Submission by

BusinessNZ

GROWING PROSPERITY AND POTENTIAL

to the

Ministry of Business, Innovation & Employment

on the

Review of the KiwiSaver Default Provider Arrangements

18 September 2019

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REVIEW OF THE KIWISAVER DEFAULT PROVIDER ARRANGEMENTS SUBMISSION BY BUSINESSNZ[1]

1. INTRODUCTION

1.1 BusinessNZ welcomes the opportunity to comment on the *'Review of KiwiSaver Default Provider Arrangements Discussion Paper* (referred to as 'the Document'). We believe a review of this area of KiwiSaver is long overdue, and our expectation is that the outcome will lead to a stronger level of long-term retirement savings for many New Zealanders.

2. SUMMARY OF RECOMMENDATIONS

BusinessNZ recommends that:

a) Criterion 1 is given the greatest weighting, followed by criteria 2 and 3 (p.3);

b) A life-stages investment mandate is selected (p.4);

c) If there is to be a "nursery" period, that period is between 3-6 months in length (p.4);

d) The option of early KiwiSaver withdrawals for first-home ownership has a minimal influence on changes to the KiwiSaver default provider arrangements (p.5);

e) Options 1-3 are given greater consideration when determining any new fee structure (p.5);

f) No provision is made for the appointment of an unlimited number of default providers (p.6);

g) Certain industries or companies are not subject to mandatory exclusions (option 1, p.7);

h) Further work on option 2 results in a voluntary set of guidelines developed in consultation with default member providers (p.7);

i) Further information is sought from default providers before any preliminary option 1 decisions are made (p.8);

j) For default fund providers option 2, involving a targeted investment requirement, is voluntary (p.9);

k) Consideration is given to options from other submitters concerning capital market development, particularly regarding the reduction of regulatory barriers (p.9);

l) Option 1's proposals for member transfer receive the least consideration (p.9); and

m) If either option 1 or 2 is adopted, default members can choose to stay with their existing default provider (p.10).

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[11] Background information on BusinessNZ is attached as Appendix One.

3. OVERARCHING COMMENTS, THE DOCUMENT'S OBJECTIVES AND CRITERIA

Prior KiwiSaver Default Provider Review

3.1 BusinessNZ submitted on the 2012 review of *KiwiSaver Default Provider Arrangements* where our submission advocated for further consideration to be given to a life-cycle investment approach for a default fund. Unfortunately, this proposal was not taken up. Looking at just a simple measure, say the New Zealand NZX50 from January 2013 to September 2019, the price has gone from 4,082 points to 10,757 points, representing an increase of 163%. While those with life-stages, balanced and growth investments would have enjoyed a good proportion of such returns, anyone with the current default conservative fund setting would have enjoyed far less. Given such analysis does not take account of the increase in overseas shares during the same time period, it would be fair to say the opportunity lost to default KiwiSaver members would have been significant.

3.2 In addition, with retail interest rates continuing to fall (and not look like increasing in the foreseeable future), those in a KiwiSaver default conservative fund are essentially falling behind relative to those in less-conservative funds. Given many default fund members may be least able to invest long-term outside KiwiSaver, the cumulative effect of falling behind has implications for their retirement years, especially if superannuation provision becomes unsustainable in the future. In short, we believe change is not only required but is long overdue.

Objective for the Review

3.3 Paragraph 10 states that *"we propose that the main objective of the review is to enhance the financial well-being of default members, particularly at retirement"*. Overall, BusinessNZ strongly agrees with this main objective, especially since for many default members, KiwiSaver is the only long-term financial provision they will make for their retirement. Therefore, it is critical the best suite of options is found to ensure New Zealanders lacking financial capability have at least an adequate level of savings as part of their retirement income.

Criteria for the Review

3.4 Chapter 2 of the Document outlines the criteria for the review, namely:

1. Better financial position for KiwiSaver default members, particularly at retirement;
2. Trust and confidence in KiwiSaver;
3. Low administration and compliance costs;
4. Supporting development of New Zealand's capital markets that contribute to individuals' well-being; and
5. Promoting innovation, competition, and value-for-money across KiwiSaver.

