# still with initial provider	151,871	75,396	29,312	256,579
	% of joined still with initial provider	**94%**	**76%**	**80%**	**86%**
2012	# joined*	100,777	86,811	31,223	218,811
	# still with initial provider	98,445	73,773	27,480	199,698
	% of joined still with initial provider	**98%**	**85%**	**88%**	**91%**
Total	# joined*	939,364	734,008	246,281	1,919,653
	# still with initial provider	821,140	483,523	177,940	1,482,603
	% of joined still with initial provider	**87%**	**66%**	**72%**	**77%**

Source: IRD, administrative data

** Excludes members who have been involuntarily transferred due to scheme wind-ups.*

Table A8. Length of time current default members have been with their default provider, as at 10 September 2012

	# of members	% of current default allocated members	cumulative %
1 year or less	73,773	15%	100%
1-2 years	75,396	16%	85%
2-3 years	68,575	14%	69%
3-4 years	89,332	18%	55%
4 years or more	176,447	36%	36%
Total	483,523	100%	

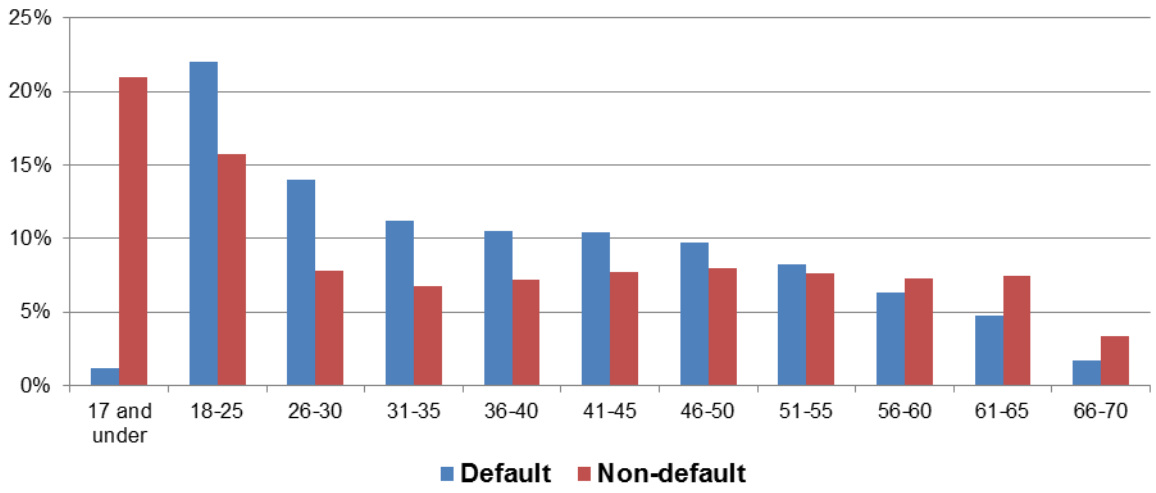
Source: IRD, administrative data

Characteristics of default and non-default members

A large proportion of the default fund members are young adults

Nearly 23% of default members are aged 25 or under.

Age profile of default fund members and non-default fund members, as at 31 March 2012



Source: FMA, KiwiSaver Report 2012

Excluding members aged under 18, default members tend to be younger than non-default members

The median age of default members is higher than non-default members. However, a high proportion of non-default members are aged 17 and under. If we exclude members who are aged 17 and under, the median age difference reverses: the median age of default members is now lower than that of non-default members.

