Report on
KiwiSaver Supply Side Evaluation

July 2010

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Executive Summary

Introduction

This evaluation is part of the joint evaluation of KiwiSaver being undertaken by Inland Revenue (IR), the Ministry of Economic Development (MED) and Housing New Zealand Corporation (HNZC).

The specific focus of this evaluation is the supply-side impacts of KiwiSaver; that is, the effect of KiwiSaver on the superannuation and managed funds market and the wider financial services sector. The effect on overall household savings will be the subject of a separate study when sufficient data becomes available.

As at 31 March 2010 the Crown is still the largest contributor to KiwiSaver with an estimated contribution of $2.3 billion. Members have contributed approximately $2.1 billion and employers $0.9 billion.

Objectives

This report uses two sets of indicators: the firm dynamics indicators – to show the health of the KiwiSaver market; and the market dynamics indicators – to show how the KiwiSaver market relates to other superannuation and managed funds more generally.

In addition the report documents:

- what market participants are saying about the key influences of KiwiSaver on the market, including impacts on fees, financial performance, marketing and overall savings levels; and
- the changes to the superannuation market and the wider managed funds sector since the introduction of KiwiSaver.

Findings

KiwiSaver is still a small part of the overall managed funds sector, making up only 9% of total funds under management compared to 29% for other superannuation schemes. Furthermore, the average member account balance remains low at just under $5,000 as at 31 December 2009 (based on 24 survey respondents).

The last two to three years have seen the largest cyclical economic downturn in the global economy since the Second World War, which was clearly seen in the returns posted by KiwiSaver funds and other managed funds more generally. This, however, has not slowed the growth of KiwiSaver with contributions and member growth continuing.

As at 31 December 2009 53% ($2.6 billion) of KiwiSaver assets are invested in New Zealand; this is a higher proportion than for other New Zealand superannuation schemes which is 38%, but less than New Zealand managed funds in general (56%). KiwiSaver funds also have a higher proportion of funds (14% or $697 million) invested in New Zealand (NZ) equities than both other superannuation schemes (9%) and NZ managed funds overall (11%). Yet KiwiSaver's small absolute size means it has little impact on capital markets within New Zealand at present.

In the short term the profitability of providers' KiwiSaver activity remains marginal. This is because funds under management is the main driver of revenue and this has taken a hit with the adverse economic conditions within which KiwiSaver has operated over the past three years. In addition, the halving of the minimum member contribution to 2% and setting the Compulsory Employer

Contribution (CEC) to 2% (rather than having it increase to 4% in 2011) will slow the growth of funds under management. Profitability has also been influenced by the level of costs associated with servicing a large retail client base (with small average balances) and aspects of KiwiSaver such as queries about, applications for, and the administering of hardship claims[1].

The low level of profitability within the industry is expected to push consolidation within the industry. The consolidation of providers may not mean the disappearance of smaller providers as some have been able to build robust niche positions within the market. Of the 24 providers responding to the survey, 79% expected that the number of providers will likely decrease over the next three years.

The health of the KiwiSaver market is most strongly shown from its profitability. While profits are being squeezed in the short term, not least due to the global financial downturn, the profitability for providers over the longer-term appears likely to be quite positive. The second key indicator of health is the number of substantial players, i.e., those that have at least 5% of the market share. The fact that two active choice providers have a market share of greater than 5% is a good sign of current competitiveness; the six default providers also have a market share of greater than 5%.

The exit and entry of schemes is another aspect of competition within the market. To date three schemes have closed to the market while two have opened in 2010. The two new schemes, operated by Milford Asset Management and Kiwibank, both had relationships with existing KiwiSaver providers. The ease of transferring members and accounts from schemes that have closed to other providers can be seen as a positive for the way KiwiSaver was established.

The introduction of the Financial Markets Authority (FMA) is seen by providers as a positive step towards increasing the transparency of fees and returns, as well as helping to restore public confidence in the financial sector more generally.

This report highlights a number of innovations in the market, such as new schemes, repositioning by providers, and new strategies by providers to offer high quality services to their members.

Policy Implications

The low level of transparency around fees and returns was highlighted in our 2008 report[2]. It is still an issue and the government intends to address this through legislation currently being drafted. Work is also being under taken by the Investment Savings and Insurance Association (ISI)[3] to introduce industry standards in this area. As the new Financial Markets Authority (FMA) is established, it will be important to ensure that the opportunity to introduce transparency around fees and returns works well in practice in this market.

With the current low profitability of KiwiSaver schemes in general, there is a need to monitor compliance costs imposed on providers, particularly with the recent Cabinet decisions regarding changes to the governance and reporting requirements for retail KiwiSaver schemes to be implemented through the FMA. It also needs to be acknowledged that the sector will not promote KiwiSaver aggressively to the general public and that the government kick-start payment and member tax credit (MTC) remains important to the success of the policy. The 2010 survey of

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[1] Most major providers interviewed identified this as being an issue and set out the detailed work required. The IR survey of individuals (undertaken in 2010) found that only 3% of respondents had been successful in a hardship claim. However, this may not be representative of the total population.

[2] The report can be found at: http://www.med.govt.nz/templates/MultipageDocumentTOC____40717.aspx

[3] The ISI is an industry body made up predominantly of the large banks and insurance companies who offer financial service products. It lobbies Government on tax and regulatory issues and attempts a level of industry self-regulation.

individuals shows that Government contributions (the kick-start payment and MTC) were the second most important factor in members' decisions to join KiwiSaver (19% of 474 members)[4].

With the level of new members still growing strongly, there is an ongoing question around the required number and position of default providers. These providers have a privileged position in the market which arguably affects competition. This is due to be reviewed in 2014. However, the ease of transfer between schemes lessens the effect of the default provisions. The report of the GA shows that approximately 4% of members transferred between schemes during the year ended 31 March 2009. Furthermore, the GA has indicated that this figure will increase for the latest period. There is some concern that the ease of transfer could constrain the performance of KiwiSaver due to the implications for liquidity. However, given the other considerations to competition it is too early to consider changes to the market.

Evaluation method

In undertaking this report, MED:

- surveyed the KiwiSaver providers[5] (24 out of the 31 providers surveyed responded to the survey);
- carried out desk-based research;
- interviewed seven providers and the ISI; and
- sought expert advice from Erikson and Associates Ltd, an independent firm of actuaries, investment strategists and business consultants

Future work

It is envisaged that this report will be updated in two years time and again when the study of the effect on overall household savings is undertaken.

Future work could look at assessing how well KiwiSaver providers have invested funds as this would help to test the health of the market. This assessment would need to draw on consistent reporting of returns and the selection of appropriate benchmarks. It could also consider the extent to which providers' use best practice processes for the selection of portfolio allocations and investments within these allocations.

[4] The most important factor, selected by 40% of respondents, was: *a way to make sure I have enough money for my retirement/future*.

[5] Providers are those organisations that administer schemes and that have a scheme provider agreement with Inland Revenue.

Introduction

KiwiSaver was principally introduced to help New Zealanders maintain their living standards in retirement by helping them save for retirement from their income. A secondary intention was that it would help local capital markets by providing an additional source of investment funds. On 1 July 2010 KiwiSaver had been running for three years. A key part of ensuring the future success of KiwiSaver is to maintain a positive environment for KiwiSaver providers so that they will continue to provide sufficiently competitive KiwiSaver schemes for New Zealanders to invest in.

This report looks at how the market has developed to facilitate KiwiSaver in meeting its objectives. It considers whether the market for KiwiSaver is one in which providers will be able to continue to offer a range of applicable and viable products.

This report was produced with input from Erikson and Associates Ltd who are an independent firm of actuaries, investment strategists and business consultants.

Objectives

This report uses two sets of indicators: the firm dynamics indicators – to show the health of the KiwiSaver market; and the market dynamics indicators – to show how the KiwiSaver market relates to other superannuation and managed funds more generally.

In addition the report is to document:

- what market participants are saying about the key influences of KiwiSaver on the market, including impacts on fees, financial performance, marketing and overall savings levels; and

- the changes to the superannuation market and the wider managed funds sector, since the introduction of KiwiSaver.

Evaluation method

In this report we have used the following sources of information:

- The framework developed for MED by PricewaterhouseCoopers (PwC) in 2008 to study changes within the KiwiSaver and wider managed funds markets. This report loosely follows the PwC framework.

- The Government Actuary (GA)'s annual reports on superannuation and KiwiSaver. These reports provide information on fund flows, membership and schemes. The data for superannuation, however, is not as timely as the Managed Funds Survey (MFS) and does not have a consistent reporting date. [6]

- The MFS (conducted by the Reserve Bank of New Zealand (RBNZ)) is completed quarterly by most fund managers and includes 90% of funds under management. It reports on total funds under management, investment in various New Zealand asset classes and total investment overseas.

- The 2010 survey of KiwiSaver Providers conducted by MED (24 out of the 31 providers surveyed responded to the survey).

[6] The GA report, issued as at 30 June each year, states that the majority use a 31 March balance date.

- Interviews with seven Providers and the Investment Savings and Insurance Association (ISI) New Zealand.

- Inland Revenue's KiwiSaver evaluation survey of individuals (CB survey of individuals), which included KiwiSaver members and non-members (conducted by Colmar Brunton in 2010).

- Inland Revenue's monthly statistics on KiwiSaver membership. Membership information for managed funds more generally is not available.

- The Eriksen's Master Trust Survey. This is a quarterly survey of New Zealand employer master trust fund performances which Eriksen & Associates have been conducting since March 1997. It includes all of the major master trusts, which are multi-employer superannuation schemes managed by major financial service providers.[7]

- Morningstar's KiwiSaver Survey.

- The Plan for Life managed fund survey.

Report Structure

This report builds on the PwC study and re-examines the KiwiSaver market within the context of that framework in the following sections.

- **The wider economic environment** within which KiwiSaver operates such as the volume of managed funds within New Zealand, the performance of the NZX, and other markets.

- **The firm dynamics framework**. This covers various aspects including competition, consumer choice, innovation, profitability, return on investment, consolidation and market entry. We highlight some of the concerns raised in the original report relating to reporting and transparency of fees and returns and discuss what has happened subsequently.

- **The Market Dynamics framework**, taking into account assets under management, New Zealand investment, New Zealand equities, membership and schemes.

  The framework places the KiwiSaver market within this wider setting in terms of funds under management and membership. This section shows how KiwiSaver fared in the recent economic downturn compared to the wider environment.

  The operation of the KiwiSaver market plays an important part in determining if KiwiSaver will be successful.

- **Backgrounds changes likely to impact on the KiwiSaver market** and wider financial sector, including the views of some of the providers on these changes.

- **Issues around default providers and default investment options**.

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[7] A feature of this survey is that the performances are shown net of all fees and tax, so that it shows the actual return that members can expect to see credited to their balances.

- **Findings and Conclusions**
- **Appendix 1: Evaluation method**
- **Appendix 2: Provider survey results**

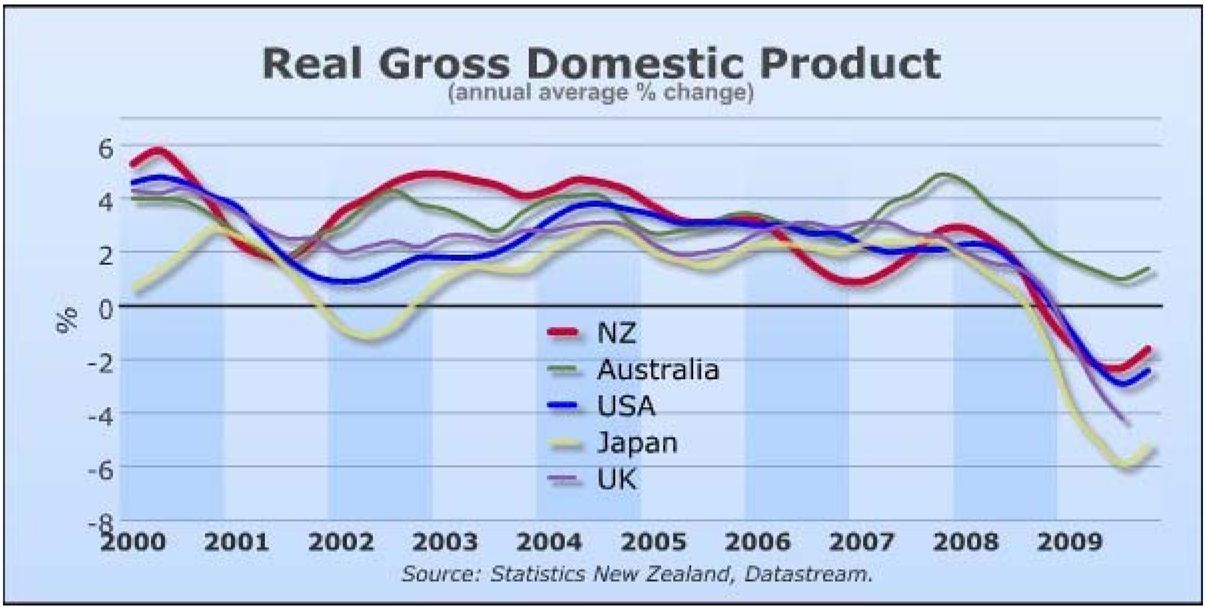
Current Economic Environment

Wider economic conditions

The last 2-3 years have seen the largest cyclical economic downturn in the global economy since the second World War, which was aggravated by the high levels of both government and personal debt in many of the developed countries. A wider global depression was averted by the application of massive government stimulus, especially to those struggling major financial institutions which were deemed too large to be allowed to fail. While this averted immediate catastrophe, it also loaded more debt onto governments which were already indebted while facing lower tax revenues and higher social costs (unemployment benefits) from the downturn.

The following graph shows the manner in which GDP in the developed nations fell after the start of the credit crunch, with Japan, the U.S. and the U.K. being particularly badly affected. It is no coincidence that these all had serious impending, or current, structural problems at the outset, and that these were exacerbated by the crisis. All three countries now have serious public debt which will take some years to bring to manageable levels.

Australia (especially) and New Zealand have come through the crisis relatively well, largely because their banking systems have remained intact. Australia has benefited from the continuing demand for industrial minerals from China and the government's stimulus packages.



Europe now has serious issues relating to how to manage the varying monetary policy needs of the different Euro zone countries. There is a bitter debate (also present in the U.S. and U.K.) as to whether continued stimulus or strictly enforced austerity is the most appropriate fiscal policy.

Whatever measures are taken, the current global downturn appears to be with us for some time yet, with any eventual recovery possibly following further periods of (hopefully short-term) recession in the developed western countries. While Asia (especially China) is providing trade growth stimulus to the world economy, the debt issues in Europe and America are continuing to adversely affect and essentially dominate global capital markets.

