**Kiwibank Limited and Gareth Morgan KiwiSaver Limited**
**Joint submission**

**to the**

# Ministry of Business, Innovation and Employment ("MBIE")

**on the**

# Review of KiwiSaver Default Provider Arrangements Discussion Document

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## Introduction

We appreciate the effort that MBIE has put into creating the Review of KiwiSaver Default Provider Arrangements Discussion Document and welcome the opportunity to provide feedback on this and are happy to meet with representatives of MBIE to discuss any of the points raised in this document.

## Key Points

Whilst the original default provision has been successful in its scope the role is limited and has led to some unintended consequences. There is an acknowledged financial literacy deficit and a lack of engagement with savings and investment products in New Zealand which needs to be addressed. The Government has the opportunity to use KiwiSaver as a way to increase that engagement and promote a greater understanding of the role of investment in retirement savings. The existing arrangements whereby members can be automatically allocated without making an active choice perpetuates this lack of engagement. We believe that the structure should focus on encouraging Kiwi's to take an active part in their retirement savings.

## Recommendation

It is for this reason that we believe the practice of defaulting members who do not make an active choice regarding their KiwiSaver investments should be removed. All prospective members should be required to actively choose a KiwiSaver provider, and preferably a fund, at the time of beginning new employment – much the same as you would provide your bank account or tax rate information to your employer. To really encourage greater retirement savings and financial literacy and awareness, we need to further engage people in making decisions regarding their retirement savings, rather than relying on deficient mechanisms such as life cycle funds.

To enable this to be effective, there will need to be increased education and participation from employers at the time of new employment. Currently the KiwiSaver information provided to new employees is very limited and doesn't stress the importance (in particular to those in the 18-35 age bracket) of saving for retirement and fostering these habits at the time of entering the workforce. We recommend that employers provide their prospective new employees with a KiwiSaver information pack that has comprehensive information as to the purpose, features and benefits of KiwiSaver. There will be a list of "nominated providers" in this information and the new employee will be required to select one of these as part of their employment sign up and this will become their chosen provider. The information provided as part of this package will have information on how to obtain more details about the different nominated providers. This pack will contain mainly static information and would be easily downloaded from the IRD website.

Employers will have to take a more active role in ensuring that their new staff member provides them with correct contact information such as address, phone number, and email address to enable their new KiwiSaver provider to make contact. This will decrease the problem that is currently facing default providers as to the incredibly high volume of "lost" members who they do not have contact information for and therefore have no hope of encouraging active participation in retirement savings.

## Nominated Providers

KiwiSaver providers should be able to register with the IRD as a "nominated provider" on an annual basis – this will put their scheme details in the information packs that will be provided to new employees. By having the process such that providers are able to opt in to join the nominated provider listing, this will enable restricted schemes and others who do not wish to participate the option to opt out. Providers will be required to meet minimum criteria such as was previously set for the original default provider tender process. They will be required to have a default investment fund that is conservative as per present requirements. They will be able to “opt out” of the nominated provider listing on an annual basis, thereby removing themselves from the information packs provided to new employees.

As part of the requirements for being a nominated provider they will be required to send information packs to new members who are allocated to them from Inland Revenue via employers in the same way they are required to at present for employer chosen members.

This process will encourage active participation from all providers in ensuring they are delivering the best possible KiwiSaver experience to members. As there will be a higher level of competition, providers will be required to increase the information they provide to potential new members to assist them with their retirement savings. It will also heighten competition on fees. By enabling all providers who meet criteria the same opportunity to obtain members through employers this will encourage growth within the industry.

## Life cycle funds

We reject the idea of a life cycle default product for the following reasons:
- Age is inadequate in assessing risk appetite
- Many members are “saving” for retirement not “investing”. Members with low risk appetite are forced to suffer market volatility and risk with no guarantee of a better return
- Changes to the statutory age of retirement may result in further arbitrary changes in asset allocations
- Many members would prefer the certainty of an outcome
- Life cycle funds does not guarantee a better return, and the increased risk may result in a short fall compared to other strategies
- Age does not take into account market circumstances and an arbitrary change in asset allocation as a result of age can produce very different returns for members who differ only in birth date
- It would involve making assumptions about a default member’s circumstances, aspirations and risk tolerance; assumptions neither the government nor individual providers are in a good position to make.
- A life cycle default product would increase investment risk for a time with no guarantee of an increased return over that particular period (the last ten years highlights that expected relative returns do not hold good even over quite long periods of time)
- It assumes drawdown at 65. Members may wish to remain in employment and contribute beyond the age of 65.

By defaulting members who are already disinclined to make an active choice regarding their retirement savings into a fund that will effectively “make decisions for them” you would be further discouraging any active engagement from these members regarding their retirement savings.