Table A9. Median age of KiwiSaver members, as at 31 March 2012

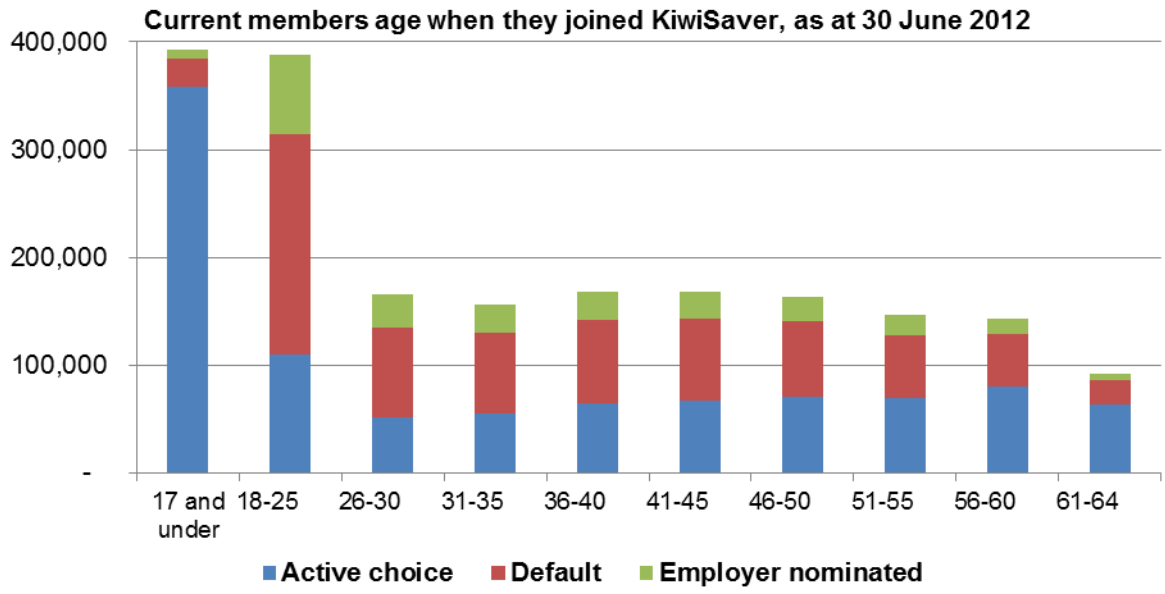
	Default members	Non-default members
All age groups	**36-40**	**31-35**
Excluding members aged 17 & under	**31-35**	**41-45**

Source: FMA, KiwiSaver Report 2012

Age profile of members when they initially join a KiwiSaver provider

As shown in the graph below, a large number of KiwiSaver members join when they are aged 25 or under. The majority of members who joined KiwiSaver when they were aged 17 or under did so by actively choosing a provider.

Excluding those aged 17 and under, younger people are more likely to initially enter the default fund when they join KiwiSaver.



Source: IRD, administrative data

Membership and asset holdings of different fund types

Default funds are the single largest fund type in KiwiSaver

It appears that there are similar proportions of KiwiSaver members in each of the three main fund categories (conservative, balanced and growth), with each category accounting for roughly 30% of total non-default funds (adding active default to conservative). A high proportion of non-default members have all or part of their KiwiSaver account in cash. However, the average amount invested per member in cash funds is particularly low suggesting that many members have only part of their KiwiSaver account in a cash fund.

Table A10. Number of members in each fund, as at 31 March 2012

	Members		Amount in each fund		Average invested per member
Default	**447,274**		**$2,921m**		**$6,530**
		% of non-default		**% of non-default**	
Non-default	**1,269,188**	**100%**	$9,815m	100%	$7,733
Cash	694,265	55%	$640m	7%	$922
Growth	549,711	43%	$2,822m	29%	$5,134
Conservative	430,176	34%	$2,266m	23%	$5,268
Balanced	396,682	31%	$2,832m	29%	$7,139
Active Default	139,131	11%	$809m	8%	$5,816
Other	27,781	2%	$295m	3%	$10,636
Socially responsible	26,217	2%	$22m	0%	$839
Shares	23,813	2%	$101m	1%	$4,247
Fixed interest	7,890	1%	$13m	0%	$1,649
Property	3,267	0%	$13m	0%	$3,961
Total	**2,298,933**		**$12,735m**		**$5,540**

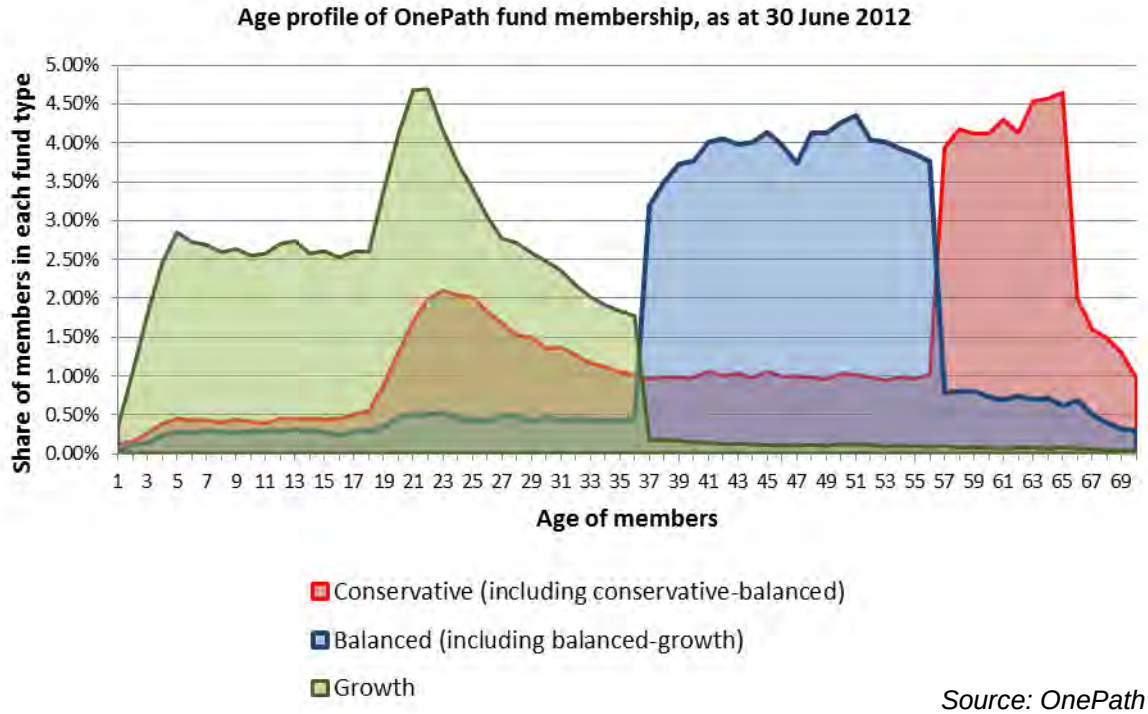
Notes:

- *Some members have an investment in more than one fund, therefore the "member" column does not add to the total for non-default members.*
- *In this table, default members include only members who are automatically enrolled but their employer does not have a preferred scheme. Non-default members include members who have opted-in plus members who are automatically enrolled but their employer does have a preferred scheme.*

Source: FMA, KiwiSaver Report 2012

Members who choose their fund appear to follow a life-stages model

The graph below shows the age profile of members in three of OnePath's main fund types. The sudden shifts around 36 years and 57 years suggests that OnePath automatically switches members' funds in line with a life-stages type model. This means the data may be of limited use to consider what types of fund people are choosing for themselves.

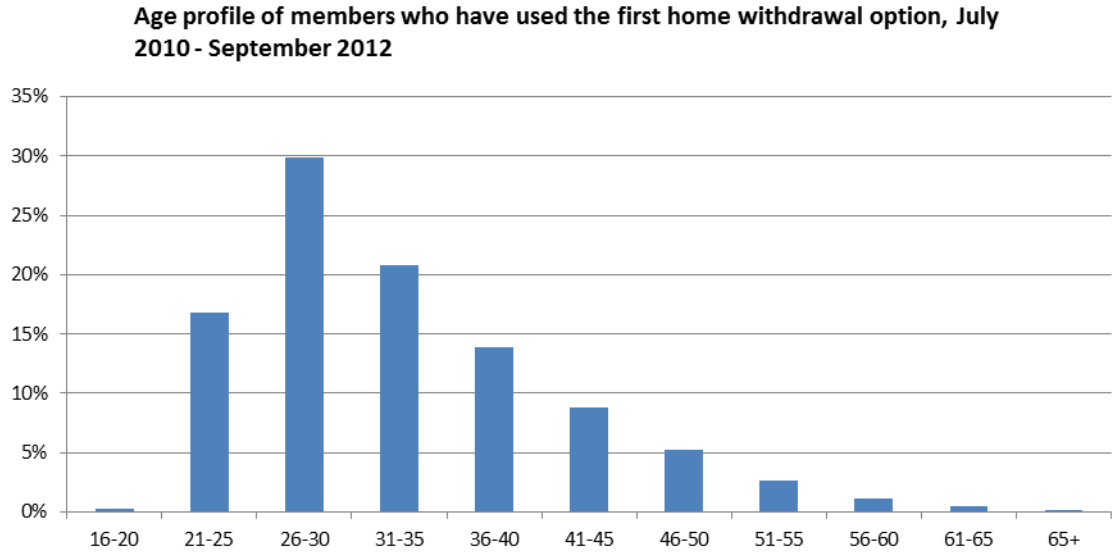


Source: OnePath

First home withdrawal

Members who use the first home withdrawal option tend to be young

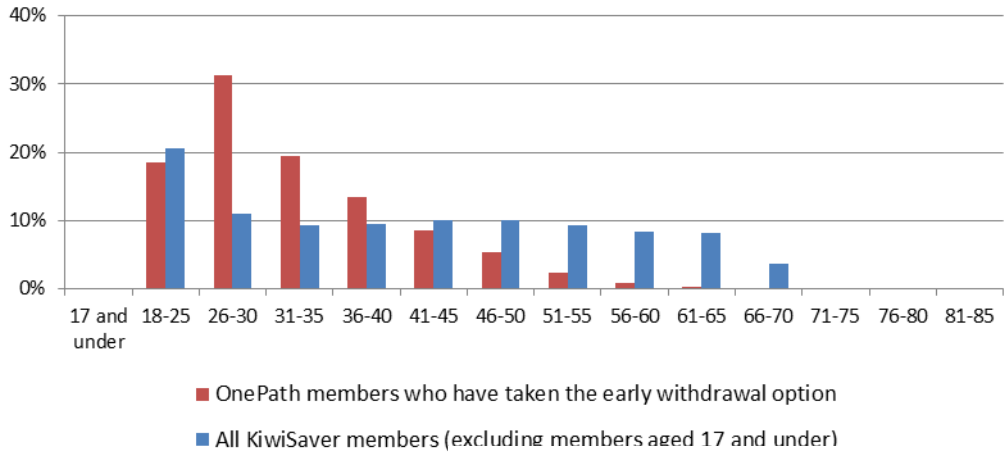
Between July 2010 and September 2012 providers notified Inland Revenue of first home withdrawals for 9,321 individual members. The majority of these members are aged under 35.



Source: IRD administrative data

This is consistent with information from OnePath. OnePath, which represents around 20% of all KiwiSaver members (at 30 June 2012), has had around 2,000 members use the first home withdrawal option. This represents roughly 0.5% of OnePath's members. In addition, members who use the first home withdrawal option tend to be younger than the average KiwiSaver member.