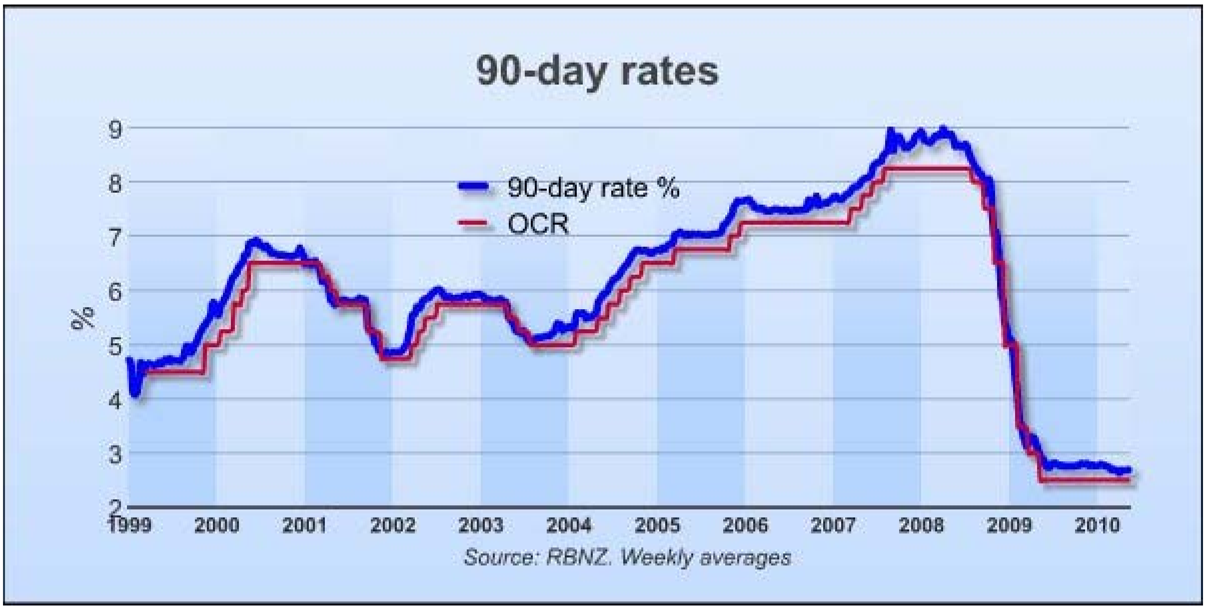
Interest Rates

Following the immediate crisis in 2007 and early 2008, capital markets and interbank lending dried up. Lenders in New Zealand and elsewhere began to fail as the more vulnerable borrowers started to default on their repayments, and investors failed to turn over their investments.

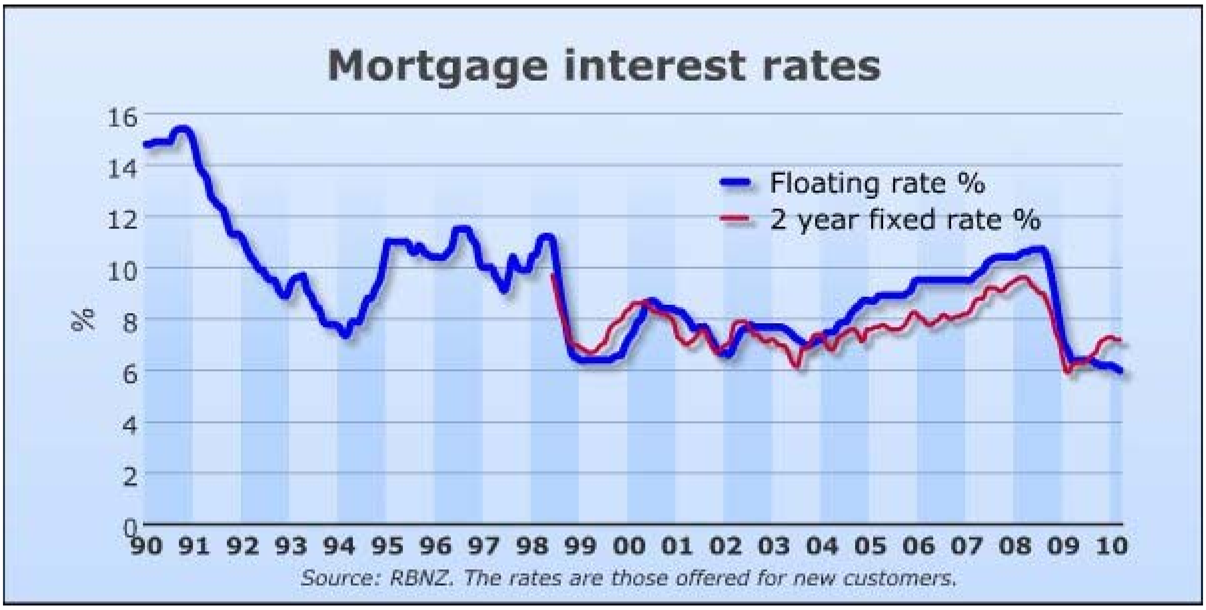
Asset prices fell abruptly as everyone sought cash to ensure their immediate liquidity, and short-term interest rates rose sharply - which placed more pressure on already overextended corporates and homeowners.

As a result, central banks in the worst affected countries slashed interest rates to near zero, and have kept them low since. New Zealand and Australia have since started to slowly increase their interest rates, however this has been done cautiously to avoid snuffing out an already fragile recovery.

The following graph shows the manner in which 90-day bank bill rates fell rather abruptly from historically high rates, to a low level which has left very little scope for further reduction.



How that has fed into retail New Zealand mortgage interest rates is shown in the next graph. The sharp fall in the fixed rate during 2008 and 2009 is evident, as is the recent upturn in the 2-year fixed rate as expectations of further interest rate rises increase. The New Zealand housing market appears to be still soft, with the number of sales at a low level while the public tries to reduce household debt.



Overall, the threat of low interest rates stimulating over-consumption is generally seen as much less likely than the risk of too-high rates depressing demand to the point that unemployment remains high.

Asset markets were generally inflated prior to the recession and have not returned to their former levels. Some recovery has occurred from the extreme lows. The continuing uncertainty has also resulted in investors tending to react strongly to both good and bad news, which has also created continuing volatility.

Effect on Managed Funds

The adverse economic conditions of the past three years have had a significant effect on managed fund performances which have also fluctuated widely. The following chart shows how the NZX and MSCI[8] indices have fallen since their high points in September 2007. While much of the value lost has been regained, current levels are still well below their pre-crash peak and the recovery has been spasmodic and volatile at times. This has been reflected in the values of those managed funds which are heavily weighted towards growth assets.

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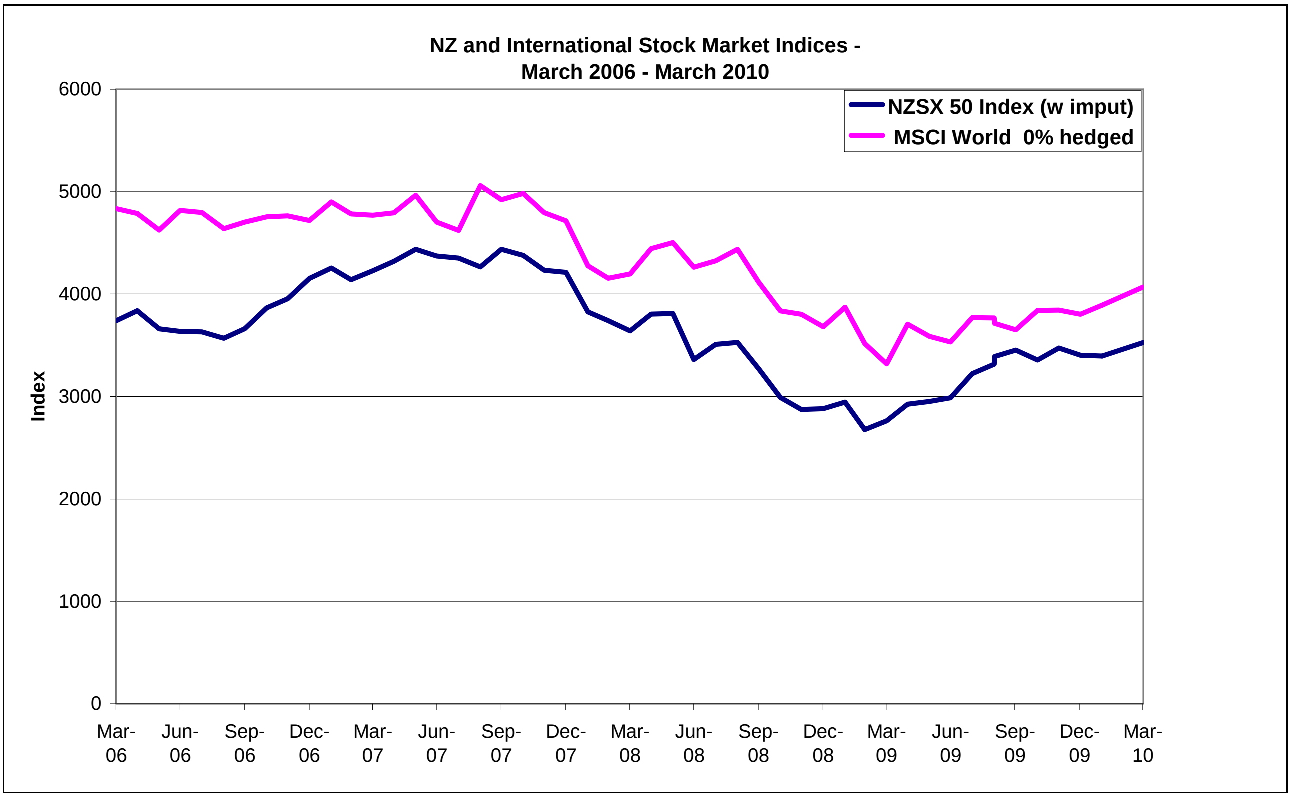
[8] Morgan Stanley Capital International (MSCI) constructs a variety of indices covering a wide range of developed and emerging economies and a wide range of economic sectors.

They are used to help institutional investors benchmark their returns and as a basis for some exchanged-traded investment funds.

Housing and property values are also below their pre-crash highs since the bubble, induced by excess and freely available credit in many countries. This has now been replaced by a surplus of stock as financially over-committed owners try to liquidate their assets.



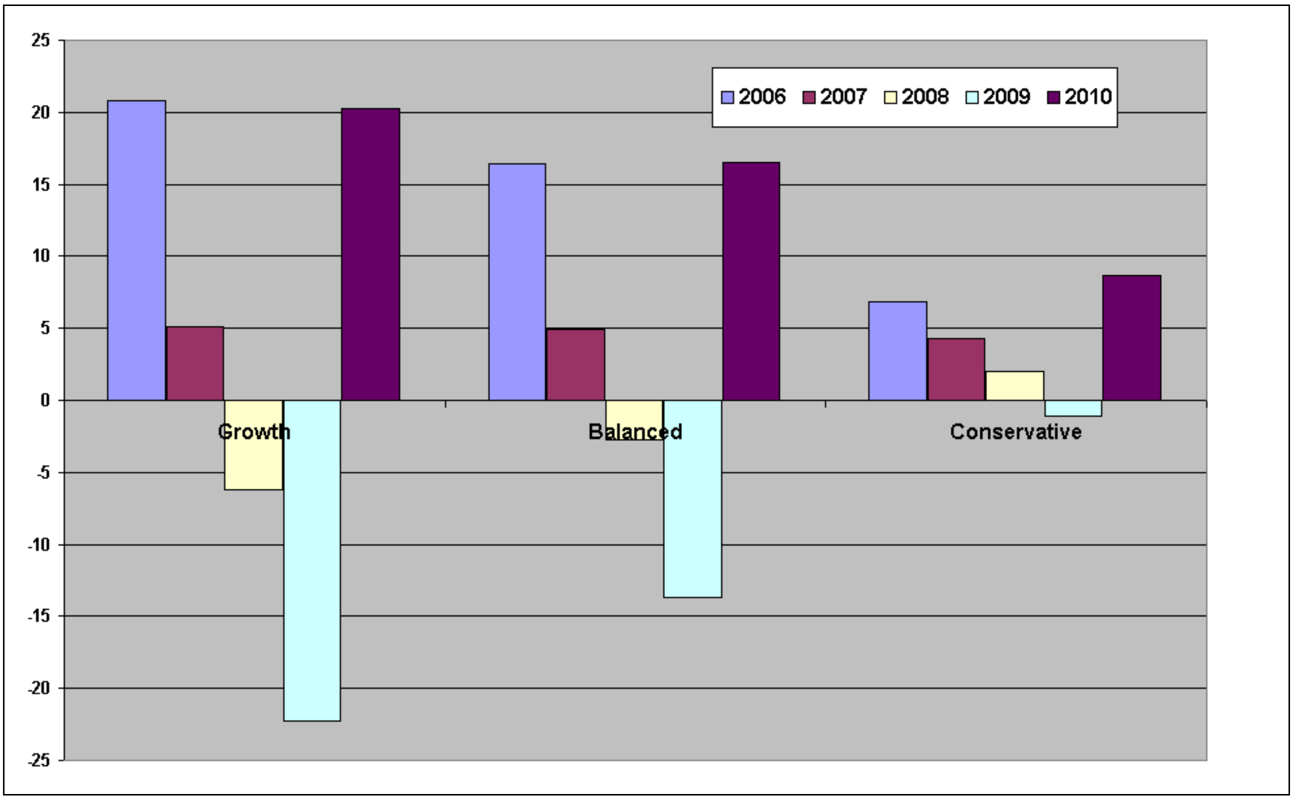
For the following discussion we have used analysis from the quarterly Eriksen's Master Trust Survey, which has been reporting on the superannuation funds invested via employer master trusts since 1997. It has been used in this report to give a longer timeframe than is available from the KiwiSaver surveys, since KiwiSaver monies have, to date, been invested for less than three years.

The Eriksen's Survey reports the after tax (at 30%/33%) and fees returns, which are the actual returns that a scheme member should actually receive in their account, rather than the pre-tax KiwiSaver returns which are generally quoted in performance surveys, but which are very difficult to adjust to allow for tax at the various rates which could apply.

The master trust providers included in the Eriksen's survey are largely also KiwiSaver providers. Their master trust investment performance can also be taken as reasonable proxies for their KiwiSaver investment options.