The Document asks how the criteria should be weighted. While BusinessNZ does not have any strong views on the exact nature of the weighting between the five criteria, we believe the most important is clearly criterion 1, although criteria 2 and 3 also play an important role. However, we believe the least important is criterion 4, which we will discuss in more detail below.

Recommendation: That criterion 1 is giving the greatest weighting, followed by criteria 2 and 3.

4. INVESTMENT MANDATE

4.1 Overall, BusinessNZ considers chapter 3 of the Document central to future changes to the default KiwiSaver member scheme, namely in proposing a change to the current practice of adopting a conservative investment mandate for default funds.

Problem definition

4.2 Given BusinessNZ's view that the key to any regulatory investigation is to have a clear and well-understood problem definition, we see paragraphs 32 and 33 of the Document as providing an acceptable and justifiable reason for intervention.

4.3 For more than a decade, a large proportion of KiwiSaver members has been in (conservative) default funds on a long-term basis and the reason for this needs to be examined. Although the same issue was looked at by the 2012 review, use of the default option persists. But as the status quo, the default option produces a worst outcome for KiwiSaver members who would be in a far better financial position on retirement had they opted for a less conservative fund.

4.4 We agree with the list of factors in paragraph 35 that explain why individuals remain in a default option having not made an active choice to do so. Simply put, when such an option is available, some people will simply 'set and forget', no matter how much additional information is provided.

Options for investment mandate

4.5 The Document provides four options for addressing the default investment mandate:

1. Life-stages investment mandate;
2. Balanced investment mandate;
3. Growth investment mandate; or
4. Conservative investment mandate.

4.6 Obviously, option 4 (retaining the conservative investment mandate) does nothing to move the needle towards putting KiwiSaver default members in a better financial position, particularly on retirement. Therefore, we do not support a continuation of the status quo. Our view is backed up by the point made in paragraph 54 that option 4, on balance, would have a negative effect compared with the other three options.

4.7 Any of the other options would be significantly better than option 4 and so we would have no concerns were one or other be adopted. However, as mentioned above, in 2012 we submitted that a life-cycle investment approach would be the best way forward. This option would place greater emphasis on asset allocation based on age, while still providing a level of protection for older KiwiSaver members who would not have time to rebuild their funds if the market experienced a swift downturn.

Recommendation: That a life-stages investment mandate is selected.

4.8 Paragraph 49 mentions the possibility of an initial conservative "nursery" period (i.e. six months or a year) when a member starts their life-stages. This would give individuals time to make a choice about their investments before shifting to a higher-growth fund. In principle, BusinessNZ is not against this idea as it provides a buffer period before shifting from a low risk to a higher risk fund. But if this option were introduced, we would not want the nursery period to be any longer than six months and it could be as short as three months if most submitters were in support.

Recommendation: That if there is to be a "nursery" period, that period is between 3-6 months in length.

Potential issue in relation to first-home buyers and people making early withdrawals

4.9 The Document asks, if a life-stages, growth or balanced option is adopted, how should the problem of early withdrawals by first-home buyers and others be mitigated? First, paragraph 6 of the Document mentions that providers targeting specific member engagement at potential first home buyers might help. However, as noted, for some, no amount of additional information will prevent incorrect long-term decision- making (or in many cases making no decision). Fundamentally, there is a level of responsibility that needs to be placed on KiwiSaver members who decide to enter the scheme and have no interest in which fund their contributions go into, yet have expectations around withdrawing funds for their first home.

4.10 From a policy point of view, we believe the focus of the review should be on the stated objective of retirement income maximisation and lifetime earnings, rather than on other targets such as first home ownership. While we appreciate the importance home ownership has for many New Zealanders, owning a house to live in is not considered an asset because it does not generally provide an income stream. Also, we are conscious of the fact that while today, first home ownership affordability is an important issue, this does not mean it will be of equal importance in the future. Instead, we would want changes to the default scheme that would allow for a longer policy time horizon, ensuring default members have the best opportunity to maximise their retirement savings.

4.11 Further, it is largely a moot point whether higher risk default schemes would have any great effect on short-term withdrawals. Paragraph 59 rightly points out that for many people, any negative consequences of withdrawing their KiwiSaver funds in the short-term would be less significant than the long-term benefits of a higher growth fund.

