bnz

BNZ’s submission - Review of KiwiSaver default provider arrangements

Contents

1 Introduction 5

2 Executive Summary 5

1 What is your feedback on the proposed objective for the review? 7

2 What is your feedback on the proposed criteria for the review? How should the criteria be weighted? 7

3 What is your feedback on the problem definition for the investment mandate? Is a move away from a “parking space” purpose justified? 7

4 Should the investment mandate options (and other options, for example in relation to fees) apply only to default members who have not made an active choice, or should they also apply to members who have made an active choice to stay in the default fund? Why or why not? 8

5 If a life-stages option is adopted, what “stages” should apply and to which age groups? Should there be a “nursery” period? 8

6 If a balanced investment mandate is adopted, what range for growth assets should be applied? 10

7 If a growth investment mandate is adopted, what range for growth assets should be applied? 10

8 If a conservative investment mandate is adopted, what range for growth assets should be applied? 10

9 If a life-stages, growth, or balanced option was adopted, how should we mitigate the potential issue in relation to first-home buyers and other people making early withdrawals? 11

10 What would be the administrative costs to providers of choosing a life-stages option? 11

11 What is your feedback on the different options? Do you agree with our assessment of the costs and benefits of the option? Which option do you think is best and why? Is there another option that we have not considered that would be better than the options discussed? 12

12 What is your feedback on the level of value that KiwiSaver default members get for their fees? What are the costs that are within and outside a provider’s control? To what extent are fees too high? 13

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

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

15 What fee arrangements would best promote the objectives of the review? What is your feedback on the fee options? Do you agree with the costs and benefits identified? Which option (or the status quo) do you prefer and why? What other approaches or models could be used to reduce fees? 14

16 How has the number of providers in the default market affected innovation, competition and value-for-money in the default market and in KiwiSaver more generally? 15

17 Do you agree with our assessment of the costs and benefits of the different approaches for the number of providers? Can you provide us with evidence that might help us quantify the size of the costs and benefits? What option do you prefer and why? 15

18 If a "minimum requirements" approach is taken should this be on a period-based or rolling system, and why? 16

19 Are there higher investment costs for responsible investing? If so, how likely are these costs to contribute to lower net returns? 16

20 How does responsible investment affect returns? Does it increase or decrease returns, and to what extent? 17

21 Should the default provider arrangements be used to achieve objectives in relation to responsible investment? 17

22 Would default members want their funds to be invested more responsibly? If yes, is the same true if responsible investment means potentially limiting future returns? 17

23 To what extent is it a problem that default members do not have information about whether their investments are made responsibly? Would having more information make a difference to the behaviour of default members? What alternatives might there be to more/standardised information to address responsible investment concerns? 18

24 Do providers' current responsible investment exclusions meet what default members would expect? 18

25 If this option is adopted, what industries or sectors should be excluded? Should the government instead adopt an international exclusion standard or certification regime? What would be the costs associated with an exclusion or certification regime? 18

26 If this option is adopted, what form should standard disclosure take? For example, should all providers be required to provide a statement listing all excluded companies by sector? 19

27 What is your feedback on our assessment of the costs and benefits of the responsible investment options identified? Which option (or the status quo) do you prefer and why? 19

28 What limitations or problems exist in relation to New Zealand's capital markets? How could the settings for KiwiSaver default providers be amended to support the development of New Zealand's capital markets? How do the liquidity and pricing rules affect default provider investment in alternative New Zealand investments? 20

29 How could the default settings be used to develop New Zealand's capital markets? What parts of New Zealand's capital markets are most in need of development? 20

30 Should default funds take an active role in helping develop the New Zealand capital markets? Would this support the purpose of the KiwiSaver Act and the accumulation of retirement savings by default members? 20

31 To what extent is the management of default funds currently located in New Zealand or carried out by New Zealand entities? 21

32 What is your feedback on a New Zealand-based management option? If this option is adopted, which part of the investment process do you think should be based in New Zealand to help develop New Zealand's capital markets? What type of mechanism would best give effect to this requirement? 21

33 What is your feedback on a targeted investment requirement? If the option is adopted, what market should be targeted by an investment requirement (eg early stage companies)? 21

34 What is your feedback on our assessment of the costs and benefits of the options to develop New Zealand's capital markets? Which option (or the status quo) is best and why? Is there another option that would be better than the options discussed? 22

35 What is your feedback on the problem definition for the transfer of members? What other problems are there in relation to the transfer of members? 22