The chart below uses returns from the Eriksen's Master Trust Survey and shows the after tax (at 30%/33%) and fees returns for growth, balanced and conservative superannuation options invested in superannuation funds via employer master trusts. It can be seen that, as might be expected, the higher risk categories fell by the most during the years to 31 March 2008 and 2009 and that they made the greatest recoveries, although they are still well below their pre-crash levels.

One Year Returns to 31 March by Risk Category



Source: Eriksen's Master Trust Survey 2006-2010

Brief History of Superannuation Fund Balances

From past GA reports it is interesting to see the lack of growth in superannuation fund savings since the mid 1980s.

In March 1987 there were $12 billion in New Zealand superannuation savings assets held in some 6,000 superannuation schemes. By 1990, following the October 1987 stock market crash, the December 1987 superannuation tax changes from EEt (exempt contribution income, exempt investment income and partially taxed benefits) to TTE (Taxed contribution income, Taxed investment income and Exempt benefits) and the broader economic reforms to manufacturing and agriculture, the number of schemes had reduced to 3,000 and assets to $11 billion. The trend of a declining market continued:

- By 1994 the number of schemes had reduced to 2,000 but funds had risen to $14 billion.
- In 1995 the number of schemes was down to 1,500 but funds had increased to $14.4 billion.
- By 2004 the number of schemes had dropped to 600 but the assets had reached $16.7 billion.

KiwiSaver Firm Dynamics

Our evaluation framework, developed in 2008, uses seven firm dynamics indicators to monitor the supply-side impact of KiwiSaver.

The following table summarises the values of those indicators as at June 2008 (as given in the 2008 report) and at December 2009. Each indicator is then discussed in more detail below. Further detail can also be found in Appendix 2 which contains the relevant results from the survey of providers.

Firm Dynamics at 30 June 2008 and 31 December 2009 Compared

Aspect	Measure	Source	Schemes June 08	Schemes Dec 09	Providers June 08	Providers Dec 09
Competition	Number of Providers with greater than 5% of market share.	Survey			7	8
Consumer choice	Number of retail schemes and Providers.	GA register	36	34	31	30
Innovation	Number of new schemes/ new Providers.	GA register	25	2	11	0
Profitability	Providers expecting profitability.	Survey			91%	83%
Return on investment	Number of Providers with payback periods of less than 8 years.	Survey			91%	60%
Consolidation	Number of schemes and Providers.	GA register	54	52	31	30
Market entry	Number of new providers offering publicly available KiwiSaver schemes.	GA register	-	-	11	0

Competition

Market concentration is the primary indicator for competition. The following measures of market concentration have been adapted from the 2008 study.

Providers with 5% or more market share

As at 31 December 2009, eight KiwiSaver providers had 5% or more market share in terms of funds under management (one more than reported in the 2008 study).

The Herfindahl-Hirschman Index (HHI)

Another measure of market concentration is the Herfindahl-Hirschman Index (HHI). The HHI takes into account the relative size and distribution of the companies/groups in a market and approaches zero when a market consists of a large number of groups of relatively equal size. The HHI increases both as the number of groups decreases and as the disparity in size between those groups increases. Markets with an HHI between 0.10 and 0.18 are considered to be moderately concentrated, while those with which an HHI is greater than 0.18 are considered to be concentrated.

At 31 March 2010 the KiwiSaver market had an estimated HHI value of 0.13 using assets invested as the proxy for market share, or 0.11 using membership. By this measure the KiwiSaver market thus falls midway into the moderately concentrated range.

For comparison the table below shows the Herfindahl-Hirschman Index (HHI) for various types of managed funds taken from the Plan for Life Survey as of 31 March 2010. This indicates that all of the markets tested are moderately concentrated. KiwiSaver is comparable in market concentration to the market for other superannuation products and is only slightly more concentrated than the market for non-superannuation and retail funds.

Herfindahl-Hirschman Indexes (HHI) for the managed funds sectors

	HHI based on FUM
KiwiSaver	0.13
Other Super	0.13
All Super (incl. KiwiSaver)	0.12
All Retail	0.10
All Non-Super	0.11
Unit Trusts + Managed Funds	0.11

Source: Plan For Life Survey as of 31 March 2010

Distribution of Schemes by FUM

Each KiwiSaver scheme offered to the public is a separate entity which must be registered with the GA.

The entity which administers and operates each KiwiSaver scheme is that scheme's provider. While most providers operate only one scheme, some operate more. For example ING provides one scheme under its own name however, as a wholly owned subsidiary of the ANZ Group, it also provides the ANZ Bank and National Bank schemes. The advantage of this to ANZ/ING is that it gives them three schemes which can be sold under its three major retail brands, while only having only a single set of processing overheads.

The following table has been compiled from the GA's 2008 and 2009 KiwiSaver reports and includes those schemes that supplied the relevant numbers. The table shows that the total number of schemes has increased by 8 (17%) from 46 to 54 – with the distribution of fund sizes broadening as the largest schemes grow at a greater rate than those "in the middle of the pack".

Distribution of schemes and members based on schemes asset size[9]

Scheme Size	Number of Schemes		Number of Members	
	March 2008	March 2009	March 2008	March 2009
Under $0.5m	13	11	1,009	446
$0.5m to under $2.5m	8	9	6,495	2,259
$2.5m to under $ 10m	10	10	34,897	15,565
$10m to under $25m	6	6	60,399	45,839
$25m to under $50m	3	6	383,387	79,759
$50m to under $100m	5	3		115,054
$100m and over	1	9		716,687
Total	46	54	486,277	975,608

Source: Adapted form the GA reports

We note that there are some indications of healthy competition in the market structure. The top seven providers include one non-default provider (Westpac) at number four[10], showing that it has been able to use the distribution provided by its extensive branch network to overcome the inherent disadvantage (vs. the default providers) in not gaining new members through the auto enrolment process. The market share gained by some of the smaller and less well resourced niche providers, especially Gareth Morgan and Fisher, is also remarkable and shows the power of their brand amongst retail investors.

How Providers Intend to Compete For Members

One measure of competitiveness in a market is the extent to which the players in it compete for new business. The 2010 MED provider survey questioned providers about the measures they intended to take in the future to increase their membership.

Selected results from the provider survey are summarised in the attachment at the end of this report. From the responses to the first three tables shown in the appendix, it can be seen that:

- Over the coming year the majority of providers will target both new and existing KiwiSaver members.
- However only two indicated that their strategies between existing KiwiSaver members and those that have yet to join were different.
- A third aspect of membership that providers were focused on was stemming the flow of members transferring out of their products – member retention.
- A number of methods are employed by providers to attract new KiwiSaver members, with direct marketing to existing client bases, financial advisors and employer-choice agreements being the most common. Approaching clients/cross selling is also popular.

[9] The data has been obtained from statistical returns made by the trustees of KiwiSaver schemes "registered" under the KiwiSaver Act 2006 that had commenced enrolling new members as at 31 March 2008 and 2009.

[10] Westpac is ranked forth in terms of funds under management in the Plan For Life KiwiSaver Analysis of Funds (as at March 2010).

- Although not differentiated in the survey itself, the interviews showed that the financial advisors used could either be internal or external to the provider.

- Methods used to attract existing KiwiSaver members did not generally differ from those used to attract new KiwiSaver members.

The rate of member transfers between schemes is also considered as an indicator of competition within the market. The GA's KiwiSaver Report shows that for the year ended 31 March 2009, 39,969 members transferred from one KiwiSaver Scheme to another.

Some providers expressed concern that a high rate of transfers could represent members chasing returns and that this could show a lack of financial understanding by members. An alternative interpretation is that they are changing providers as they believe their current one is under performing.

Consumer Choice

Consumer choice can be measured by the number of product offerings - both the number of schemes and the total number of investment options available within those schemes.

Number of Products Offered

As reported above, in 2008 there were 54 registered schemes. These were offered by 48 different companies and administered by 31 providers. Of the 54 schemes 36 were retail with the remainder being for specific corporate groups.

Since then three schemes have closed, Asteron, EO Financial Services (NZ) Limited and IRIS KiwiSaver Scheme, and two new ones have become available – Milford KiwiSaver Plan (which previously managed an investment option within Aon's KiwiSaver product) and the Kiwibank KiwiSaver Scheme (Kiwibank previously had a retail arrangement with Mercer). This brings the total number of registered schemes to 53, with 36 being available to the public (the IRIS KiwiSaver Scheme was not available to the general public).

Two thirds of the 24 survey respondents believed that the number of KiwiSaver investment products would increase over the next three years. In contrast, over two-thirds believed that there would be an overall decline in the number of corporate superannuation schemes.

Providers' expectations of the future number of schemes and providers are a function of current and future profitability (and therefore viability of KiwiSaver). Expectations and actual growth rates will differ between providers, as will the ability to absorb any losses through other business activities until KiwiSaver becomes profitable in its own right.

The fee revenues being earned on a per member basis and based on funds under management and the growth of both funds and members, will not justify continued participation by some small providers.

Although survey respondents (namely KiwiSaver providers) mostly believe that traditional superannuation schemes will continue to decline, they are unlikely to disappear for a number of reasons, since:

- the 2% plus 2% minimum contribution rate and the government incentives to KiwiSaver are unlikely to be sufficient to live off in retirement despite New Zealand Superannuation; and

- people will want to be able to access some form of retirement savings prior to the age at which they are eligible for KiwiSaver and New Zealand Superannuation.

Number of Fund Types Available

Choice also comes in the form of investment fund types that the public can invest in. They range from the standard offerings of conservative, balanced and growth, to a multitude of single sector funds such as equity, property and cash. There are also 'ethical' funds and those that allow members to essentially build their own portfolios. The GA's 2009 report to Parliament provides a breakdown of membership and funds by fund type.

This table highlights not only the popularity of the default options, but also the general conservative nature of those joining KiwiSaver with 491,499 members in Active Default, Conservative, and Cash funds – approximately half of the active choice members.

Number of Members Investing By Fund Type – 2009

Fund Type	Members Investing*	Funds Invested($millions)
Default total	309,708	874
Active choice funds		
Active Default	63,186	156
Conservative	211,111	280
Balanced	242,620	634
Growth	217,637	475
Cash	217,202	143
Shares	13,761	22
Fixed Interest	3,363	5
Property	3,258	8
Socially Responsible	2,419	5
Other	24,292	54
Active choice total	998,849	1,783

Source: GA KiwiSaver Report 2009.

* Members with contributions split between different funds are counted against each type of fund to which they contribute.

Ease by Which Members Can Move Between Schemes and Investment Options

In considering the competitiveness of the KiwiSaver market, an important consideration is how easily members can move between schemes and investment options. Within KiwiSaver, members are able to transfer between investment options within a scheme, and to transfer between different schemes at will using the portability option which allows members to transfer, therefore allowing them to take full advantage of the choices offered.

Although the process to transfer is easy, the numbers transferring has been low. As mentioned previously, the GA's KiwiSaver Report shows that for the year ended 31 March 2009 4% or 39,969 members transferred from one KiwiSaver Scheme to another. A similar story can be seen from the survey of individuals (completed on 2010) that found that 90% of the 474 members surveyed had never changed their provider.

Profitability

Our 2008 study acknowledged that an efficient and competitive KiwiSaver market requires a certain minimum number of providers, with an expectation of sufficient returns to stay in the market and to grow their business.

This aligns well with the overall objective of encouraging a long-term savings habit in New Zealanders and the accumulation of retirement savings through KiwiSaver.

A challenge for the KiwiSaver market is that the larger corporate providers (banks and insurance companies) dominate the market, and many have had to make a considerable capital investment which it is likely to take some years to recover. However, smaller niche players with fully outsourced back offices can also compete effectively with much lower volumes of membership.

While details of individual providers' profitability are not available for reasons of commercial confidentiality, we understand that:

- the larger corporate providers have had to make a considerable capital investment which it is likely to take them some years to recover since the operating margins have been kept tight by the considerable competition in fees and the GA's monitoring of fees;

- the decision to reduce the minimum member contribution rate from 4% to 2% will affect the accumulation of funds under management which is the major driver of revenue for providers. To date, the uptake of KiwiSaver membership has been very consistent at about 1,000 per day[11]. However, this small minimum contribution level delays the achievement of breakeven because the largest profit driver is funds under management which is a function of contributions;

- the decision to enter the KiwiSaver market appears to have been made by the larger insurance and banking providers because they felt they had to be represented, even at marginal profitability since KiwiSaver was seen at the time it started as the future of retirement savings in New Zealand which would, over time, displace existing superannuation products;

- entry was difficult for some providers to justify in terms of a financial business case (because of the considerable capital investment required). However, they did it because they thought they had to for competitive reasons;

- development costs have been higher than originally expected due to the level of government-imposed changes to KiwiSaver; and

- the base level of fees is kept low because it is set by competition and the GA-supervised default providers. We note, for example, that Mercer has recently (June 2010) reduced its monthly administration fee by more than 25% to be more competitive.

Over time the main driver of profitability in this sector will be the level of funds under management. As KiwiSaver is still new, average account balances are small and there are associated fixed costs from the establishment of KiwiSaver schemes for providers to recover. Although a few providers have a profitable KiwiSaver business, as a whole the sector is not yet profitable.

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[11] The figure of 1000 new members per day was calculated from monthly IR KiwiSaver member statistics form June 2009 to April 2010.

Providers will have to grow average scheme member balances, as well as increase membership, so as to spread the level of fixed costs and achieve scale economies to lower average member costs. Some providers have a client base which will just be too small to be viable over the medium term unless they adopt the outsourcing model.

The MED survey showed 83.4% of the 24 providers expect that their KiwiSaver schemes would be profitable over the next 10 years, down from 91% in the 2008 survey (this survey received 27 responses from the 31 providers surveyed). The interviews showed that the leading providers are facing continued upward pressure on costs (e.g., the queries about, applications for, and the administration of hardship claims), and downward pressure on fees.

The average member account balance is just under $5,000 as at 31 December 2009 (based on 24 survey respondents). The GA report of March 2009 indicated that, at that time, the average balance was only $2,700, but since then another annual member tax credit payment was made together with regular contributions and investment earnings.

Although, over the long term, there will be good business for providers via a stable and growing market, the growth of that market does very much depend on providers' ability to promote it. The MED survey found that, because many KiwiSaver schemes currently lack profitability, they are not being distinctively promoted[12]. For some of the largest providers the revenue from KiwiSaver is insignificant compared to other parts of their business and, as a result, it does not attract much attention or resources. Some smaller providers also struggle with the overall viability of their business.

Contributing to this view is the increasing administrative costs associated with withdrawals, transfers, and administering the first home withdrawals. Increasing the complexity of KiwiSaver, (such as the proposed changes to how children can join[13]) and the additional monitoring and reporting requirements that will be introduced, may further increase administration and compliance costs.