4.12 The purpose of the KiwiSaver Act is effectively to encourage long-term savings habits and asset accumulation so that members can enjoy a better standard of living in retirement. While it can be argued that a home is part of asset accumulation, it is important to remember that KiwiSaver was originally designed to ensure the accumulation of wealth in KiwiSaver accounts. Therefore, decisions about an optimal default investment mandate should not centre on the issue of first-home buyers and the making of early withdrawals.

4.13 The obvious answer to the question of whether it is reasonable to assume some people in the default fund are there because they are intending to withdraw funds for a first home purchase, is 'yes'. There will always be some who have signed up for this very reason. However, the more relevant question is to what extent should the first home withdrawal facility influence the design of the default product? And to that, given the reasons provided above, the answer is 'very little'.

Recommendation: That the option of early KiwiSaver withdrawals for first-home ownership has a minimal influence on changes to the KiwiSaver default provider arrangements.

5. FEES

5.1 The Discussion Document outlines six options for fees, namely:

1. Government sets a fee;
2. Two-stage assessment of fees in procurement;
3. Percentage-based fees reduce as provider's funds under management increase;
4. No fees for under 18-year olds;
5. No fees for low balances; and
6. No annual fees.

5.2 BusinessNZ believes options 4-6 should not be given any further consideration. Options 4 and 5 would simply lead to cross-subsidisation, not to mention the option 5 problem of what would be considered a 'low balance'. As pointed out in paragraph 107 of the Document, option 6, involving no fees whatsoever, would invariably lead to providers increasing percentage-based fees instead.

5.3 Regarding options 1-3, BusinessNZ has no strong views as to which, or which combination of options would be optimal for both government and default providers. Having looked at the costs and benefits of criterion 1, paragraph 99 of the Document picks up on the commonality of the three options when it comes to ensuring a better financial position on retirement. However, we agree with the point made in paragraph 100 that it might be difficult for government to determine what an appropriate fee would be. Any decision on options 1-3 (or some variation of them) would need strong approval from default providers, given any fee change (either up or down) would have an obvious effect on their business model.

Recommendation: That options 1-3 are given greater consideration when determining any new fee structure.

6. NUMBER OF PROVIDERS

6.1 As we said in our submission to the 2012 round of consultation, BusinessNZ has no view on the optimal number of default KiwiSaver providers. However, in general we would not favour a bare minimum number of default providers existing (i.e. 1-2) given the benefits of competitive tendering.

6.2 In response to feedback sought on whether to appoint an unlimited number of providers, on balance BusinessNZ believes this would pose more questions than answers. The Document's table 3 sets out a useful analysis of the costs and benefits of appointing a larger or unlimited number of providers, and therefore gives a good steer towards the likely answer.

6.3 A key point mentioned in table 3 concerns the trust and confidence issues that could arise if default providers can opt-out of the default regime at any time. This issue also relates to chapter 8 of the Document (discussed below) and the transfer of members. Particularly, we believe any move to allow default providers to come and go as default providers needs to be considered with caution and fully thought through.

Recommendation: That no provision is made for the appointment of unlimited number of default providers.

7. RESPONSIBLE INVESTMENT

7.1 In contrast with the 2012 KiwiSaver default review, the 2019 review looks at the issue of responsible investment, given product disclosure statements must currently state whether investment policies and procedures take responsible investment into account.

7.2 First, BusinessNZ would like to point out that we are not against any form of legal investment available in the market. We believe consumers should be able to invest in areas such as weapons manufacturing, alcohol, fossil fuel options or cigarette manufacturing, compared with areas such as clean green technology. It is the right of all investors to make their own choice about the investments they are comfortable with, given that money invested is the personal money of the investor, not the state.

7.3 Second, the subjective nature of what is deemed 'responsible investment' means there should be no requirement for default providers to exclude certain sectors/industries from their default fund portfolios. What is considered responsible investment one day can quickly be considered as not the next. Also, cutting off areas where funds can be invested leads to an increasingly smaller pool of options, harming the balance between risk and return often required for alternative default KiwiSaver schemes. Any move to restrict the pool of possible investment needs to meet a high threshold in terms of standard policy practice.

Problem definition - would default members want their investments to be more responsible?