36 If default members are transferred from providers with more members to providers with fewer members, how should we decide which members are transferred? 22

37 If transfer option 1 or 2 were adopted, how should default members be given a choice to remain with their current provider for this option? 22

38 What is your feedback on the transfer options and the costs and benefits of the options? Which option (or not transferring at all) do you prefer and why? Is there another better option we have not considered? 23

39 What factors should the review consider in deciding transition timeframes? 23

40 Should active defaults be considered default members for the purposes of transfers? How should active defaults be treated and notified of any changes to default provider settings? 23

41 What is your feedback on the member education requirements that default providers should have in relation to default members, and how these should be enforced in the instruments of appointment? 23

42 What is your feedback on the other requirements that should apply to default members? 24

1 Introduction

1.1 Bank of New Zealand ('BNZ') has prepared this response to the Review of the KiwiSaver Default Provider Arrangements discussion paper (the 'Discussion Paper').

1.2 BNZ welcomes this opportunity to respond to the Discussion Paper and acknowledges the significant work that has been done to present a wide range of reform options for the current default provider settings.

1.3 BNZ also supports the submission of the Financial Services Council.

2 Executive Summary

2.1 The Discussion Paper is ambitious in scope and proposes a wide range of potential reform options. BNZ has reflected on all aspects of the Discussion Paper but considers that the key matters of importance are as follows:

- BNZ supports a change in the investment mandate for default members to a life-stages option. We believe this option will lead to better outcomes at retirement for default members. However, for this option to be successful, BNZ considers it is critical that providers who are appointed are given flexibility to use their existing funds and not be forced to build something that will only be used by default members. Additionally, setting appropriate parameters for a life-stages investment option requires careful consideration and a range of inputs. Therefore, BNZ considers further consultation may be required in relation to the design of the life-stages mandate.

- Default providers will need to work together with the Government and regulators on a wide-reaching public awareness campaign to communicate any decision to change the investment mandate. The emphasis should be on how a change in the investment mandate may impact default KiwiSaver members making early withdrawals (for example first home buyers).

- BNZ considers that fees are best managed by competitive forces and supports Option 2 assessing fees via a two-stage process in procurement. To the extent that a decision is made to regulate fees more intensely, BNZ considers that it is important that fees outside of the default fund choice are brought into the scope of that regulation in order to create more equitable outcomes between default and non-default members.

- BNZ supports the retention of a limited number of default providers but agrees that concentration risk needs to be addressed and recommends that could be done by capping the number of default members that are allocated to a default provider.

- In relation to responsible investment, BNZ considers the priority to be standardisation of responsible investment definitions to develop a consistent market understanding about what responsible investment means. Until there is greater consistency in the market about what responsible investment means, BNZ does not support mandatory exclusions of certain industries or companies or mandatory standard disclosure in the form currently proposed.

- BNZ supports transferring default members from default providers that are not reappointed as default providers.

- BNZ supports ongoing assessments of default providers and a requirement on default providers to evidence how they are meeting member information requirements and would welcome an opportunity to work further with MBIE as these requirements are refined.

Should the Treasury or Ministry of Business, Innovation and Employment have any questions in relation to this response, please contact:

Paul Hay
GM Regulatory Affairs
Bank of New Zealand

DDI: (04) 474 9028
Mobile: (021) 159 8172
Email: paul_hay@bnz.co.nz

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

1.1 We agree with the objective of the review being to enhance the financial well-being of default members particularly at retirement and would emphasise the importance of this objective being at the forefront of the issues that are addressed throughout the Discussion Paper. As an organisation, we are committed to supporting default Kiwisaver options that best align with good customer outcomes.

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

2.1 When assessing the Options presented in the Discussion Paper, BNZ considers that criterion 2 (Trust and Confidence in KiwiSaver) should be given the greatest weighting as achieving this is fundamental to the success of KiwiSaver. In our view all the other criteria should work to support the goal of increasing trust and confidence in KiwiSaver. We would suggest giving criterion 2 a weighting of 60%. We consider that it be followed by criterion 1 (Better financial position for KiwiSaver default members, particularly at retirement) and criterion 5 (Promote innovation, competition etc) both at 15%. And finally, criterion 3 (Low administration and compliance costs) at 10%.

2.2 BNZ considers criteria 4 (Support development of New Zealand's capital markets that contribute to individuals' wellbeing) to be of less importance as compared to the other criterion and in this respect supports the position stated in the Capital Market 2029 report that there should be no specific mandate that default funds be used for capital markets' development[1].