The following table estimates the operating profits made by the seven major KiwiSaver providers and the six medium sized providers. In each case we have used the FUM and number of members from the 31 March 2010 Morningstar KiwiSaver Survey and have estimated their total KiwiSaver revenues based on the quoted fees. We have then estimated each provider's operating profit by assuming that all of their monthly administration fees and trustee fees are used to administer the scheme, and that their primary operating profit consists of 25% of their investment management fees.

Based on this analysis we estimate their operating profit (excluding initial set up costs) to be of the order of that shown in the table below. The annual operating margin shown has been calculated as the gross operating revenues less the estimated operating cost. The percentage operating profit is the annual operating profit expressed as a percentage of the gross operating revenues.

[12] KiwiSaver promotion is largely as part of a suite of financial services.

[13] In the consultation documents for new legislation it is proposed that only legal guardians will be able to enrol those under 16, and that 16 and 17 year olds will have to sign jointly with their legal guardians.

Indication of KiwiSaver Profitability as estimated from published information – 2010

	FUM ($m)	Members	Annual Operating Profit ($m)	Profit Margin (%)
Major Providers				
AMP	655	94,773	1.48	17.8%
ASB	1,062	253,687	0.85	7.7%
AXA	397	83,090	0.66	11.6%
ING (incl ANZ, National) **	1,210	67,000	1.33	18.5%
Mercer	392	75,437	0.53	11.2%
Tower	402	82,135	0.67	12.4%
Westpac	492	145,744	0.75	11.2%
Medium Sized Providers				
Gareth Morgan	346	47,527	0.69	25.0%
Fisher	132	15,898	0.32	19.3%
Huljich	128	55,000**	0.36	9.1%
Fidelity	106	52,170	0.14	5.8%
Aventine	86	16,328	0.15	12.1%
Grosvenor	69	18,763	0.19	12.5%

31 March 2010 Morningstar KiwiSaver Survey
**Membership numbers not available, so estimated value shown.

Although positive, these are generally not high margins, especially when the set up costs of initially getting into the market are considered (our 2008 report indicated that set up costs ranged from $50,000 to $5,000,000, the median response was $500,000). In comparison, the profit margins for some of the major providers' regular superannuation products on a comparable basis are approximately 20%.

Return on Investment

Our evaluation framework assessed provider expectations of the payback period expected on their initial KiwiSaver investment.

This was tested through the MED survey of providers. Of the 24 providers that responded to the survey 60.9% expected the payback period to be eight years or less, down substantially from the 91% from the 2008 survey. This change is likely to reflect those issues discussed above regarding current and expected profitability.

Consolidation

The superannuation and managed funds industry is one in which volume (both in terms of members and funds under management) plays an important part in the long-term viability of providers. This is highlighted through the MED survey where providers see consolidation in the industry as inevitable.

The survey results and associated interviews indicated that providers expect that some will never attain a profitable level of business and will eventually exit from the market. As noted above, 79% of those responding believed the number of providers would decrease over the next three years (compared to 68% in the 2008 survey) while 71% believed the number of schemes would decrease over the same period (compared to 56% in the 2008 survey).

While there have been two new KiwiSaver schemes registered over the last 18 months there has also been some consolidation with three schemes closing. Consolidation can also occur at the institutional level. For example, AMP's possible acquisition of AXA, both of which are KiwiSaver providers.

Overall it is expected that the weaker players will withdraw from the market over time. This is likely to include some of the larger (primarily overseas-owned) institutions due to their different organisational (including capital) structures compared to the smaller locally-owned companies. The larger institutions typically have higher overheads, higher profit expectations for products and the KiwiSaver product is internally competing with other products (both within and outside New Zealand) for company resources.

Market Entry

Ease of entry into the market by new providers is another important feature of a competitive market.

The lower the cost to enter the market then the higher the chance that this will occur. In the case of KiwiSaver, the introduction of boutique investment manager schemes has been assisted by a Trustee company offering a fully outsourced back office service.

Responses to the 2008 survey gave the range of set up costs experienced by new or enhanced providers at between $50,000 and several million dollars. The existence of competition helps drive efficiency and innovation, deterring those looking to enter the market unless they are equipped to provide the required services and products.

The number of new companies offering retail KiwiSaver schemes, as per the GA's register, has been adopted as the indicator for market entry.

As discussed previously under the Consumer Choice section, in 2010 two new KiwiSaver schemes have been registered, Milford Asset Management's Milford KiwiSaver Plan and Kiwibank's Kiwibank KiwiSaver Scheme.

Disclosure of Fees

Fees are one way for providers to differentiate themselves from those of their competitors.

The disclosure of fees and ease of comparison between schemes and products has recently received attention in the media and the industry.

The Sorted website (www.sorted.org.nz) provides a publicly available fee comparison tool. However industry members have questioned its accuracy in some cases and, therefore, the validity of its comparisons. It does at least provide a helpful starting point.

Although there is no fixed fee structure, most providers charge a monthly fee to cover fixed administration costs which varies between $2 and $3, a trustee fee and a funds management fee which is charged as a percentage of each member's account balance, to cover the costs of investing and managing those balances.

Typically these fund fees range between 0.3% and 1.2% of funds invested, depending on the amount of effort required to manage each fund. Cash and conservative funds tend to be at the low end while actively managed growth funds are at the higher end.

There are however a number of variations to this. Some of the boutique providers charge a performance fee, while others charge lower fixed fees and higher variable fees. Fee comparisons then become complicated by whatever assumptions are made about the likely fund performance and the level of the average member's account balance.

We note that the new Kiwibank scheme, for example, charges a lower fixed fee but a higher variable (funds management) one. Such a fee structure is attractive to a new member starting from a zero balance, but would be expensive to someone who has accumulated a high balance.

The MED survey of providers asked: “What changes have you seen in the way providers disclose their fees to the public and how has the transparency and ease of fee comparison between products improved since KiwiSaver began?”

The question received 11 responses, with the general theme that there has been little, if any, change since KiwiSaver began, and some improvement is now required. Providers believe that the work being undertaken by the ISI to develop standards for its members and the proposed policy changes will result in improvement.

KiwiSaver Market Dynamics

The impact on the national savings attributable to KiwiSaver is outside the scope of this evaluation and is to be picked up primarily by the analysis of the Survey of Family, Income and Employment (SoFIE).

The market dynamics part of the evaluation framework concentrates on monitoring the development of the KiwiSaver market, and its impact on the superannuation market and wider managed funds sector.

Our evaluation indicators developed by PwC focus on the superannuation and managed funds markets and the effect KiwiSaver has had on them. The 2008 report defined a baseline and a base point to consider the relative performance of the KiwiSaver market. The baseline was based on the:

- level of savings in superannuation products prior to the KiwiSaver introduction;
- total value of managed funds; and
- level of retirement savings which would happen in the absence of KiwiSaver.

The market dynamic indicators in the table below show the change in the variables from one period to the next, and the relative influence of KiwiSaver and superannuation on the overall level of managed funds.

Market Dynamic Indicators as at 31 December 2008 and 2009

	Managed Funds		Superannuation		KiwiSaver	
	2008	2009	2008	2009	2008	2009
Assets ($m) [a]	55,921	62,290	16,826	18,448	2,134	4,946
NZ Investment [a]	61%	56%	43%	38%	58%	53%
NZ equities [a]	10%	11%	9%	9%	12%	14%
Membership	N/A	N/A	578,414[b]		900,509[c]	1,274,160 [c]
Schemes	N/A	N/A	540 [b]		54[d]	52 [d]

Source:
[a] *Sourced from the Managed Funds Survey, December quarter 2009.*
[b] *Sourced from the Report of the Government Actuary for the year ended 30 June 2009, with the addition of the Government Superannuation Fund.*
[c] *Supplied by Inland Revenue.*
[d] *Sourced from the KiwiSaver Schemes Register maintained by the Government Actuary.*

As of 31 March 2009 (the latest comparable reporting date) the GA's annual KiwiSaver report reported total KiwiSaver FUM of $2,654 million while the Managed Funds Survey reported $2,648 million (a difference of 0.2%).

Total Managed Funds

KiwiSaver assets are a subset of the more general category of managed funds. Managed funds are reported in aggregate by the Reserve Bank of New Zealand (RBNZ) through their Managed Funds Survey (MFS) and by various research houses who provide market advice and commentary such as Fundsource, Morningstar, and Plan for Life. Total Managed funds reported in the MFS are shown below.

Total Managed funds ($m) as at 31 December

2004	2005	2006	2007	2008	2009
54,220	57,417	64,423	65,256	55,921	62,290

Source: RBNZ – MFS

The level of funds was substantially reduced by the fall in asset prices following the onset of the global credit crisis in 2007 and 2008. The level of funds under management rose by only one percent from December 2006 to 2007, followed by a 14 percent decline between December 2007 and 2008. The impact of the downturn identified in the 2008 report is even more pronounced two years later.

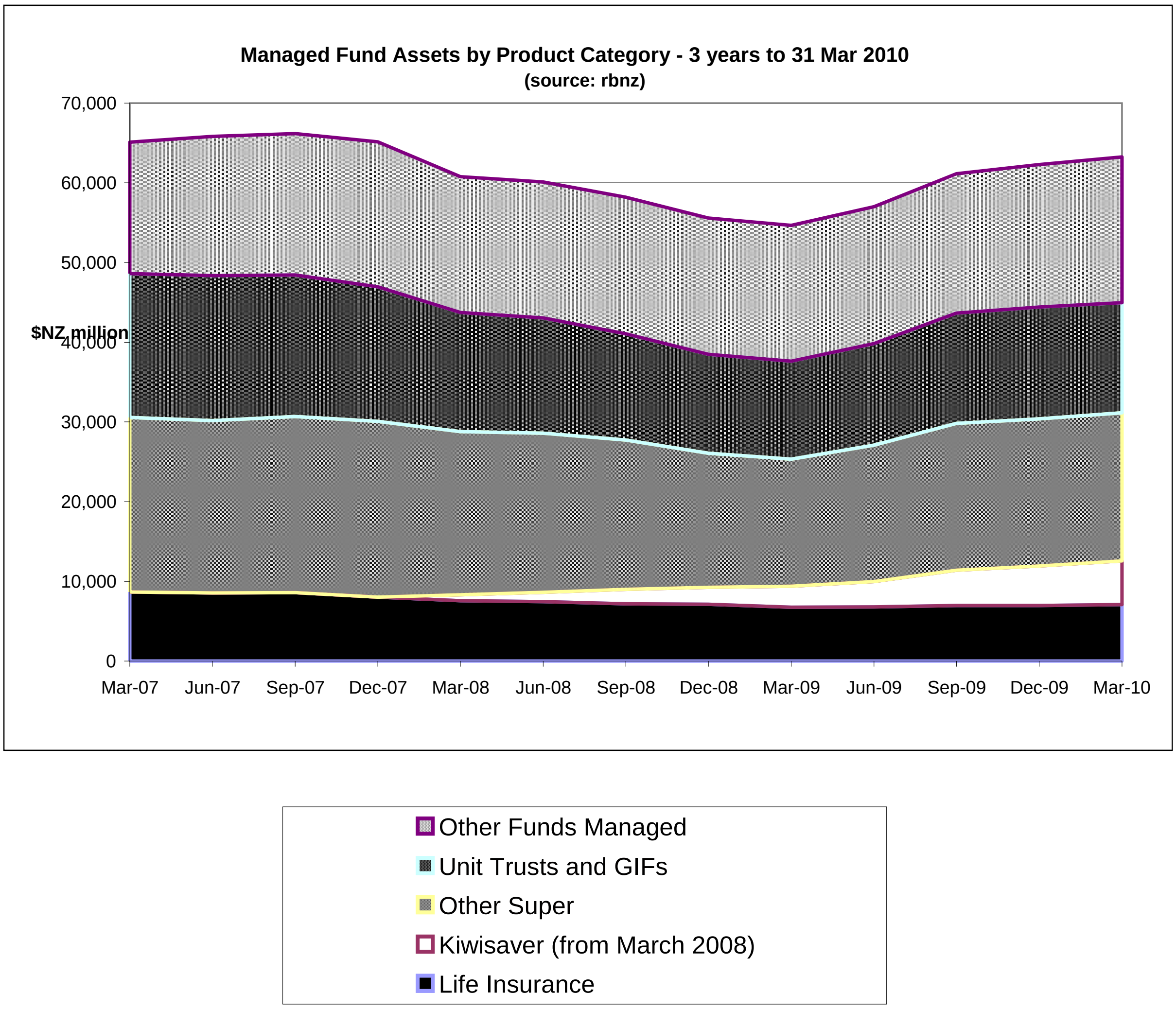
This decline probably reflects both a decline in asset values and a reduced flow of funds into managed funds products. In 2009 the level of funds under management returned to a positive growth rate (11%). However, the total value of funds under management still remained below where they were in December 2006.

Assessing KiwiSaver's effectiveness in increasing savings is complicated by the possibility that some of the increase in KiwiSaver funds invested might not be from an overall net increase in savings. There is the possibility, for example, that they might in part represent substitution from other means of savings, or fluctuations in asset prices. In practice there appears to have been little or no transfer of existing assets from other managed funds into KiwiSaver, although ongoing KiwiSaver contributions may have replaced other forms of saving. We cannot yet say whether KiwiSaver is new savings/money, and this will need to be the subject of a separate study which is part of the interagency evaluation plan for KiwiSaver. In this respect, the recent CB survey of individuals for IR tried to broach this issue. The results show that just over a third of members (39% of 474) consider KiwiSaver to be an additional means of retirement saving. Also, KiwiSaver households say that 35% of their contributions would have been spent on daily outgoings in the absence of KiwiSaver.

On an empirical basis we can say that the sheer size of the KiwiSaver member base (approximately 1.4 million) is far higher than the number of members of employer-sponsored superannuation schemes (approximately 400,000) so that, while there will have been some cannibalisation of superannuation scheme savings, the sheer number of KiwiSaver members is such that most will be new contributors to a retirement savings scheme.

Contributions made by, or on behalf of, younger KiwiSaver members under 25 will probably be a substitution of consumption for investment since these age groups are not normally participants in managed funds. The advent of KiwiSaver has also increased the employee participation in superannuation. For example, a client of Eriksen's, a multi-national employer, has seen a 20% increase in retirement savings membership as a result of the combined offering of superannuation and KiwiSaver.

The following table illustrates the principle that KiwiSaver funds are still a relatively small part of the overall total.



The table below shows how the growth of savings in KiwiSaver has impacted asset values in life insurance; other superannuation funds; funds in unit trusts and group investment funds (GIFs); and other managed funds.