7.4 We strongly support the point raised in paragraph 132 of the Document that default members are free to choose a more responsible fund if they wish. Freedom of choice is a key element when looking at responsible investment under the auspices of default member schemes.

7.5 We urge caution with the supposed evidence showing KiwiSaver members in general as interested in responsible investment, including both the Colmar Brunton and Consumer NZ research. Responsible investment questions tend to see respondents choosing what they deem the socially desirable response, rather than indicating actual choice. This is evident from both the Colmar Brunton and Consumer NZ findings; both give the impression of KiwiSaver members expecting their investments to be made responsibly and ethically but with only a fraction choosing their provider based on these criteria. The same can be said of those willing to accept a lower return from a responsible fund.

7.6 In addition, neither piece of research differentiates between KiwiSaver members actively choosing their investment product and those who end up as default members. Our view would be that if certain members decide not to actively choose the type of investment they want, then why would they also care whether a default fund promotes responsible investment.

7.7 Also, we believe there is poor alignment between where responsible investment sits and the review's objective. As stated above, the primary objective should be to ensure default members acquire adequate savings so that, on retirement, they can enjoy a decent quality of life. Looking through the criteria, we struggle to see how any of this is achieved by attempting to promote so called responsible investment. We would rather see effort put into the type of investment vehicle, as opposed to what could end up being a costly and prohibitive discussion about picking and choosing actual investments.

7.8 Last, we think any discussion of responsible investment for default funds is largely irrelevant. If some KiwiSaver default holders are not pleased with investment changes made, there is nothing stopping them from switching to an active fund that complies with their view of responsible investing. In fact, it could be argued that if the stated numbers of KiwiSaver members strongly advocating for responsible investment are to be believed, there is a greater chance of getting default members into active funds simply by not having default funds in responsible investments. This would be a perverse outcome but highlights the tricky nature of what is being examined.

Options for responsible investment

7.9 The Document outlines two options for responsible investment:

1. Require mandatory exclusion of certain industries or companies, and/or
2. Standard disclosure for responsible investment

7.10 Given our discussion above we do not support option 1 that would require default providers to exclude certain sectors/industries from their default fund portfolios. We believe this option goes fundamentally against the primary purpose of ensuring a better financial position for KiwiSaver default members by reducing default providers' options for investment. Not to mention the highly subjective nature of what can be deemed to be responsible investment.

Recommendation: That certain industries or companies are not subject to mandatory exclusions

7.11 Regarding option 2, BusinessNZ is more open to changes that would allow for the disclosure of responsible investment criteria. Overall, we believe transparency of information can assist both businesses and consumers to make what they consider the most advantageous decision for their own set of circumstances.

7.12 The Document provides the option of requiring default providers to follow a standard method of disclosing responsible investment criteria. However, BusinessNZ is of the view that this might not be the best approach. Instead, we would support the establishment of voluntary guidelines written in consultation with default member providers. That way questions as to what would or would not be required by way of disclosure would be answered, but with an inbuilt flexibility where default providers could choose the best way to disclose their responsible investment criteria.

7.13 Shifting towards a voluntary set of guidelines as opposed to imposing a mandatory standard method of disclosure is a logical step when moving up any regulatory pyramid, as well as lessening the possibility of unintended consequences.

7.14 Last, given the subjective nature of what is deemed responsible investment, we have no firm views about what would have to be disclosed. However, if, in consultation with the various providers, some form of guidelines was established, this would help mitigate inevitable uncertainty.

Recommendation: That further work on option 2 results in a set of voluntary guidelines developed in consultation with default member providers.

8. CAPITAL MARKET DEVELOPMENT

8.1 In addition to the issue of responsible investment discussed above, the Document also examines capital market development. We consider the options put forward for both these broad issues are simply two sides of the same coin. One option seeks to exclude the ability to invest in certain areas while the other seeks to make certain areas mandatory. Neither approach is in the best long-term interests of default KiwiSaver members.

8.2 BusinessNZ supports having deep and liquid capital markets in New Zealand to further the growth of New Zealand businesses and the wider New Zealand economy. We have consistently advocated for an improvement in the quality of regulation across all facets of the economy, to help reduce barriers and facilitate better opportunities for capital market development.