Age profile of members who have taken the early home withdrawal option, as at 30 June 2012



Source: OnePath

It appears that most members who use the first home withdrawal option are in the default fund

While we do not have data on how many of these members are in the default fund, approximately 60% are from default providers (compared to around 24% of current members) and only around 20% chose their current provider. This suggests that a more than proportionate share of first home withdrawal option users are/were in the default fund.

Appendix Two

Capital market returns for New Zealand

Figure 1 shows that, over the last 112 years, the real value of equities, with income reinvested, grew by a factor of 531.2 as compared to 10.5 for bonds and 6.4 for bills. Figure 2 shows that, since 1900, equities beat bonds by 3.6% and bills by 4.0% per year. Figure 3 shows that the long-term real return on New Zealand equities was an annualized 5.8% as compared to bonds and bills, which gave a real return of 2.1% and 1.7% respectively. For additional explanations of these figures, see page 37.

Figure 1

Annualized performance from 1900 to 2011

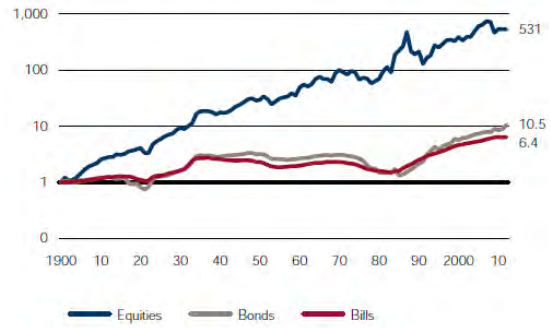


Figure 2

Equity risk premium over 10 to 112 years

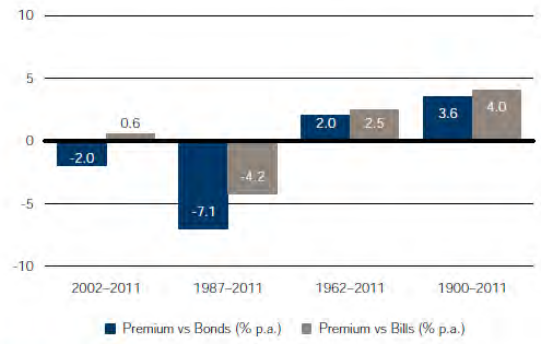
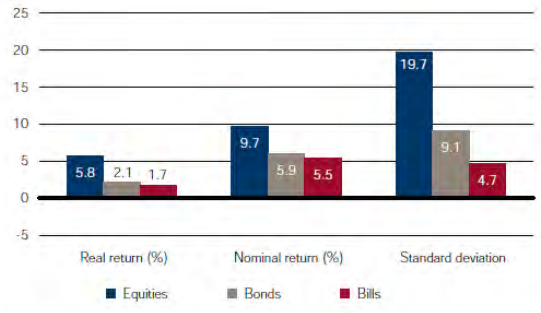


Figure 3

Returns and risk of major asset classes since 1900



Source: Elroy Dimson, Paul Marsh, and Mike Staunton, Credit Suisse Global Investment Returns Sourcebook 2012.