Managed fund assets – by product category

	Mar-2008 $m	Mar-2009 $m	Mar-2010 $m
Life insurance	7,573	6,728	7,079
KiwiSaver	746	2,657	5,489
All other super	20,458	15,950	18,567
Unit trusts and GIFs	14,968	12,312	13,830
Other funds managed	17,028	17,005	18,299
Total Managed Funds	60,772	54,652	63,264

Source: RBNZ – MFS

In the two years since March 2008, KiwiSaver has grown to $5.5 billion from a zero base in July 2007, whilst the total of all managed funds has only grown by $2.5 billion. Life insurance has fallen by $0.5 billion, all other super has fallen by nearly $1.9 billion and GIFs by $1.1 billion. The decrease in asset value of these managed funds are mainly due to the economic downturn over the last two years, but it appears very likely that the introduction of KiwiSaver, with its associated incentives to save, have caused people to reduce new investment in other products.

Total Funds under management totalled $62.3 billion in Dec 2009, up 12% on the previous year, of which superannuation accounted for 30% and KiwiSaver 8%.

Funds under management

Year end 31 December	2005	2006	2007	2008	2009
All Managed Funds	57,337	64,304	65,123	55,578	62,290
% change		12%	1%	-14%	3%
Superannuation	19,686	21,506	22,049	16,826	18,448
% change		9%	3%	-24%	10%
% total managed funds	34%	33%	34%	30%	30%
KiwiSaver				2,134	4,946
% change					132%
% total managed funds				4%	8%

Source: RBNZ – MFS

The overall contribution of KiwiSaver to total funds under management has increased from March 2009 – March 2010 from 4% to 8%. KiwiSaver exhibited the highest increase in terms of both absolute change and percentage increase compared to the other categories of managed funds reported by the RBNZ.

The newness of the KiwiSaver schemes compared to those in the other managed funds categories is reflected in the relatively small level of total funds under management compared to contributions made.

Over the year to 31 March 2009 the GA reported that KiwiSaver funds under management grew from $702 million to $2,654 million, despite an investment income loss of $140 million.

The contributions from the members, employers and the crown totalled $1,957 million. Withdrawals were minimal and totalled less than $3 million (excludes transfers to other KiwiSaver schemes and fees).

Of note is that the combined contributions from employers and members to KiwiSaver schemes are half that reported for superannuation contributions despite KiwiSaver membership being higher. This reflects the likely higher contribution rates and older age (and therefore likely higher income) of those contributing to superannuation schemes.

KiwiSaver Financial Statistics – March 2010

The table below shows the breakdown of payments to scheme providers for the financial year ending 30 June 2009 and the period up to 31 March 2010.

KiwiSaver Funds flow by source

Payments to providers	1 July 2008 – 30 June 2009	Financial year 1 July 2009- 31 Mar 10 (9 months)
(gross)	($) million	($) million
Employee deductions	916.6	793.8
Employer contributions	354.7	467.9
Voluntary contributions	6.1	5.7
Total member contributions	1,277.4	1,267.4
Member tax credit (MTC)	321.8	572.0
Kick-start	471.5	284.4
Fee subsidy	33.9	8.7
Interest	11.7	3.7
Total crown contributions	838.9	868.7
Total payments to providers	2,116.2	2,136.1

Source: IRD. MTC figures represent all MTC paid to KiwiSaver providers. Figures exclude MTC paid to complying funds. GA report June 2008 omits 30 June 2008 data for above.

Of the $5.3 billion paid to Providers as at March 2010, $2.3 billion will have been paid by the government, $2.1 billion by members and $0.9 billion by employers.

Superannuation

Superannuation products also fall within the managed funds sector, and are potentially closely substitutable for KiwiSaver. Both are reported separately within the MFS.

The change in the levels of superannuation FUM is similar to that of managed funds overall, as can be seen in the table below, with the growth of funds under management slowing between 2006 and 2007 and a decrease of 14% being seen between 2007 and 2008. The increase in KiwiSaver FUM in 2009 contributed to an annual overall FUM increase of 23.4%.

Total superannuation funds under management ($million)

Year end 31 December	2004	2005	2006	2007	2008	2009
FUM ($m)	19,245	19,686	21,506	22,049	18,960	23,394
Annual increase (%)		2.3	9.3	2.5	-14.0	23.4

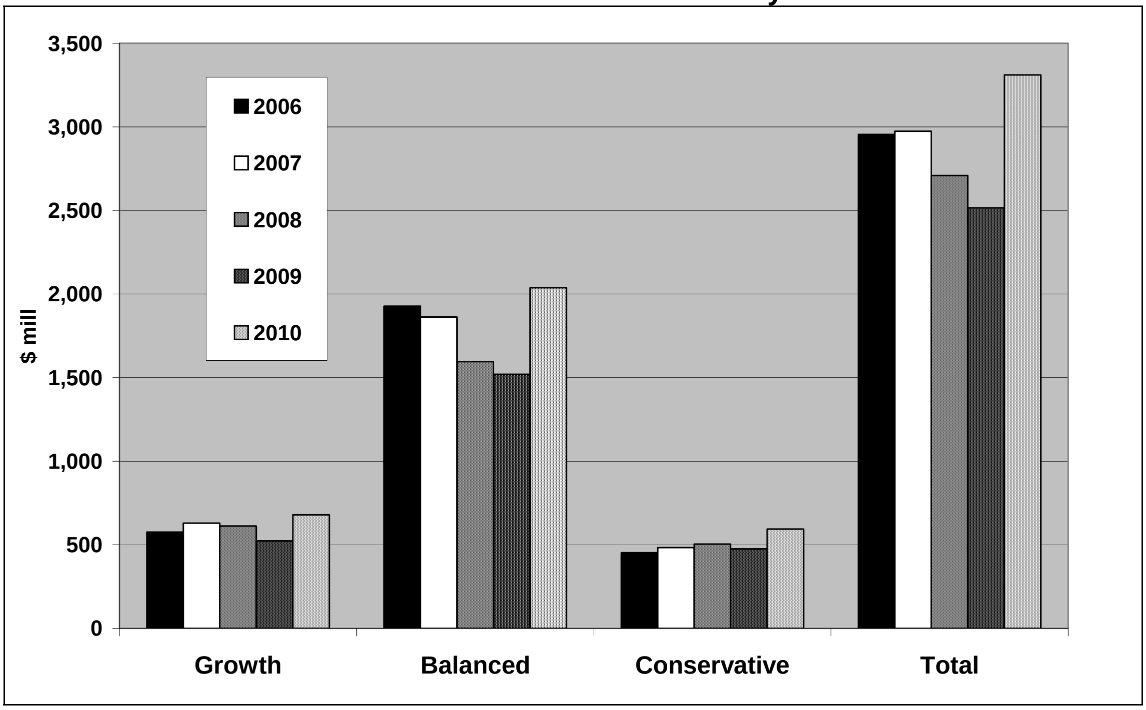
Source: RBNZ – MFS, Total of KiwiSaver and all other Superannuation

In the 12 months to 31 December 2008 the GA reported that superannuation FUM (excluding the Government Superannuation Fund) decreased by $3,706 million. This change was dominated by exits of $4,855 million (offset by contributions of $2,251 million) and investment losses of $1,088 million.

We can see the rebound that occurred in 2009 with the value of funds under management increasing 23%. The superannuation funds under management appear to have outperformed total managed funds which only exhibited a 1% increase, possibly because they were invested more conservatively and hence suffered lower investment losses in 2008 and 2009. Unlike total managed funds, the total superannuation funds under management for 2009 exceed the 2006 level.

Fund levels taken from the Eriksen's Master Trust Survey are consistent with the GA and MFS reported fund levels. The chart below shows the levels of funds surveyed by the Eriksen's Master Trust Survey as of March 31 for the years 2006-2010. These represent a large part of the total employer superannuation funds in New Zealand and should also be representative of the fund flows for standalone super schemes.

Managed Funds invested in growth, balanced and conservative funds as reported in the Eriksen's Master Trust Survey



Source: Eriksen's Master Trust Survey Mar 2006- Mar 2010

It can be seen that what had been a steady rise in funds was interrupted by the investment downturns during 2008 and 2009, but that the levels of funds have largely recovered - due largely to the recovery in investment markets. An analysis of these fund level changes indicates that they appear to be due largely to the change in asset prices, and hence fluctuating returns, with the remaining part of the changes being due to contributions and other regular cash flows.

While the downturn in the level of balanced funds appears to have dropped disproportionately, we understand that this is due at least in part to transfers of funds from balanced to conservative options (growth fund investors were less likely to do so because of the higher level of losses which they would then lock in).

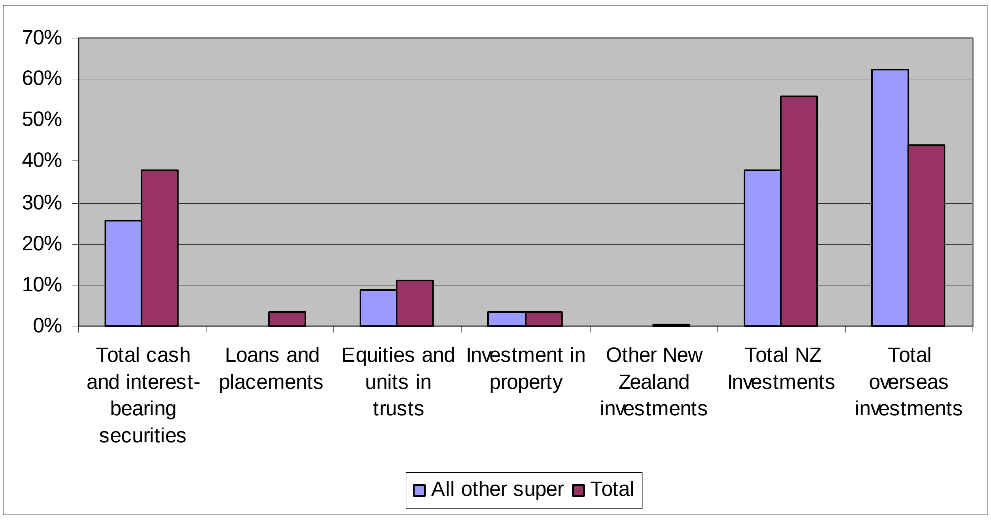
The effect of KiwiSaver, to date, appears to be slight since the level of superannuation funds is still much larger than those for KiwiSaver. KiwiSaver is being funded from current members' earnings and contributions rather than transfers of previously accumulated assets. The CB survey of individuals supported this. It found that, of the 116 KiwiSaver households that had a current superannuation scheme, only 9% had transferred some or all of their contributions to KiwiSaver.

Investment across asset classes

The MFS provides a breakdown on where the funds are invested within New Zealand. The asset splits for total managed funds and superannuation are displayed below.

Overall there is a lower proportion of superannuation assets invested in New Zealand compared to total managed funds overall. This may be because superannuation funds tend to have diversified fund mixes including a majority of overseas assets, whereas managed funds, as a whole, include various specialist and largely undiversified funds which are invested in New Zealand.

Managed Funds by assets class superannuation and total managed funds



Source: RBNZ – MFS

It is these differences that are likely to explain the differences in performance. The Statistics New Zealand section of the MFS shows 77% of total managed funds invested overseas are invested in equities.

Investment in New Zealand assets

How KiwiSaver will impact on other markets within New Zealand is also of interest. The table below compares the level of investment in New Zealand across managed funds, superannuation and KiwiSaver.

Overall KiwiSaver funds have flowed in at a higher rate into the New Zealand market relative to other superannuation, but still slightly below managed funds overall.

Percentage of Funds invested in New Zealand

Year end 31 December	2005	2006	2007	2008	2009
Managed funds	58%	57%	56%	61%	56%
Superannuation	45%	45%	42%	43%	38%
KiwiSaver				58%	53%

Source: RBNZ – MFS

Of particular interest is the potential effect KiwiSaver may have on New Zealand's equities market. The table below shows that KiwiSaver has a relatively higher flow of funds into New Zealand equities than managed funds and other superannuation.

The decline within the managed funds sector and superannuation in value of holdings in New Zealand equities is likely to reflect both a decline of market value, but also a shift away from allocating funds to New Zealand equities. This appears to reflect the fact that the number of quality stocks on the NZX which are not dual listed has shrunk somewhat and because, increasingly, superannuation schemes are investing in Australasian equities rather than pure New Zealand equities when allocating funds to domestic equities.

Percentage of Funds invested in New Zealand equities

Year end 31 December	2005	2006	2007	2008	2009
Managed funds	13%	13%	13%	10%	11%
Superannuation	13%	14%	12%	9%	9%
KiwiSaver				12%	14%

Source: RBNZ – MFS

On the other hand the increased allocation in KiwiSaver funds represents increased flows of funds to active choice funds (in a sense more funds into non-conservative funds), which tend to have a higher asset allocation to New Zealand equities. The table below shows the variation in asset class for a default provider, AMP, between its default scheme, balanced fund and growth fund. It can be seen that the default scheme has only 5% in New Zealand equities, compared to the balanced fund, which has 15%.