Investment Mandate

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

3.1 We agree that a move away from a "parking space" purpose is justified. This is because the concept of default funds as short term "parking spaces" does not appear to be well-understood given the large proportion of default members who stay in default funds and do not engage with their default providers. That said, it may be the case that default members remain in the default funds because they are happy with them - although lower than growth fund returns, the returns on conservative funds may be considered reasonable by some members on a risk-adjusted basis, when also considered against traditional investments (for example term deposits). Also, in our experience, many default members who make an active choice continue to opt to stay in the default fund which suggests that there is a general degree of comfort and familiarity with them. In addition, we note that asset maximisation will not be an appropriate approach for all default members – for example, those who are close to retirement will be more focused on reducing risk and protecting their wealth. However, on balance we do not think these factors should outweigh a move to a purpose for default funds that focusses more on asset maximisation.

[1] See page 27 of the Capital Markets 2020 report "We do not favour the specific mandate that default funds be used for capital markets' development".

bnz

3.2 In our view, the problem definition should reflect that a change to a focus on asset maximisation will also mean an increase in risk. This change in the risk profile, as well as the increased growth potential, would need to be well communicated to default members (from both default providers and the Government). This exercise could also have positive benefits in increasing awareness in non-default (active members).

3.3 Further we agree that a move away from a "parking space" purpose will change the nature of provider engagement, but that provider engagement remains important. At the outset if a decision is made to change the investment mandate for default members, there will need to be a high degree of communication about this. Going forward we would expect the scorecard for default providers to be more balanced to include other measures of engagement in addition to active fund choice e.g. default members providing contact details, updating tax information etc and include more focus on member education about KiwiSaver and financial literacy.

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

4.1 Our view is that the decisions of default members who have made an "active choice" should be respected and maintained and this would be in line with the public's expectation. We consider that overriding a member's decision would be highly confusing. It also conflicts with the KiwiSaver policy goal of driving choice by a member. We note that default providers' Instrument of Appointment (IoA) seeks to provide security only to those default members that have not made an active choice. Overriding a member's active choice to stay in a default fund suggests that conservative funds are never the right choice, which is incorrect. We think that trust in KiwiSaver would be seriously undermined if a member was moved from a fund of their choice to another fund with a different risk appetite setting.

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

5.1 Many providers don't currently offer a life-stages option. As such, a significant amount of effort would need to be undertaken by providers to offer this. In doing so, providers may want to use their existing funds, as opposed to being required to build something that they may only choose to offer to their default members (because it doesn't align with the provider's view of what is 'best' for its customers). This may lead to the default option being perceived as inferior to what the provider offers its 'active choice' members, which may detract from instilling trust and confidence in KiwiSaver. Allowing providers to use their existing funds addresses this problem.

5.2 In order to deliver an appropriate life-stages option, significant work would need to be undertaken to determine the most appropriate asset allocation for each life stage. Also, consideration will need to be given to how to move default members through the various life stage profiles in a way which minimises risks. If a life-stages option is adopted, a simple example of how this could work is provided below.

a. Stage 1 could be called something like ‘Early career’. Members in this stage would potentially be up to the age of 40 or 45. A high allocation to growth assets (80-90%) would be taken in order to maximise returns and build their retirement nest egg.

b. Stage 2 could be called something like ‘Pre-retirement’. Members in this stage would potentially be between the ages of 40/45 to 65/70. This is the de-risking stage, where they would transition from a high allocation to growth assets to a much lower allocation.

c. Stage 3 could be called ‘Retirement’. Members in this stage would be 65 or 70 years and older. A lower allocation to growth assets (20-30%) would be taken in order to reduce risk and protect their retirement nest egg.

5.3 In our view, the objective of the life-stages option is the key factor that will determine the parameters of the ‘glide path’ (i.e. the allocation to growth assets at the start, the points in time at which the de-risking begins and ends, the allocation to growth assets at the end, etc). For example, if we assume that the objective is to provide sufficient income in retirement for members, the parameters could then be determined as follows:

a) Establish a view of what a ‘typical’ member would look like.

b) This could include broad population characteristics such as income at retirement, age at which drawings would start, life expectancy at retirement, and the level of government funded superannuation. To help with this, it would be useful to have more information on members than what is currently available – for example, member contribution rates.

c) Decide what the retirement benefit is that is to be targeted (e.g. a fixed dollar amount, income replacement percentage, etc).

d) Use stochastic modelling to determine the parameters that are most likely to achieve the retirement benefit that is targeted for the typical member, given an acceptable level of risk.