If individual providers wish to offer their members the option to invest in a life cycle product, this should be something outside of the default process.

We believe that we should be further educating members to take an active part in their retirement savings and make conscious decisions regarding the investment of these. It is by increasing awareness and knowledge as to the longer term purpose of KiwiSaver and the benefits that it can provide to Kiwi’s in their retirement that we will have a more actively engaged KiwiSaver membership and address the financial literacy deficit. This education needs to start at the beginning of their retirement savings which for many will be upon starting a new job. By automatically enrolling members into an arrangement which actively discourages member interaction and discussion around risk tolerances and expected outcomes then the current situation may well be worsened.

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

We are not in favour of the current default arrangements.

***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.***

N/A

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

Risk, while related to, is not volatility and it is quite misleading to equate the two. Risk is related to the possibility of losing purchasing power in the context of investment and consumption objectives. The industry preoccupation and erroneous equation of variance to risk is an over simplification that is dangerous for national savings.

Members do not like losing money, period. In general, Kiwis are conservative in nature and they tend to exit out of risky assets just after they fall and enter them just before they fall. They tend to follow the crowd.

The answer is to create a competitive and level playing field where full disclosure and transparency empowers members to choose and where competitive pressure incentivises providers to deliver excellence in member empowerment.

***4. Are there other reasons to change from the current settings that we have not considered? If so, please clarify.***

The current default structure promotes non-engagement from members. There is a recognised deficit of financial literacy in the general population – the current structure promotes new members to slip into a default product and they may never actively engage in their retirement savings and investment future. This means that a high percentage of default members will have little or no understanding of retirement investing and engagement in their financial future. The current arrangements should be replaced with a structure which promotes engagement and builds financial literacy.

There is currently not enough required of the default providers – they have been n a privileged situation in receiving the allocation of members who do not engage in their retirement savings. They receive the benefit of greater funds under management (FUM) and scale from the volume of members however there is no obligation on them to use their privileged position to increase member engagement and financial literacy.

The current structure commercially benefits a select number of providers and results in an uneven playing field for other providers. This creates a hindrance to competition for other providers to increase their growth through increased FUM and membership numbers.

If an active choice is forced on the member at the time of joining it provides a level of engagement and ownership within the member. It will also promote increasing competition between providers which will likely result in downward pressure in fees and an increase in the provision of information.

***5. As an organisation, what indicators do you use to assess a client's risk tolerance?***

Assets, liabilities, cashflows (Income and expenditure over horizon), investment horizon, objectives, personal views of risk, personal views on their appetite and capacity for loss, both real and temporal.

***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?***

Discussions on investment objectives that include the following inputs:
Investment horizon, whether it's for a first home, assets, liabilities, income and expenditure, objectives and risk tolerance (appetite and capacity).

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

The focus should be on higher levels of disclosure and transparency. This will allow members to make informed decisions regarding their retirement savings.

***8. Is a traditional life-cycle investment approach appropriate for a default fund and if so, why?***

We reject the idea of a life cycle default product for the following reasons:

- Age is inadequate in assessing risk appetite
- Many members are "saving" for retirement not "investing". Members with low risk appetite are forced to suffer market volatility and risk with no guarantee of a better return
- Changes to the statutory age of retirement may result in further arbitrary changes in asset allocations
- Many members would prefer the certainty of an outcome
- Life cycle funds does not guarantee a better return, and the increased risk may result in a short fall compared to other strategies
- Age does not take into account market circumstances and an arbitrary change in asset allocation as a result of age can produce very different returns for members who differ only in birth date
- It would involve making assumptions about a default member's circumstances, aspirations and risk tolerance; assumptions neither the government nor individual providers are in a good position to make.
- A life cycle default product would increase investment risk for a time with no guarantee of an increased return over that particular period (the last ten years highlights that expected relative returns do not hold good even over quite long periods of time)
- It assumes drawdown at 65. Members may wish to remain in employment and contribute beyond the age of 65.

***9. Do you have any concerns with life-cycle funds? (Note: we address withdrawals for first-home purchase below)***

By defaulting members who are already disinclined to make an active choice regarding their retirement savings into a fund that will effectively "make decisions for them" you would be further discouraging any active engagement from these members regarding their retirement savings.

If individual providers wish to offer their members the option to invest in a life cycle product, this should be something outside of the default process. T

***10. Is a target date investment approach appropriate for a default fund and if so, why?***

No it isn't appropriate. A target date fund will focus on an end point for KiwiSaver of 65 being the age of eligibility for National Superannuation. This is not an appropriate end point for all investors. Many members of KiwiSaver who are already eligible to withdraw their savings are choosing to keep them invested – recognising the fact that the funds that have been saved are to assist them with their retirement income. Other members with lower balances are choosing to withdraw all funds. It is for this reason that there isn't a "one size fits all" approach that can be taken when setting investment approaches.