8.3 Chapter 7 of the Document looks at whether the KiwiSaver default settings play a lesser or a greater role in achieving such results and in principle, BusinessNZ can see KiwiSaver playing a part in developing domestic capital markets. However, the mechanism for achieving this must be well thought through as clear and overwhelming evidence will be essential if any changes made are not to create unintended consequences.

8.4 First, however, we would like to point out that the key element of the capital market issue is touched on in paragraph 181 which rightly points out that in regard to option 1, any such effect will depend on a default member fund moving further towards a higher risk option. And paragraph 175 states that a general move away from a conservative fund to one taking on more risk could also see a natural shift towards deepening capital markets in New Zealand - the spill-over effect of part of all investments seeking higher-growth oriented assets. Therefore, BusinessNZ reiterates our view that there must be a move away from a conservative fund if the review's other areas for change are to succeed.

8.5 In addition, paragraph 174 states *'we have not included an option to require providers to invest a certain percentage of default funds in New Zealand'*. BusinessNZ strongly agrees with this decision particularly as, the same paragraph points out, default funds are already heavily invested here. Further, a mandatory investment push in one area could lead to over-exposure to the New Zealand economy while hampering fund managers' ability to take an optimal and careful investment approach.

Options for change

8.6 Regarding specific options, the Document outlines two possibilities, namely:

1. New Zealand-based management requirement; and/or
2. Targeted investment requirement

8.7 With option 1, we believe the first step will be ascertaining the level at which New Zealand-based management is already occurring in New Zealand. It may the case that a significant number of the activities associated with default fund management are already being conducted in New Zealand. Therefore, any attempt to introduce a New Zealand-based management requirement might have little effect, or conversely, place an onerous burden on default providers. While there will always be a fair degree of subjectivity regarding an optimal New Zealand-based management requirement, we urge caution in setting an arbitrary requirement which default providers will have to meet.

Recommendation: That further information is sought from default providers before any preliminary option 1 decisions are made.

8.8 With option 2, we struggle to see how this is not ordering default providers to invest in certain areas. As discussed above, on the one hand there is a clear statement that the Document does not include an option to require providers to invest a certain percentage of default funds in New Zealand. However, requiring default providers to invest in a certain percentage of default funds with a specific focus is essentially, just that. While the focus on New Zealand assets is not expressed, it is implied, especially as the only example given is investing in alternative New Zealand assets. Although the Document argues that it would likely be a small percentage with a specific focus, we do not believe this is the point.

8.9 In principle, default providers should be free to allocate 100% of their funds to whatever they believe is in the best interests of their investors. Our concern with introducing an arbitrary percentage is that once embedded, the percentage can be increased further for either vested interest or political purposes. Also, in relation to the above discussion of responsible investment, there could be a precedent set requiring a certain percentage of funds to be allocated to whatever is deemed a responsible investment.

8.10 More broadly, as with the responsible investment discussion, we are concerned that capital market development is another area that takes the eye off the prize, that is, that the primary purpose of KiwiSaver is to ensure default members are in a better financial position, particularly when they retire. We have absolutely no concerns about default providers deciding to focus a percentage of default funds on a specific target if they believe this will assist with default members' long-term savings. However, such decisions should always be voluntary, not mandatory.

Recommendation: That for default fund providers, option 2, involving a targeted investment requirement, is voluntary.

8.11 Last, BusinessNZ is open to other options being explored to develop New Zealand's capital markets, particularly where the KiwiSaver legislation has regulatory barriers prohibiting investment in higher-growth orientated assets. We would support further engagement on this matter, if other submitters have identified areas for regulatory improvement.

Recommendation: That consideration is given to options from other submitters concerning capital market development, particularly regarding the reduction of regulatory barriers.

9. TRANSFER OF MEMBERS

9.1 Given the possibility of some default providers not being reappointed, we believe it is important to find the best option for member transfer to minimise disruption to both members and default providers. The Document has identified three options:

1. Allocate all default members among appointed default providers;
2. Default members from default providers not reappointed would be transferred; or
3. Existing default providers retain their default members.