5.4 Consideration will need to be given to the treatment of default members once they reach their KiwiSaver retirement age. For example, is the intention that the government will set the investment parameters for life stages from the accumulation phase (which would seem to be the current focus) through to the default member’s decumulation phase (where they to continue to be a KiwiSaver member)?

5.5 Our view is that a ‘nursery’ period is not required. The key reasons for this are:

a) Providers should be engaging with all new members on whether the life-stages option is the most appropriate for them.

b) Member balances are very small in the beginning. Therefore, the savings that are ‘at risk’ by not being in the most suitable fund are very small.

c) KiwiSaver providers don’t appear to charge buy/sell spreads. As such, there isn’t an explicit cost to the member for switching to a different fund. That said, there is an implicit cost that is borne by members who don’t switch – i.e. they bear the costs of

members who do switch. As such, we support APRA's view that the use of buy/sell spreads is best practice, and they should therefore be considered for KiwiSaver funds. This becomes a much more important consideration should a life-stages approach be adopted.

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

6.1 Under this option, we would recommend a range of 43-57%. The key reasons for this are:

a) The range should be narrow enough to ensure that the chosen risk profile is adhered to. If the range is too wide, some providers may offer a fund that more closely resembles a 'moderate' investment mandate at the one extreme, or a 'balanced growth' investment mandate at the other. A narrower range ensures that the fund that is offered is 'true to label'.

b) The range should be wide enough to mitigate the risk (cost) of having to rebalance too frequently.

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

7.1 Under this option, we would recommend a range of 73-87%. The key reasons for this are:

a) The range should be narrow enough to ensure that the chosen risk profile is adhered to. If the range is too wide, some providers may offer a fund that more closely resembles a 'balanced growth' investment mandate at the one extreme, or an 'aggressive' investment mandate at the other. A narrower range ensures that the fund that is offered is 'true to label'.

b) The range should be wide enough to mitigate the risk (cost) of having to rebalance too frequently.

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

8.1 Under this option, we would recommend a range of 13-27%. The key reasons for this are:

a) The range should be narrow enough to ensure that the chosen risk profile is adhered to. If the range is too wide, some providers may offer a fund that more closely resembles a 'defensive' investment mandate at the one extreme, or a 'moderate' investment mandate at the other. A narrower range ensures that the fund that is offered is 'true to label'.

b) The range should be wide enough to mitigate the risk (cost) of having to rebalance too frequently.

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

9.1 Default providers can help mitigate the potential issue in relation to first-home buyers and other people making early withdrawals via early communications that highlight the risks to such groups and aim to ensure such customers are in the right fund. In addition, we would support highlighting the increased risk for early withdrawers in the other forms of engagement with default members e.g. the IR communications that go to default enrolled members and information on the Financial Markets Authority and Sorted websites etc.

9.2 Beyond such communication, we do not think providers should be required to take any further steps to mitigate the potential issues in relation to first-home buyers and other people making early withdrawals. This is because we think that supporting the best *long-term outcomes* should be the priority for default providers. The purpose of the KiwiSaver Act is to encourage a "*long-term*" savings habit and the objective of this review is to enhance the financial well-being of default members, "*particularly at retirement*". We also agree with the Consultation Paper that most first home buyers are engaged and therefore do not think that applying specific member engagement requirements on providers targeted at potential first home buyers is warranted. In respect of people making other early withdrawals for example for hardship this is always an unforeseeable risk event for KiwiSaver members and should not guide the overall investment mandate.

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

10.1 We expect a life-stages option would create more trading activity in the market which results in increased transaction costs and resourcing costs. As such, as mentioned earlier, the implementation of buy/sell spreads should be considered for KiwiSaver funds. In addition, for those default providers that do not offer life stages today, significant investment will be required in registry platforms to manage this type of investment solution.

10.2 Whether there is a more significant cost consequence will depend on how the life-stages option is structured. Our preference, and what we consider to be the most cost effective, would be for the Government to set the framework of the life stages i.e. the trigger ages and stages, but leave default providers free to determine their own asset allocations (i.e. income assets vs growth assets). This would enable default providers to move members through their own funds when the threshold transfer condition (i.e. age) is triggered. The alternative (Government setting asset allocations for the funds) may require default providers to create a suite of single-purpose funds (Life Stages funds for default members only) which would be inefficient and costly (both in terms of establishment, but also ongoing compliance) and challenging from a commercial perspective. Default providers are likely to have a suite of funds that they already consider optimal to stage members through when age triggers are met. There is a risk that if the government determines the asset allocations for each fund, and especially if these are set conservatively, this will impact on competition and may be difficult for default providers to offer beyond their default members.