A target date fund will also further encourage a lack of engagement as people can choose to not participate in their investment decisions for retirement.

***11. Is there, in your view, a minimum scale requirement for implementing a target date investment approach? If so, what would the minimum size be?***

We don't believe that implementing a target date investment approach is appropriate for default situations.

***12. Financial advisers / providers - Are there issues with, or barriers to, capturing age data? If so, please elaborate.***

There are no barriers to capturing age data. This is required as part of enrolment to KiwiSaver.

***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.***

The focus should remain on preserving their capital until members make an active choice and engage in their retirement savings. We consider conservative investment to be a suitable proxy for this.

***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?***

As above. The focus should instead be on encouraging active participation and engagement from all members in KiwiSaver. Any solution which promotes non-engagement should be discouraged.

***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?***

Partially – it is reasonable to assume that some people remain in the default fund because they are intending to withdrawal funds for a first-home purchase. It isn't necessarily reasonable to assume they have intentionally followed a default process for this reason.

***16. To what extent do you think the first-home withdrawal facility should influence the design of the default product? Please explain.***

The design of the default product shouldn't be influenced in any way by the first-home withdrawal facility. The biggest intention of KiwiSaver is to provide a member with retirement savings – a first-home withdrawal is a facility that will only be used by a select few.

If a member is intending to use their KiwiSaver funds to purchase a first home, then they should be actively engaged with their savings. Members shouldn't be relying on a default arrangement to invest their funds appropriately. By encouraging active engagement from the time of initial enrolment, it is more likely that a prospective first home buyer will actively participate in their investments and be in the position to make choice about the risk tolerance and required outcomes including their options for investing prior to a first home withdrawal.

***17. What, in your view, is the best approach to deal with members intending to use their KiwiSaver for a first home purchase?***

Refer to 16.

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

No. the statement is too sweeping and does not recognise the nuanced and varied nature of active management.

Active management is a very broad concept and there are many different styles of active management, even within large "efficient" markets such as the US large cap market. Some of these styles have long running positive track records and others perform in different environments offering diversification benefits even with modest or no returns on average.

Passive management relies on markets being efficient. Market efficiency is difficult to assess and even markets considered to be efficient can have periods of inefficiency (e.g. bubbles).

Rather than being prescriptive on the basis of a sweeping generalisation, it is important that schemes should provide choice and full fee, risk and track record transparency so that investors can make informed choices about whether they are getting value for money within a competitive framework.

***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.***

It is not possible to make sweeping statements about asset classes, some segments and styles in various asset classes are more or less suited at different times and for different purposes. Again, full and open disclosure of process, performance, risk and fees should be the focus so that investors can make informed choices in a competitive market not prescriptive generalisations that loosely rule certain asset classes as being "passive" or "active".

***20. In your view, do you consider the rationale listed above to be accurate? If not, why not?***

Alternative assets is a catchall basket that can be summarised as "hard to understand, high fee, don't know how to value effectively". The variety of alternative assets is high and some of them can add real value. The NZ industry has not been well provided with alternative assets with a very patchy track record. This more than anything else has led to reticence and rightly so.

**21. Do you have any suggestions or proposals as to how the asset classes might be made more attractive for KiwiSaver investment?**

As is pointed out, "high fees, high risk (or immeasurable risk), lack of performance track record and illiquidity" are all the reasons why many "alternatives" have not been attractive. Given the patchy track record of the NZ investment industry and the lack of local skill in alternatives in general it would be best to focus on full disclosures of risk, fees, track record and process while delivering efficient tax policy that allows providers to give investors access to global capability.

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

One of the biggest issues confronting the KiwiSaver schemes is the dearth of good and accessible assets in NZ across the board. As the "wall" of KiwiSaver money grows the ability to easily access offshore investments in NZD and in a fee and tax efficient manner is of paramount importance to the long term success of the scheme.

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

It is broadly reasonable. The current structure does little to promote genuine competition between providers. There is a lack of impetus for genuine innovation of products, the design and delivery of these along with improved levels of customer service and information/education provided to KiwiSaver members.

Non-default and boutique providers are hampered by the lack of genuine competition under the current default arrangements – they have an uneven playing field in which to compete. Random allocation of default members stifles competition between default providers and eliminates the ability for other providers to compete in this market. Default providers are in the privileged position of being guaranteed additional members and FUM with virtually no engagement or action on their part. There is no need for them to actively engage with their default members and increase the levels of service they provide or further enhance their product offerings for default members.