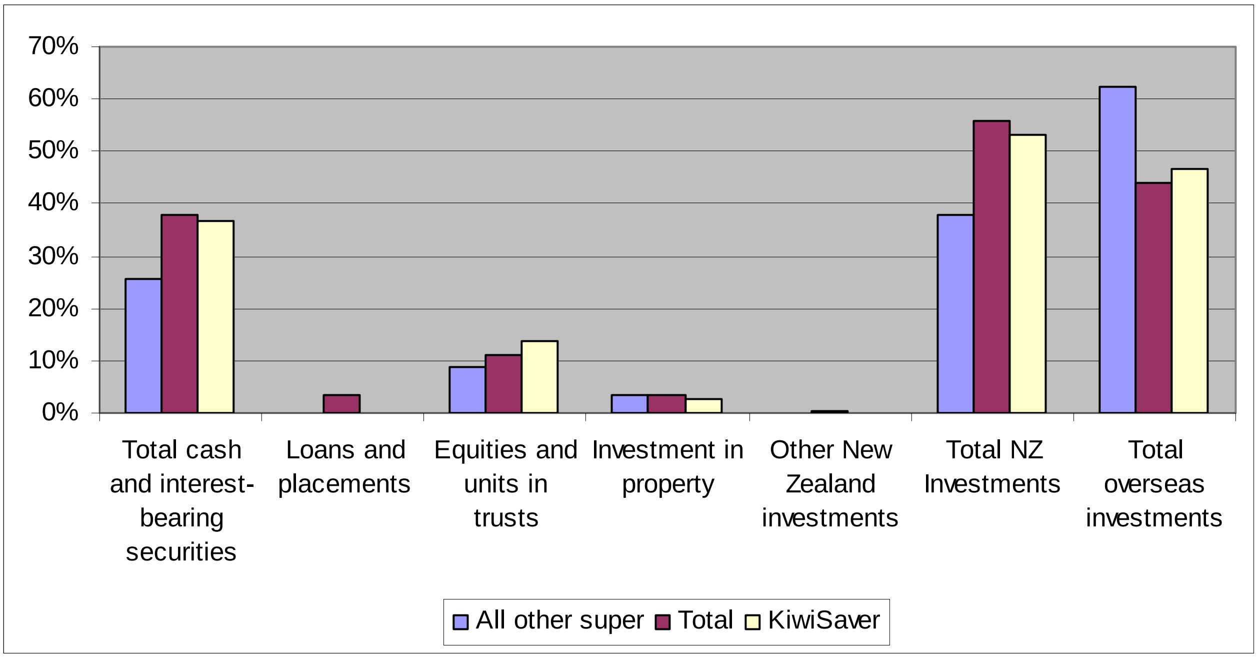
Asset allocations for AMP's conservative, balanced and growth funds

Asset Class	**Default scheme (Conservative)**	**Balanced**	**Growth**
	%	%	%
Cash	68	5	9
NZ Bonds	7	20	10
Overseas Bonds	5	15	4
Total Defensive	80	40	23
Property	3	10	13
NZ Equities	5	15	17
Overseas Equities	12	35	47
Total Growth	20	60	77
Total	100	100	100

A breakdown on where the funds are invested within New Zealand is displayed in the chart below.

The distribution of funds reflects the choices that KiwiSaver members have made about the funds they have selected. As there are still a third of KiwiSaver members in the conservative default funds, we see a marked difference in the allocation of funds to cash and interest bearing securities compared to other superannuation funds.

Managed Funds asset allocation
Total, other Superannuation and KiwiSaver (as at 31 December 2009)



Source: RBNZ – MFS

Note that the total value also includes life insurance, unit trusts, group investment funds (GIFs), and other managed funds.

The table below shows how the proportion of KiwiSaver assets invested in New Zealand versus those held overseas has decreased.

Proportion of KiwiSaver Assets invested in New Zealand and abroad

	Mar-2008	Mar-2009	Mar-2010
Total NZ Investments	58.6%	59.1%	52.5%
Total overseas investments	41.4%	40.9%	47.5%

Source: RBNZ – MFS

Over the last 12 months, the proportion of investments overseas has increased by 6.6% so that, as of March 2010, nearly half of investments are offshore. The higher proportion of New Zealand assets is likely to have been 'inflated' by the relatively high number of KiwiSaver members with conservative default funds, and the consequently high holdings of cash and fixed interest.

The next table shows how KiwiSaver assets are invested. Of note is the relatively high proportion of New Zealand cash and bonds versus equities. As noted above, this is due to the high number of members in conservative default funds.

KiwiSaver asset allocation

	Mar-08	Mar-09	Mar-10
NZ Cash/Deposits	18%	15%	14%
NZ Bonds	29%	29%	23%
NZ Equities	9%	13%	13%
NZ Property	3%	3%	3%
Total overseas investments	41%	41%	48%
Total KiwiSaver funds	100%	100%	100%

Source: RBNZ – MFS

Membership and Schemes

The table below shows the number of KiwiSaver members in each age band vs. the total number of the New Zealand population in that group. (Population data is taken from the 2006 census).

KiwiSaver Membership and take-up

Age band	KiwiSaver membership (March 2010)	NZ Population (2006 census)	Take up
0-17	245,538	1,053,666	23.3%
18-24	215,457	385,074	56.0%
25-34	219,242	519,000	42.2%
35-44	221,892	615,252	36.1%
45-54	222,753	546,153	40.8%
55-65	236,887	447,759	52.9%
65+		461,034	
Total	**1,369,609**	**4,027,938**	**38.4%**

Source: IR and 2006 census

Take up has already reached 38% of the eligible population (those under 65). The take up at ages 18-24 is particularly interesting as this age group does not traditionally participate in superannuation savings. Taking into account the 240,000 who have opted out, there are 2.0 million people who have neither taken up nor opted out. This could be viewed as suggesting 60% of the under age 65 population are potential new customers. A point will be reached at which the number of prospective new KiwiSaver members becomes limited. If the take up were to approach 80% of those of working age, there would be in the region of 1.2 million potential new customers, with the largest proportions coming in the age range 25-54. This would increase the total KiwiSaver membership to 2.6 million.

We expect, based on trends over the last year or so, that the membership to KiwiSaver will continue to grow for the next three years around the current rate of 1,000 per day. This will provide a market of willing buyers to promote and sell to. However, once the current population is enrolled the environment will become tougher as only children and new immigrants who obtain New Zealand permanent residency will be eligible for new membership.

When new members start to dry up, providers will have to compete for transferring members. There will be more intense competition around investment performance as well as price and service including the range and quality of schemes on offer.

At that stage, with a mature market we expect significant consolidation of the major "generic" providers, although the niche boutique providers may be able to sustain their smaller volume business models by enticing members away from the major players rather than signing up new members.

Superannuation membership has continued the decline that started before the introduction of KiwiSaver. We expect this to stabilise somewhat with the popularity of KiwiSaver.

From a peak of funds under management of $12 billion as at 31 March 1987, superannuation scheme assets have continued to shrink steadily, in real terms, as a result of the removal of tax incentives in 1987-1990 and a remuneration trend to pay salaries and remove benefits to avoid Fringe Benefits Tax in the 1990s.

Increased compliance costs and regulation meant that, before the introduction of KiwiSaver, only 4% of employers provided their staff with superannuation benefits.

Superannuation membership

Year	**2005**	**2006**	**2007**	**2008**	**2009**
Superannuation	**691,605**	**656,086**	**635,297**	**578,414**	**N/A**

Source: GA reports

KiwiSaver membership was 1.4 million on 30 April 2010. Over the past 11 months the growth in total KiwiSaver membership has been strong with approximately 30,000 new members per month, with little monthly variation.

KiwiSaver membership (selected months)

Month	**June 2008**	**June 2009**	**September 2009**	**December 2009**	**March 2010**	**April 2010**
KiwiSaver	716,637	1,100,540	1,189,597	1,274,160	1,369,609	1,401,005

Source: IR

The number of schemes is an important measure as it can be used to indicate the stability of the market, effects of competition, substitution and consolidation within the market. The number of superannuation and KiwiSaver schemes is reported annually in the GA's reports.

In a similar fashion to superannuation scheme membership, the number of superannuation schemes has been in decline for a number of years prior to the introduction of KiwiSaver due to increased compliance costs, increased fiduciary risks for trustees and the removal of government incentives for employees to save in this manner. There has also been replacement of standalone superannuation schemes with membership of multi-employer master trusts, which can offer a wider range of investment options and reduced administration costs.

The number of KiwiSaver schemes reported in the GA reports decreased by two to 52 between 2008 and 2009. There have been further changes in 2010 with a third provider leaving and two new providers registering schemes, bringing the total number of registered KiwiSaver schemes as at 30 June 2010 to 53.

Number of Superannuation and KiwiSaver schemes

Year	2004	2005	2006	2007	2008	2009
Superannuation	625	590	576	560	540	N/A
KiwiSaver					54	52

Source: GA reports

Survey Respondents' Views of the Future Market

The MED survey of providers asked which factors would most strongly influence the size and shape of the superannuation industry over the coming years. This received 16 responses.

- Government changes to KiwiSaver were most commonly seen as factors that would influence the industry with potentially a negative or positive impact. This reflects KiwiSaver's position as a government-sponsored savings policy (with government incentives).

- Making KiwiSaver compulsory and increasing the contribution rate[14] were seen as ways for government to improve the sector, as well as having long-term benefits for New Zealanders.

- Changes in supervision and in transparency of reporting were seen as potentially improving KiwiSaver's image.

- Consolidation of the market through acquisitions and public confidence in the KiwiSaver industry are predicted to have a strong influence on the size and shape of the sector in the future.

- Consolidation will influence the shape of the sector through a reduced number of providers, allowing the remainder to increase their level of funds under management. Public confidence in the sector, on the other hand, will influence the overall level of membership and funds flowing into KiwiSaver schemes.

- Poor performance of funds and questionable ethical behaviour in the KiwiSaver industry and wider financial markets are a concern for providers, as it impacts on all players in the industry through the public's perception of financial markets.

- A number of opportunities were highlighted through the interviews and survey of providers. Once membership reaches a steady state and average balances improve, competitive behaviour will become more apparent – fees may become lower and advice will improve. Additionally, there will be more money available for education of members.

- KiwiSaver was also seen by providers as a great opportunity to improve the financial literacy of the public. This would hopefully result in increased membership as well as interest in, and understanding of, other financial products. KiwiSaver was likely to lead to the development of new investment products including renewed interest and investment in the annuities market.

[14] In this case contribution rate should be considered as the sum of money flowing to providers. From a policy perspective how this achieved is important, however from a provider's perspective the source of the funds is less relevant.

- Future major risks for the KiwiSaver market identified by providers were a poor public perception of KiwiSaver which could, for example, occur through further ‘Huljich like’ episodes, the handling of hardship claims, or government’s removal of incentives.

- The evaluation findings reinforce recent government decisions on the Financial Markets Authority and enhancing KiwiSaver governance and reporting. The sector sees these changes as important for its efficient operation. (The default provider monitoring arrangements are not seen as being effective – they would not have identified the Huljich issue).

- Provider disclosure and transparency of fees to the public: There were 11 responses with the general theme of “little if any change has occurred in the disclosure of fees to the public since KiwiSaver began, improvement is required”. The work being undertaken by the ISI and the attention of MED on the issue will hopefully result in improvements.

- Minimal fees and compliance costs.

- The pressure to keep fees to a minimum while introducing increased regulation and compliance was also seen as a risk to the market, the reasons being the effects on profits and growth, particularly for those without other products when existing fee income is low.

Default Providers and Default Investment Options

Default Providers

A feature of KiwiSaver is the existence of six default KiwiSaver providers. Auto enrolled members and active choice members who do not select a provider are randomly, but evenly, allocated to these providers. Default providers were appointed for a seven year initial term until June 2014.

The six default providers are:

- AMP
- AXA
- ING
- TOWER
- ASB
- Mercer

Four of these are traditional financial services companies providing insurance, superannuation and investment products. ASB is a bank (which owns an insurance company), and Mercer is a superannuation administration and investment consulting company, with a fund of funds investment management capability.

Default providers are required to nominate a default investment product (default fund) within their default scheme.

The chart and table below show how total membership in KiwiSaver has increased in the year to March 2010 split by automatic enrolments; opt ins via their employer; and those who have opted in to a particular provider.

Method of joining KiwiSaver

	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10
Opt in via provider (active choice)	422,519	477,971	536,458	589,838	649,745
Opt in via employer	186,298	195,940	200,660	204,418	207,873
Automatically enrolled	391,466	426,629	452,479	479,904	511,991
Total membership	1,000,283	1,100,540	1,189,597	1,274,160	1,369,609

Source: IR

Total membership has risen steadily by 369,000 in the last 12 months to almost 1.4 million members, with auto enrolled members comprising about 36% of the total KiwiSaver membership to date. This indicates that auto enrolment has been an important factor in helping default providers to build their membership so far.

Overall, however, the proportion of members choosing their provider has increased from 42% in March 2009 to 47% in March 2010, with a lower proportion being automatically enrolled or opting in via their employer, suggesting that people are increasingly shopping around for their provider.

In Australia there is also a propensity for individuals to simply go with the default investment option with 51.4% ending up in a default fund (see the table below) where there was access to other options. However, in Australia the default options are generally balanced fund portfolios and what is not known is the level of an 'active' or conscious choice by individuals to go with the default option.

Investment choice – take up and active choice

	Corporate fund	**Industry fund**	**Public Sector fund**	**Retail fund**	**Total**
% assets subject to investment choice	55.0	84.7	65.0	65.9	62.8
% assets in default option for those with access to investment choice	55.6	80.3	73.2	24.7	51.4

Source: APRA Annual Superannuation Statistics, June 2007 (released 2008)

At recent conference on *Retirement and Intergenerational Equity,* the keynote speaker (Kent Weaver) suggested that *if options are too complicated, people will "choose" the default option*. Weaver showed that over time the number of new entrants into Sweden's Premium Pension system (PPM) that chose an active choice fund decreased from 2000 to 2005 and over the same time the number of options increased.

Default Investment Options

Under the KiwiSaver Act, default providers must provide a conservative default option with growth assets restricted to 15 to 25 percent of the fund. Given the volatile global economy and the significant capital losses on equities in recent years, this was a sound decision. A conservative default option provides less volatility on returns and thus more steady growth. As members see their account balances growing, they gain more confidence in the product. Furthermore, if a member goes on a contribution holiday, the interest earnings on their accumulated balances are more likely to cover the fixed fee in a conservative fund without the capital losses eroding the fund if a more aggressive option were chosen.

Superannuation schemes have tended to have balanced funds as the standard default option. This is because most employers traditionally had expected employees to stay to retirement, which is most unusual today.

For KiwiSaver many members may have a shorter expected duration than to age 65 for the following reasons:

- First home deposit. While some investment advisors are suggesting that young people should select growth investment options because of the long time until they are 65, their initial time horizon until they make a withdrawal may actually be much shorter if they opt for a first home withdrawal. In that case a conservative option may initially be the most appropriate, with a more aggressive one being selected once they have bought their home.

- Serious ill health or serious financial hardship claim.

- Transfer to another provider (since their assets in their original scheme will have to be liquidated prior to the transfer).

The comparative statistics as at 31 March 2010 demonstrate the difference. For the larger KiwiSaver providers, 36% of funds are invested in the conservative default options. From the Eriksen's Master Trust Survey of major superannuation providers, 50% are in the balanced options, 26% in the conservative options and 24% in growth options.