10.2.1 Administrative costs for providers will increase with respect to the management of default member accounts. Increased and more complex communication strategies will be needed to help inform members, system changes will be required to manage the life-stage option and more complexity will exist in the day to day operation a life-stages approach.

10.3 Moving from one fund to the next during the de-risking stage is less burdensome and risky from an operational perspective than taking exposure to more than one fund during this stage (e.g. progressively down weighting the exposure to the growth fund and up weighting the exposure to the conservative fund). Additional considerations under the latter approach relate to: a) rebalancing between the two funds – setting tolerances, additional monitoring required, etc; and b) remediation – when this needs to be undertaken, it becomes more complicated for the provider to calculate if there is more than one fund involved at an individual client level.

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

11.1 We believe that Option 1 (life-stages) is the best option. It is the most appropriate option for dealing with the conflicting objectives of a wide range of members. For example, at one end there are 25-year olds who have significant human capital, very little financial capital, and who should be looking to maximise returns. At the other end there are 65-year olds who have significant financial capital, very little human capital, and who should be looking to reduce/manage risk. Option 1 enables providers to offer the most appropriate asset allocation to each member. In other words, it provides a solution that caters for a default member's entire investment journey (i.e. the accumulation and decumulation stages of their lives).

11.2 It is worth noting that some default members may perceive life stages as 'advice', and as a result may draw comfort from this approach. This may have the unintended consequence of driving engagement down further (default members may perceive that they don't need to do anything as it will be 'managed' for them).

11.3 Options 2, 3 and 4 do not address that:

a) at any given point in time, there will be conflicting objectives across a wide range of members; and that

b) over time, the objective of each member may change.

11.4 Further we do not believe that Options 2, 3 and 4 are aligned with Criterion 1 of the review ("Better financial position for KiwiSaver default members, particularly in retirement").

bnz

Fees

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

12.1 We believe the current level of fees across default providers represents reasonable value. In many instances, the fees paid by default members are significantly lower than active members in similar funds. There is also competitive and regulatory pressure to reduce the fees for the default funds that may not be matched in the non-default market. It is possible that the downward pressure on fees for default funds means that non-default members are subsidising the costs for servicing default members through their fees. Given this, we consider it is important that fees outside of the default fund are also considered in the review in order to create more equitable outcomes between default and non-default members.

12.2 BNZ recently made changes to its fees structure for its KiwiSaver funds whereby it removed the monthly administration fee and reduced the annual management fees to a maximum of 0.58%. This was done following, and in response to, customer research that demonstrated that a significant amount of confusion exists amongst KiwiSaver customers with respect to fees. To this end, we believe that simplifying fee structures and considering the pricing of all KiwiSaver funds (and not just default funds) are important steps to insuring that members are getting value for their fees and enhancing outcomes for members.

12.3 However, we would note that fees cover a wide range of costs incurred by the Scheme manager. These include, but are not limited to, custody, fund accounting, registry, supervisor fees, asset consulting, investment management, technology, advice, servicing and distribution. When compared with fees charged to investors in other types of investment funds in New Zealand (for example retail unit trusts) default fees for KiwiSaver appear reasonable.

12.4 Providers have limited ability to control the fees that overseas ***and*** domestic asset managers charge (where the provider uses specialist external investment managers). In addition, and as recognised in the review, fees cannot be assessed in isolation from the services they cover. The value members receive is intrinsically linked to the level of fees. Higher fees can mean additional benefits – they enable greater innovation, the ability to offer a broader range of assets and better membership engagement. The view that fees are too high needs to be considered against the services that are offered – lower fees may mean a lesser service.

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

13.1 We agree that the standard fixed fees could disproportionately impact lower income earners and under 18s. We consider this to be less of an issue for under 18s given that they are not default members and there has been an active decision to establish and contribute to a KiwiSaver fund despite the costs.

13.2 There is also a contra argument that members with higher balances naturally cross subsidise members with low balances. This is particularly true where all members have access to the same services irrespective of their account balance.