If engagement of KiwiSaver members was forced from the point of initial enrolment and the default allocation structure was removed, this would encourage increased competition amongst KiwiSaver providers. Providers would be forced to be innovative with their products, provide higher levels of customer services and provide more competitive fees for members.

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

Fixed fees and/or Tiered Fees – these fee options are likely to encourage providers to pass on more direct charges to the scheme to offset the decrease in fee revenue. This in turn will lead to a lower level of transparency for members regarding the actual fees they are charged for their KiwiSaver investments. These options may also decrease the viability for smaller providers who will be unable to compete against larger organisations due to economies of scale.

Splitting administration functions from asset management functions – we believe that this will not be a viable option and will penalise those providers such as Gareth Morgan KiwiSaver Limited who have invested resource into bespoke back office platforms and processes which enable us to provide our members with a much greater degree of transparency and customer service.

By limiting the ability for providers to be innovative with their administration and back office functions, you will stifle competition regarding the services and functionality that can be provided to members.

***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.***

There needs to be genuine competition amongst providers – by removing the current cartel of default providers situation and allowing all eligible providers the ability to compete for members at the time of initial enrolment. Through increased genuine competition there will likely be downward pressure on overall fees for KiwiSaver members.

***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.***

As per our opening recommendations, we believe the most appropriate arrangement is to remove the default regime. Members should be required to actively choose a KiwiSaver provider at the time of beginning new employment – much the same as you would provide your bank account or tax rate information to your employer. To really encourage greater engagement and financial literacy and awareness, we need to further engage people in making decisions regarding their retirement savings.

***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?***

If there are fewer default providers on offer, this will further reduce competition between providers and therefore will stifle innovation for new products and services. There will become a monopoly with little encouragement for default providers to actively engage with their members.

***28. What are the key criteria you think the Government should employ in selecting default product providers?***

If there were to be a process of selecting new/replacement default KiwiSaver providers they would have to abide by similar terms to the original default process:

- They must have a default investment fund available – that is conservative/capital preservation in nature
- They must meet certain obligations regarding the fees that they charge on the default option

In addition to this, they must demonstrate the following:

- Their procedures for ensuring their members have full transparency regarding fees they are charged and the actual returns that they receive
- They have a programme in place to actively engage with their members on a regular basis over and above the annual requirements as at present.

***29. What proportion of costs can be separated between asset/investment management and administration/back office functions?***

The split between asset/investment management costs and administration/back office functions will vary depending on the arrangements within the provider. Many KiwiSaver providers outsource administration/back office functions to third party providers and there is a reasonably limited market of administration managers. Providers are therefore unable to drive down pricing in this area. It is not possible to determine a ratio across all providers splitting the two costs due to the different arrangements each provider has.

***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?***

Default providers enjoy the privilege of receiving high FUM and increased membership through the default process. As a trade off, they should have had an increased obligation to ensure the level of financial literacy and engagement with members is increased. There is a general financial literacy deficit within the nation and this needs to be addressed and can be done so best when an investor first begins their investment journey to retirement.

A more prudent approach would be to increase the information that is provided at the beginning of the automatic enrolment process. By providing employers with the resources to educate and improve knowledge regarding KiwiSaver when a new employee starts work, there will be an increased engagement with the retirement savings process. By ensuring that sufficient information is gathered at this stage such as address information, phone, email address etc it will better enable KiwiSaver providers to remain in contact with their members and provide them with information on a regular basis.

***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?***

If a customer is forced to make an active choice at the time of enrolment this in turn will promote a level of engagement and ownership within the member. This will in turn foster an interest in financial literacy from the initial stages. If providers are actively competing and engaging with KiwiSaver members, there will be an increase in information that is provided. Providers will be forced to be innovative and provide information/services over and above what is currently required of them. The Gareth Morgan KiwiSaver Scheme already believes in, and fosters, increased financial literacy amongst its members – this is done through the extremely high level of transparency and regular contact with the customer base.

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

Members who are currently in default products should be left as they are. From the date of change, all new automatically enrolled members will be required to actively choose a provider.

***33. Financial advisers / providers – What is your experience to date with those members eligible to withdraw their savings? Are there specific patterns of behaviour that you have noted?***

We have done an active contact programme with our 65+ members and have found that generally members with smaller balances have plans for the funds and are keen to withdraw upon becoming eligible.
There are a large number of members who are unaware that they are able to keep funds in their KiwiSaver accounts post eligibility – many of these people are leaving their funds as they are until they have had time to make a more informed decision.

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

Current KiwiSaver balances are generally insufficient to make some decumulation products viable. For instance there are questions as to whether there is sufficient depth in the insurance market to build a viable annuity product.