Examining the costs and benefits of the transfer options that would deliver the best outcomes for default members, we believe option 1 to be the least desirable. At a practical level, we simply do not see the need to allocate every default member when the discussion should really be about what option 2 examines, namely what to do with the default members from default providers not reappointed. Therefore, we rank option 2 higher than option 1.

9.2 Option 3, with existing default providers retaining their default members, would produce an interesting situation. First, if default members do not change their provider and decide to stay with what will become a non-default scheme, in a perverse way this will move a proportion of default members into an active fund, albeit most will remain in a conservative setting. Second, in some ways options 2 and 3 have similar traits but opposing outcomes. Option 2 may also incorporate the option for members to remain, while option 3 will provide the option to leave. It goes without saying that whichever option is chosen, some members of default providers who are not reappointed will leave, while some will stay. Therefore, the end outcome for options 2 and 3 may, on the face of it, be relatively similar.

9.3 However, one point not made in the Document relates to future scenarios. We believe any decision here should note the fact that while a default provider may not be reappointed at present, that does not rule out later reappointment. For whatever reason, an ex-default provider might in future decide to reapply and after meeting the criteria, be re-appointed. Therefore, would it be best if, for this reason, ex-default providers had the capacity to keep a proportion of their default members? And if re-appointed at a future time, would it be the case that those default members who had stayed on would then also be re-appointed as default KiwiSaver members? In short, any decision on the three options presented needs to recognise future implications for default members.

9.4 Overall, we have no strong views separating options 2 and 3 and would support further work being undertaken on these two options, particularly where commonality can be reached. However, we do not believe option 1 should be given any further consideration.

Recommendation: That option 1's proposals for member transfer receive the least consideration.

Member choice to remain

9.5 As touched on above, both options 1 and 2 also discuss the additional possibility of members choosing to remain with a default provider. Broadly speaking, if option 1 or 2 proceeds, BusinessNZ supports the choice of members staying with their current provider. While we are not in a position to provide details on exactly what that mechanism should be, for a scheme that has been built on the freedom to be active or inactive with investment choice, any option removing the right for default members to stay where they are would seem contrary to that inherent position.

Recommendation: That if either option 1 or 2 proceeds, default members can choose to stay with their existing default provider.

10. MEMBER ENGAGEMENT

10.1 BusinessNZ remains a strong supporter of financial literacy initiatives to help all New Zealanders make the most advantageous decisions to improve their overall wealth. Presently, there are various programmes assisting with this, including initiatives developed by several default providers.

10.2 We have no concerns with default providers deciding to work together in a voluntary and coordinated manner on the matter of their members' financial literacy or deciding to use a third-party provider. Default providers should be free to choose whatever system works best to ensure financial literacy initiatives are successful. However, while such initiatives should be encouraged at every opportunity, we do not believe they should be mandatory as all schemes have a monetary cost that default providers need to consider. If such programmes were to become mandatory for default providers, we would be concerned that these initiatives would end up simply as a 'tick the box' exercise, as some default providers will have little interest in financial literacy initiatives.

10.3 Last, as initially pointed out, it must be recognised that whatever the level of financial literacy, there will always be a proportion of the KiwiSaver population that will neither listen, nor care. But by opting to stay in the KiwiSaver scheme, such individuals have at least taken one important step towards improving their long-term savings, particularly their retirement savings.

Appendix One - Background information on BusinessNZ

BusinessNZ is New Zealand's largest business advocacy body, representing:

- Regional business groups EMA, Business Central, Canterbury Employers' Chamber of Commerce, and Employers Otago Southland
- Major Companies Group of New Zealand's largest businesses
- Gold Group of medium sized businesses
- Affiliated Industries Group of national industry associations
- ExportNZ representing New Zealand exporting enterprises
- ManufacturingNZ representing New Zealand manufacturing enterprises
- Sustainable Business Council of enterprises leading sustainable business practice
- BusinessNZ Energy Council of enterprises leading sustainable energy production and use
- Buy NZ Made representing producers, retailers and consumers of New Zealand-made goods

BusinessNZ is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

In addition to advocacy and services for enterprise, BusinessNZ contributes to Government, tripartite working parties and international bodies including the International Labour Organisation (ILO), the International Organisation of Employers (IOE) and the Business and Industry Advisory Council (BIAC) to the Organisation for Economic Cooperation and Development (OECD).