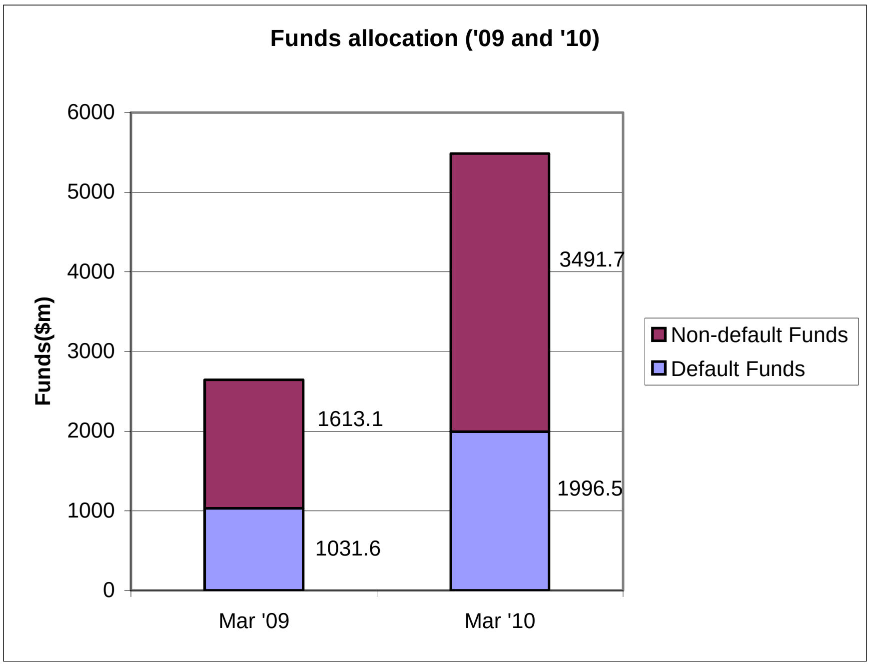
As the global volatility is continues, and taking account of the above factors, the current conservative default investment option is showing its worth.

The table and chart below shows the proportions of default and non-default funds for the default providers as at March 2009 and March 2010, showing how the proportion of default funds fell from one year to the next.

Default funds as a percentage of total funds under management by provider

Provider	% Default Funds Mar '09	% Default Funds Mar '10
AMP	45.7%	41.3%
ASB	55.8%	52.7%
AXA	80.2%	79.4%
ING	28.8%	23.3%
TOWER	73.3%	67.0%
Mercer	80.1%	76.5%

Source: Morningstar and Plan for Life.



Source: Morningstar and Plan for Life

The main reason for the shift has been the success of some default providers in gaining active members. ING has been particularly successful through employers and their ANZ and National bank channels. AMP has gained through the employer channel and ASB through both the employer and bank channels. Westpac is not a default provider but AXA and, to a lesser extent, Mercer have not attracted many active members.

This suggests that brand and existing relationships are strong selling points.

Regulatory Changes Affecting KiwiSaver

The KiwiSaver market (and the wider financial sector) will be affected by three associated regulatory changes being the:

- establishment of the FMA;
  - Increased monitoring and reporting has been foreshowed;
- Financial Advisors Bill;
  - Introduction of new standards for advisors;
- Securities Trustees and Statutory Supervisors Bill;
  - Relating to the use of independent trustees.

The regulatory changes are affecting providers in three ways:

1. Senior managers are responding to the policy initiatives and seeking to accommodate the changes in a cost effective way. However, this involves allocating additional staff resources and obtaining professional advice from externals.

2. Staff are expected to undertake additional training and come to grips with the new requirements, yet still process and achieve their regular workload.

3. The distribution team also need training, but must manage their independent or internal financial advisors to up-skill and yet maintain their sales volumes and morale.

The combination of the introduction of the FMA and Financial Advisors regulation will inevitably give rise to some uncertainty and business risk. However, once implemented, this should put New Zealand in a sound position relative to international standards.

The establishment of the FMA is seen as necessary and should gain the support of the industry if well implemented.

Independent trustees provide a valuable level of security to KiwiSaver members and additional governance. However, the resources available to the professional trustee corporations have been stretched by issues surrounding finance companies and their need to provide internal segregation of front and back office functions. An important role of the FMA will be to liaise with trustee companies regularly on both a formal and informal basis.

Delays have occurred in clarifying the professional requirements and disclosure on financial advisors' risks. As mentioned previously, KiwiSaver is a generic product whose benefits are specified by law. As a commodity the key areas of differentiation are fees, investment performance and service. The margins within the product can sometimes permit a modest commission for advisors but delay may put at risk the overall profitability of the product.

Other Issues

General Factors Influencing the KiwiSaver Market

Looking forward a number of factors will influence the KiwiSaver market, many of them relating to the current economic downturn:

- The continuing global financial crisis is likely to bring further volatility and uncertainty to international markets, thus influencing investment returns, and making some KiwiSaver members question the value of saving in this manner.

- The current complexity (the number provisions and range of funds available) of KiwiSaver makes it hard for some members to fully understand their opportunities and options.

- The new financial adviser legislation will increase the costs of promoting and distributing KiwiSaver products.

- Any further changes to the design of KiwiSaver will have cost implications for those providers who have to update their systems.

- The number of providers will fall over time as the industry consolidates.

- There has been a steady increase in the number of investment options offered by providers. In our opinion a single conservative, balanced and growth option is probably sufficient at this stage of development and financial literacy. The boutique niche providers could be expected to provide a wider range of funds.

Superannuation vs. KiwiSaver

Providers see conventional superannuation and KiwiSaver having complementary roles. KiwiSaver offers a basic level of retirement savings (2% member and 2% employer), reinforced by government incentives. As the balances of KiwiSaver members accumulate there will be a generation of retirees who will receive substantial lump sums into retirement. We note that, at a contribution level of 2% (employee) + 2% (employer), a typical KiwiSaver account balance would be around $500,000[15] in today's dollars for someone who contributed from age 25 to 65. The 2% + 2% level of contribution is popular because it reduces, for some, the amount of individual contribution required to receive the maximum member tax credit.

Beyond that incentivised level, however, there is little reason to make additional savings via KiwiSaver since they would then be locked in until 65 for no convincing reason. There is also no reason to put additional lump sums voluntarily into KiwiSaver (with the exception of ensuring that they receive the maximum member tax credit) since these are also locked up until 65. Despite this, the CB survey of individuals found that 32% of 474 members gave "Savings are locked in until I am 65" as an important factor when joining KiwiSaver and it was the most important factor for 2% of members.

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[15] This is based on an employee on $48,000 p.a. joining KiwiSaver at age 25 and retiring after 40 years service at 65. His or her salary increases at 3% p.a. and the investments earn a net rate of return of 2.5% real over inflation at 2.5% p.a.

Since the historical level of contributions to employer funded superannuation schemes has been higher than 2% by each of the members and their employer, we see a continuing place for employer funded superannuation schemes as a vehicle for employees and employers to make additional contributions to. Prior to the recession resulting from the global financial crisis, the tight labour market was forcing employers to offer benefits to attract and retain staff. This trend has reversed with the current level of unemployment.

Saving via a superannuation scheme also has the advantage of making funds available on withdrawal from the scheme, should they be required to meet some other financial need during a person's working life.

Performance Issues in the KiwiSaver Sector

Volatility of investment returns and the possibility that members will crystallise losses when switching providers or investment options. As members can freely transfer between schemes, providers face a potential liquidity risk.

Adverse publicity over the ethics of a KiwiSaver provider undermines the public's confidence in the product as well as the industry. This is being addressed by the formation of the FMA, increased reporting to the GA and the up-skilling of financial advisors.

Erosion of Returns by Fees. This is a particular issue with conservative options where the level of expected returns is lower. However, the GA ensures that the fees being charged are not unreasonable.

Ability of the providers to manage cost effectively the changes to both KiwiSaver and the regulatory regime in which it operates. This is the main performance issue but the continuing growth in membership and funds under management, together with healthy competition, should overcome the issue provided no changes to benefit design are made in the near future.

Promotion by Providers

While there was some promotion and explanation of KiwiSaver by IR at the time it was launched, there has been little or no general promotion since by either government agencies or the providers (who have generally just stuck to existing distribution channels). The IR, Retirement Commission (Sorted) and providers' websites are all informative, but require some active attempt to access them.

The CB survey of individuals found that some incentives are better known than others. Large majorities are aware of the Government kick start payment (92% of all respondents) and employer contributions (81% of all respondents), but fewer are aware of the Government's tax credit (58% of all respondents). In addition knowledge of the flexibility afforded to the unemployed and self-employed in deciding how much to contribute is also low (35% and 45% of all respondents respectively). Given the lack of knowledge about some of the more specific aspects of KiwiSaver amongst the general public there is probably a need for more general promotion in the daily news media and by the industry or government agencies, although it might be hard to decide just who should be responsible given the divided roles undertaken by ISI, Workplace Savings, IR, MED, the Retirement Commissioner and so on.

Promotion by providers to prospective members, and to retain existing members, tends to be low with communications being largely limited to the statutory minimum. Some providers have notified those members who have contributed less than that required to receive the maximum member tax credit in a year, which was well received by investors.

Complexity of Product

While the design of KiwiSaver is relatively simple compared to some other investment and superannuation products, there is still a considerable amount of ignorance as to its principles and finer points by the general public (as highlighted in the above section on Promotion by Providers) – which in turn reduces their ability to make the most of the opportunities it offers to them. .

This situation is not surprising given New Zealanders' level of financial literacy. When investigating the financial literacy of New Zealanders the RBNZ found that:

> *New Zealanders are aware of some of the financial issues that they face, but they are ill equipped to make financial decisions. They do not effectively understand the basic financial terms or instruments or, more worryingly, the concept of risk and return. Furthermore, they do not use existing financial disclosures or credit ratings in a manner that would enhance their understanding of financial exposures.* (Reserve Bank of New Zealand: Bulletin, Vol. 70, No. 2)

There is a risk that changes to the design could further confuse people and add to providers' costs.

An example is the proposed change to enrolments for those under 18. During the 2008/09 year, only 6% of the 180,000 under 18 year old members contributed through Inland Revenue to their accounts, most having been enrolled by parents wanting to see them get the $1,000 kick-start. This is possible because anyone can now join up a child under 18 to KiwiSaver, thus committing the child to contribute once they start earning (unless they take a contribution holiday). There is also the possibility that, if they do not contribute initially, that much of their $1,000 kick-start could be taken up by fees before they start to contribute.

For these reasons, it has been suggested in the consultation documents for new legislation that only legal guardians will be able to enrol those under 16, and that 16 and 17 year olds will have to sign jointly with their legal guardians. This change, however, may not affect whether or not contributions are made to children's accounts, given that parents (legal guardians) are enrolling children now and not making contributions. Commentators in the sector have told us that this could raise some different challenges. With blended families, if all a child's legal guardians have to agree, this would delay and increase the cost of the enrolment process

The legal changes to the specific benefit design of KiwiSaver, such as the added role of guardians in the signing of children's KiwiSaver applications, require providers to seek expert superannuation legal advice, interpret that advice and modify their documentation and systems accordingly. Managing this factor will require additional resources.

System Change Costs

One of the major costs in launching and operating a KiwiSaver scheme is likely to be the cost of setting up and maintaining the computer administration systems, with any legislative changes adding to the continuing burden. A feature of KiwiSaver, in fact, has been the extremely professional way in which both IR and the individual providers have implemented and operated their systems so successfully to date, in spite of the inherent complexities.

While some of the (mostly smaller) providers have isolated themselves from incurring system costs by using an outsourced administrator, most maintain their systems in-house (if only to eliminate the risk of non-performance by an outside organisation).

While the costs of system maintenance vary considerably from one organisation to another, we have heard anecdotally that some costs are considerable. One provider, for example, has a team of five people working on average one day per week each, just to provide routine support at a cost of well over $100,000 per annum. For large providers with strong compliance teams, even the cost of implementing the changes to the PIE tax rates will cost around $200,000. Legislative changes are on top of this. For this reason we consider that any changes made to the structure of KiwiSaver should simplify and streamline it, rather than make it more complex - which will only serve to both baffle members and add extra costs to providers.

A key area in which we consider that this could be done would be to ensure that all the forms and procedures used by members be standardised across all providers, even if the individual forms were still branded with providers' logos, so that the processes, for example, for applying for death benefits or first home benefits, were standardised.

Effective Monitoring by Government

The Government's strong response to the misleading reporting of KiwiSaver returns by a single provider helped reassure the market.

The combination of increased oversight by the FMA, increased reporting requirements and the licensing of financial advisors will better protect the consumer. However, the increased compliance and administration required can be expected to increase providers' costs. For example, the increase in reporting from annual to quarterly for non-default providers will require additional management oversight and system changes to produce the appropriate reports. This needs to be monitored to ensure the industry remains viable in order to effectively service the KiwiSaver product.

Provided the FMA operates a robust principles based monitoring framework and is resourced appropriately, then the risk of any inappropriate behaviour by providers should be reduced.

Transparency of Fees

Nobody wants to pay more in fees than they have to, so there is considerable interest by members in being able to compare fees between providers in a consistent manner. Mercers, for example, in June 2010 have quoted their own member research as having shown that 86% of members rated competitive fees as an important, or very important, fund feature. This is also a more significant factor since the government stopped paying the fee subsidy.

In practice however the differences in the way that different providers structure their fees make some direct comparisons difficult. Some, for example, tend to reduce their fixed monthly administration fees but load the fees they levy on member balances, while others do the reverse.

The practice of charging performance fees (i.e. fees which are essentially non-transparent since they will vary with fund performance) by some boutique providers makes comparisons between providers very difficult for unsophisticated members.

For this reason there have been suggestions by industry commentators that all providers be required to quote their fees in a standard manner, so as to facilitate an apples for apples comparison and make the comparison of funds easier. This will, in turn, aid individuals' decision making about what fund to invest in. Changing the reporting standards to publish "true" after tax and fees returns at each tax rate could also facilitate comparison.

Compulsion

At this stage some industry commentators think that there is not a good case for making KiwiSaver compulsory. Their argument is essentially:

- First, membership is already high and is still increasing so we expect it to become almost universal over time anyway. Membership has now risen from zero to 1.4 million in less than 3 years and is still increasing. This is largely due to the generous government incentives provided, and the nature of the auto-enrolment which enrols people who might not get around to actively enrolling themselves.

- Secondly, the generally wide acceptance of KiwiSaver by the public at large has come about because membership is seen as a voluntary option incentivised by the government, rather than being compulsory. The history of New Zealand superannuation policy development shows that a vocal minority are always likely to successfully oppose any hint of compulsion.

Replacement

Our analysis of the MFS by the Reserve Bank demonstrates that relatively little substitution of managed funds or superannuation schemes are occurring through KiwiSaver. The take-up by younger New Zealanders under 25 has been exceptional compared to traditional superannuation schemes. This is likely to be a result of a number of factors, one of which is the auto enrolled feature which traditional superannuation schemes did not have.

Issues facing sector over next 3 years

Providers will become more profitable as their FUM continue to rise and they streamline their procedures. Some general consolidation of the large banks and insurance companies is inevitable and likely to result in a reduction in the number of schemes operated.