OVERVIEW OF ISSUES

- The current default product was designed to provide stable and reputable funds which help establish a savings habit.
- By its design, the default product assumes that people will be able to move to funds better matched to their investment time horizon.
- Of the 740,000 KiwiSaver members initially placed in the default, around 60% of these default members remain with around half of these having been in for three years or longer.
- While some members have changed funds, experience here and overseas tells us that there will be a large and persistent group of savers who will remain in the default.

What, then, is the most suitable design including :

- Investment approach
- Institutional delivery architecture
- Pricing

KEY PARTICIPANTS & ROLE IN THE REVIEW

- The Crown — has a role as a de facto investment advisor. It is making an investment decision on behalf of a group of people who have not revealed their preferences.
- Default members — comprise 23.4% (447,274 people) of all KiwiSaver members and span in age from 18-65 but largest number (47%) are in 18—35 age group. Some default members may intentionally be in the default product. Others have not made a choice. Our review of the default product is centered around those who have not chosen, or are unequipped to choose.
- KiwiSaver fund industry— has a role in providing well-governed, well-managed KiwiSaver products that meet the manager's duties as specified in KiwiSaver Act 2006 (Schedule 1 (1B)). Also has a role in advising members as to what is the most appropriate investment product for them. Substantial fee revenue generated from default product.

THE STATUS QUO

- Invested under a conservative mandate designed to ensure capital preservation and stable returns

What has worked well

- Low volatility encouraging a savings habit
- Has performed very well comparatively over past five years
- Vanilla investment approach so low complexity and comparatively easy to oversee and monitor
- Low fees

Why we might consider changing

- May not maximize expected income at retirement as expected to deliver, on average, lower returns over the long term than a more growth-oriented investment approach
- Comparatively good recent performance is no indication of future performance
- Other mechanisms available to mitigate fees and complex governance

A decision needs to be made on whether the default product should have a short-term or long-term focus

- A short– term focus is consistent with a *conservative* investment approach and *capital preservation*
- A long– term focus is consistent with a more *growth-oriented* investment approach and *retirement income maximisation*

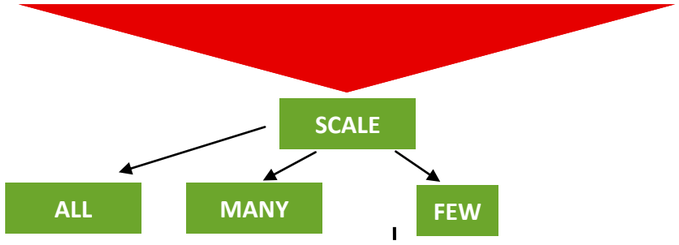
WHAT OPTION DELIVERS THE BEST OUTCOME FOR DEFAULT MEMBERS AND WHAT IS THE RISK TRADE-OFF?

INVESTMENT RISK — LOW — MEDIUM — HIGH

	LOW	MEDIUM	HIGH
• Risk to Crown of fund failure & subsequent expectation of bail out.	• KiwiSaver Act 2006 s.205—states 'No Crown Guarantee of KiwiSaver schemes or products' • Failure would be due to fraud and /or incompetence, both equally possible irrespective of investment mandate		
• Risk to Crown of volatility in returns	• Unclear at what point default members could request action and recompense from Crown. Most investments go up and down and there are a range of investment time horizons across default members		
• Risk to default members from volatility in returns	• Low across the *long-term*		• High for those members planning to withdraw funds in the *short-term* and may be forced to crystallize losses
• Risk to default members of poor outcomes	• Low if approach is a diversified investment strategy over the *long-term* • Low if invested in a conservative strategy over the *short-term*		• High if approach is a diversified investment strategy over the *short-term* • High if invested in a conservative strategy over the *long-term*
• Risk to default members' confidence in KiwiSaver and building a savings habit	• Low if approach is conservative	• Medium if approach is more growth-oriented and returns are less than expected	

DELIVERY ARCHITECTURE & PRICING

- Fund costs (charged to members as fees and expenses) can have a significant impact on outcomes
- In deciding the number of funds, usual considerations of investor 'choice' are not relevant for a default product
- The review of the default product provides an opportunity to consider what might be the most efficient delivery architecture and to negotiate fees for better investor outcomes
- The default product sets industry standards and benchmarks



- Based on the current criteria, most existing providers would be able to create an eligible default product and become default providers
- If all or many become a default product provider then:
  - Increase in complexity and governance
  - Reduced ability to leverage scale for lower pricing
  - Likely to get large variances in investor outcomes across providers
  - Mitigates concentration risk by diversifying across a range of providers

- Incumbency and concentration risk in only a few providers
- Lower costs in terms of monitoring and oversight
- Opportunity to leverage scale for lower fees
- Less variances in investor outcomes