Through membership of KiwiSaver, one might expect that a member's understanding of financial issues will increase over time and that they will subsequently research their provider and investment choices more thoroughly. This will likely occur in conjunction with growth in individual account balances. Once members start to see a substantial pool of money in their KiwiSaver account they are likely to want to invest the time in ensuring its safe stewardship.

The combination of the public's lack of financial literacy and some media reporting can unsettle investors' confidence in the KiwiSaver market. Such media reported events run the risk of discouraging people joining KiwiSaver and may reduce the level of contributions being made by existing members. The sector hopes that the proposed financial sector regulatory reforms will do much to restore public confidence in the sector.

The general image of KiwiSaver has also come into the spotlight by squabbles in the media over fee comparisons drawn on various websites. For the public such debate, if anything, increases confusion and caution over KiwiSaver. This means that big firm branding, perceived relative fees and distribution reach (including default provider status) are currently how the major providers get their members - with no special effort generally being made to stop members transferring from other schemes, or indeed, to attract other scheme members.

Most providers expect that the number of major providers will fall due to mergers and attrition. This is probably inevitable given the number of largely undifferentiated large players, since most markets can only support, perhaps, at most 3-4 such players. This is not, however, the end of the story, since most financial markets in New Zealand also have a number of niche (and usually smaller) players, each of whom provide their own points of differentiation. This is what we consider to have started to occur in the KiwiSaver market - with small innovative players such as Fisher, GMI (Gareth Morgan) and Milford becoming established.

These smaller, flexible and individualistic providers are, in some sense, the antithesis of the large corporate players. It is the entry into the market of these providers which can be considered as one of the major untold developments from the supply side, and it is one facilitated by the availability of an outsourced administrator who can potentially reduce the costs of market entry to well under $100,000. In most cases they are essentially niche providers of managed funds specialising in specific asset classes, such as New Zealand equities or alternative assets, and each with their own unique investment style. They have typically created their own KiwiSaver scheme to add volume to their existing funds management operation, and are able to offer genuinely innovative investment options. Over time, as business journalists become savvier in their coverage of these products, KiwiSaver members will become better informed and give those niche operations a try.

If so, KiwiSaver will have made a genuine contribution to the further development of the local funds management industry.

Findings and Conclusion

Findings

KiwiSaver is still a small part of the overall managed funds sector, making up only 9% of total funds under management compared to 29% for other types of superannuation. Furthermore, the average member account balance remains low at just under $5,000 as at 31 December 2009 (based on 24 survey respondents).

The last two to three years have seen the largest cyclical economic downturn in the global economy since the Second World War, which was clearly evident in the returns posted by KiwiSaver funds and other managed funds more generally. This however has not slowed the growth of KiwiSaver with contributions and member growth continuing.

KiwiSaver funds have a higher weighting to domestic assets (53%) than other superannuation schemes (38%) but less than overall managed funds (56%). These funds also have a higher weighting (14%) to New Zealand (NZ) equities than both other superannuation (9%) and managed funds (11%) in general. Yet KiwiSaver's small absolute size means it has little impact on capital markets within New Zealand at present.

In the short term the profitability of providers' KiwiSaver activity remains marginal. This is because funds under management is the main driver of revenue and this has taken a hit with the adverse economic conditions within which KiwiSaver has operated over the past three years. In addition, the halving of the minimum member contribution to 2% and setting the Compulsory Employer Contribution (CEC) to 2% (rather than having it increase to 4% in 2011) will slow the growth of funds under management. Profitability has also been influenced by the level of costs associated with servicing a large retail client base (with small average balances) and aspects of KiwiSaver such as queries about, applications for, and the administering of hardship claims[16].

The low level of profitability within the industry is seen as likely to push consolidation within the industry. The consolidation of providers may not mean the disappearance of smaller providers as some have been able to build robust niche positions within the market. Of the 24 providers responding to the survey, 79% expected that the number of providers will decrease over the next three years.

The health of the KiwiSaver market is most strongly shown from its profitability. While profits are being squeezed in the short term, not least due to the global financial downturn, the profitability for providers over the longer-term appears likely to be quite positive. The second key indicator of health is the number of substantial players, i.e., those that have at least 5% of the market share. The fact that two active choice providers have a market share of greater than 5% is a good sign of current competitiveness; the six default providers also have a market share of greater than 5%.

The exit and entry of schemes is another aspect of competition within the market. To date three schemes have closed to the market while two have opened in 2010. The two new schemes, operated by Milford Asset Management and Kiwibank, both had relationships with existing KiwiSaver providers. The ease of transferring members and accounts from schemes that have closed to other providers can be seen as a positive for the way KiwiSaver was established.

The introduction of the Financial Markets Authority (FMA) is seen by providers as a positive step towards increasing the transparency of fees and returns, as well as helping to restore public confidence in the financial sector more generally.

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[16] Most major providers interviewed identified this as being an issue and set out the detailed work required. The IR survey of individuals (undertaken in 2010) found that only 3% of respondents had been successful in a hardship claim. However, this may not be representative of the total population.

This report highlights a number of innovations in the market such as new schemes, repositioning by providers, and new strategies by providers to offer high quality services to their members.

Of the $5.3 billion paid to Providers as at March 2010, the Crown is still the largest contributor to KiwiSaver with an estimated contribution of $2.3 billion, members have contributed approximately $2.1 billion and employers $0.9 billion.

Policy Implications

The low level of transparency around fees and returns was highlighted in our 2008[17]. It is still an issue but positive steps have been seen to be taken through the legislation currently being drafted to enable regulation around disclosure of fees and performance amongst others. Work is also being under taken by the Investment Savings and Insurance Association (ISI)[18] to introduce industry standards in this area. As the new Financial Markets Authority (FMA) is established, it will be important to ensure that the opportunity to introduce transparency around fees and returns works well in practice in this market.

With the current low profitability of KiwiSaver in general, there is a need to monitor compliance costs imposed on providers, particularly with the proposed regulation of required periodic reporting. It also needs to be acknowledged that the sector will not be likely to promote KiwiSaver aggressively to the general public and that the government kick-start payment and member tax credit (MTC) remains important to the success of the policy. The 2010 survey of individuals shows that government contributions (the kick-start payment and MTC) were the second most important factor in members' decision to join KiwiSaver (19% of 474 members).

With the level of new members still growing strongly, there is an ongoing question of the required number and position of default providers. These providers have a privileged position in the market which affects competition and is due to be reviewed in 2014. However, the ease of transfer between schemes lessens the effect. The report of the GA shows that approximately 4% of members transferred between schemes during the year ended 30 June 2009. There is some concern that the ease of transfer could constrain the performance of KiwiSaver due to the implications for liquidity. However, given the benefits to competition it is too early to consider changes to the market.

The default funds, by having relatively low fees (especially when compared to traditional superannuation, non-KiwiSaver products), would appear to have applied a useful downward pressure on fees in the KS market overall.

Conclusions

The launch of KiwiSaver has been successful in encouraging New Zealanders to save for retirement. Many younger people have become members and KiwiSaver has more than trebled the number of individuals contributing to a retirement savings product. Membership is still growing by 1,000 per day.

KiwiSaver is providing a stimulus to the New Zealand financial sector. Providers see KiwiSaver as a medium/long term growth opportunity. Building the necessary infrastructure to support the product has made it marginally profitable in most cases.

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[17] The report can be found at: http://www.med.govt.nz/templates/MultipageDocumentTOC____40717.aspx

[18] The ISI is an industry body made up predominantly of the large banks and insurance companies who offer financial service products. It lobbies Government on tax and regulatory issues and attempts a level of industry self-regulation.

The global financial crisis and resulting volatility of investment returns has not impeded KiwiSaver's growth significantly, but has reduced its profitability for providers because the negative investment returns reduced the funds under management which, in turn, drives the level of income managers receive.

The number of providers is currently stable but more consolidation occurring will be consistent with a healthy industry.

To date the funds flow has had only a small positive impact on New Zealand capital markets. KiwiSaver funds have a marginally higher weighting to domestic assets than other superannuation schemes or managed funds.

Whilst the providers seek compulsory membership to protect their business, the overwhelming success of the current voluntary approach suggests no change is necessary.

Appendix 1: Evaluation method

In undertaking this report MED:

- surveyed the KiwiSaver providers[19] (24 out of the 31 providers surveyed responded to the survey);
- carried out desk based research;
- conducted interviews seven with providers and the Investment Savings and Insurance Association (ISI); and
- sought expert advice from Erikson and Associates Ltd, an independent firm of actuaries, investment strategists and business consultants.

Survey of KiwiSaver providers

The KiwiSaver Evaluation Survey was conducted to, among other things, expand and augment the data collected in the interviews and desk based research. The survey provided the opportunity for all providers to provide input on key issues and to provide a unified data set across all types of Providers for key economic indicators. The survey was sent to 31 Providers and achieved a response rate of 81% (25 out of 31 Providers).

The design of the survey followed that from the 2008 report to create a time series of survey data for some questions that will continue to yield information as the survey is repeated in future years.

The first survey conducted by PwC provided a benchmark of results relating to issues such as compliance, profitability and strategy, this evaluation looked to re-examine these question to reveal the changes over time.

Desk based research

The approach to quantitative desk based research was to find and assess all the relevant data sources and additional sources from the financial sector and national statistical databases. Current information about KiwiSaver supply-side trends was available through IR, industry associations, and MED. This was able to be supplemented by other related data sources including Statistics NZ, the reports of the GA on private superannuation funds, government sourced data for government superannuation funds and information from other stakeholders.

The GA collects from KiwiSaver Providers a wide range of statistical data in the form of annual returns for year ended 31 March, in accordance with the KiwiSaver legislation. This data is used at an aggregate level in the GA's report to parliament. The GA's 2009 report contains aggregate results. The GA also provides reporting on Superannuation schemes governed under the Superannuation Act 1989 and the Government Superannuation Fund.

[19] Providers are those organisations that administer schemes and that have a scheme provider agreement with Inland Revenue.

Interviews

The basis of qualitative data was interview data collected from consultations with Providers (7) and ISI. The interview process provided a unique opportunity to consider the experience of providers first hand; this has allowed the evaluation to provide a balanced perspective on the implementation and future expectations of KiwiSaver. The interview process was conducted with a structured set of questions that explored in greater detail the responses to the survey.

Eriksen & Associates Limited

Eriksen & Associates Limited (Eriksen) were employed to provide additional market detail in the report. Eriksen is a independent firm of actuaries, investment strategists and business consultants.

Appendix 2: Results from the 2010 Survey of Providers

The following results have been extracted from the 2010 survey of KiwiSaver Providers conducted by MED.

Table.1 - Types of New Member Targeted

Over the next year will your strategies to attract new members to your KiwiSaver schemes(s) target:		
Answer Options	Response %	Response Count
New KiwiSaver members (those who currently do not belong to any KiwiSaver scheme)	4.2%	1
Existing KiwiSaver members	0.0%	0
Both	95.8%	23

Table.2 - Marketing to Non-KiwiSaver Members

What are your main strategies to attract new members (those that currently do not belong to any KiwiSaver scheme) to your KiwiSaver scheme(s)?			
Answer Options	Response %	Response Count	Response % (2008)
Direct marketing to existing client base	62.5%	15	81%
Employer choice agreements	58.3%	14	65%
Approaching clients/cross selling	33.3%	8	58%
Financial advisers	66.7%	16	46%
Advertising	45.8%	11	38%
New products/funds	8.3%	2	N/A
Do not know	0.0%	0	0%
Other (please specify)		6	8%

Other comments received on strategies to attract new members were:

- No marketing undertaken
- We do encourage financial advisors but the balances are so small that it is hard for an advisor to make any money out of KiwiSaver. That may change when average balances are circa $20,000.
- Regular newsletters will be the strategy of choice
- Retention of members is as important as new members.
- Advertising through websites.

Table.3 - Marketing to Existing-KiwiSaver Members

What are your main strategies to attract Existing KiwiSaver members to your KiwiSaver scheme(s)?		
Answer Options	Response %	Response Count
Direct marketing to existing client base	63.6%	14
Approaching clients/cross selling	40.9%	9
Financial advisers	68.2%	15
Advertising	36.4%	8
New products/funds	13.6%	3
Do not know	0.0%	0
Other (please specify)		4

Other comments received on strategies to attract existing KiwiSaver members were:

- Referral scheme (offering incentive for existing members who refer transferring members)
- None
- None passive
- There is no intent to attract and thus no strategy
- Question # of the provider survey asked providers to highlight any strategies that they saw emerging in the sector to attract more business to KiwiSaver, responses included:
- fee discounts (6);
- banks cross selling (7);
- return based promotion (2);
- targeting groups;
- acquisitions; and
- promoting switching.
- One respondent mentioned that no one is promoting joining KiwiSaver more generally and that this needs to occur as had been anticipated by the policy settings for KiwiSaver.

  Providers are promoting their own products but not pushing KiwiSaver more generally as the benefits may not accrue to them and this raises the question of whether there is a continued role for government promotion? For some New Zealanders the decision is not what vehicle to use to save but the decision between saving and consuming such as paying off essential house hold items or up-grading to bigger flat screen television.

Table 4 - Expected Number of KiwiSaver / Super Schemes

Over the next three years, what do you consider will happen to:					
Answer Options	Increase	Remain constant	Decrease	Do not know	Response Count
Number of KiwiSaver Providers	2	2	19	1	24
Number of KiwiSaver schemes	4	2	17	1	24
Number of KiwiSaver investment products	16	3	5	0	24
Total number of corporate superannuation schemes (i.e. not just KiwiSaver)	1	5	18	0	24
Total number of personal superannuation schemes (i.e. not just KiwiSaver)	3	3	17	1	24

Table 5 - KiwiSaver Scheme Profitability

What is your view on the profitability of your KiwiSaver scheme(s) over the next ten years?		
Answer Options	Response %	Response Count
Very profitable	0.0%	0
Good profitability	29.2%	7
Low profitability	37.5%	9
Break even	16.7%	4
Loss making	8.3%	2
Do not know	8.3%	2

Table 6 - KiwiSaver Schemes - Payback Period

What payback period are you expecting on your KiwiSaver investment (including recouping set up costs)?		
Answer Options	Response %	Response Count
Under 5 years	17.4%	4
5 – 8 years	43.5%	10
9 – 12 years	13.0%	3
13+ years	4.3%	1
Do not know	21.7%	5

Table 7 - Expected Number of KiwiSaver Providers

Over the next three years, what do you consider will happen to:					
Answer Options	Increase	Remain constant	Decrease	Do not know	Response Count
Number of KiwiSaver Providers	2	2	19	1	24
Number of KiwiSaver schemes	4	2	17	1	24