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

14.1 We consider it would be difficult for the Government to set appropriate KiwiSaver fees (as it would be challenging to evaluate the differences in scale across organisations) and a government fee would reduce competition and risk stifling innovation. Therefore, we do not support Option 1 - the Government sets KiwiSaver fees. In our view, the ability for KiwiSaver providers to differentiate themselves on fees and the services they provide promotes healthy competition.

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

15.1 Our preference is for Option 2: Two-stage assessment of fees in procurement. We believe that fees should be considered as part of an open and competitive tender process to be a default provider in which providers are encouraged to put their best foot forward. We agree that fees should be "reasonable" for the service provided and reflect the cost of production plus some margin.

15.2 We do not support Option 3: Percentage-based fees reduce as provider's funds under management increase. The challenge with this option is that our costs do not necessarily reduce as funds under management increase.

15.3 We support both Options 4 (no fees for under 18yr olds) and 5 (no fees for low balances) subject to working with MBIE to ensure that other members are not subsidising the total cost of providing the service to such members. One option could be to enable providers to charge fees to recoup the cost of providing a service on a % of assets basis (in line with the current % fees charged by the provider). We note that this approach carries significant complexity and a high level of administrative overlay. This would be particularly true if different % based fees or no % based fees where applied to certain members.

15.4 We support Option 6 – no annual fees in principle and, as set out above, we have removed our annual management fees. However, we recognise that there is a cost to distributing KiwiSaver and an ongoing cost to providing services to members. We respect that other default providers may wish to set up their fee structure differently, which could include an annual fee.

15.5 Finally, we see a role for the Supervisors of KiwiSaver schemes in monitoring fees to ensure that they are reasonable. Currently, Supervisors do not comment on provider fees, but in our opinion, they are well placed to have a view. This could have the added benefit of giving legitimacy to a provider's business model and cost base.

Number of providers

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

16.1 We do not think that the number of providers in the default market has negatively affected innovation, competition or value-for-money in the default market. However, we do think there is significant concentration risk given 90% of the total KiwiSaver market holds their KiwiSaver account with a default provider and the top 4 providers hold a large proportion of assets. This creates a risk for KiwiSaver if an issue arises with one of these key providers. A level of concentration risk within the NZ market is not unexpected given the relatively small/limited size of the market.

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

17.1 We agree with the assessment of the costs and benefits of the different approaches for the numbers of providers. In our experience, it is important to have some scale to manage the administrative costs of being a default provider and the capitalisation of those appointed as default providers is also an important consideration. The administration effort of the default regime is significant for providers, and we imagine is significant for regulators as well. A significant increase in the number of default providers may unreasonably increase the administration burden across the industry.

17.2 We think that having an unlimited number of providers may undermine trust in the system. Barriers to entering the KiwiSaver market are relatively low and as a result there are clear differences in approach to corporate governance amongst KiwiSaver providers. Should a default KiwiSaver provider (or non-default KiwiSaver provider) fail, either because of poor corporate governance, cashflow issues, or for any other reason, this would have a significant detrimental effect on the entire industry and the reputation of KiwiSaver.

17.3 Our view is that 9 or 10 default providers is the right number. However, we do think there would be benefits in smoothing the default membership across the default providers to address the concentration risk. Currently, default members are relatively concentrated within a subset of existing default providers. While BNZ is not supportive of reallocating existing default members across default providers, BNZ does support changing the way new default members are allocated to providers to lessen the concentration of default members.

17.4 One method could be the implementation of a default member threshold, above which default providers would not be allocated new default members. For example, a default provider with more than 50,000 current default members, excluding those that have made an active choice, would not be allocated new default members (but would keep their existing default members). In our view this would help to reduce the concentration

risk and focus default providers' attention on servicing their existing default member base.

17.5 To maintain competitive pressure all default providers would need to retain their status on a rolling basis with the consequence that if a default provider loses its status, all of its default members would be switched.

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

18.1 We would suggest that a default provider needs a period of certainty to get its systems embedded and contractual arrangements with suppliers established. The current term of 7 years provides sufficient certainty. We suggest that the current provisions could be adapted so that once a default provider is established, a rolling review could work. We also see benefit in maintaining stability in the system to the extent possible. There could be a market impact if a KiwiSaver default provider were to lose its status and be required to reallocate all its members.

18.2 We would want greater clarity on what the rolling review would entail and the time periods. We note that default providers already currently report every quarter to the FMA and are subject to licensing requirements and the requirements of the Instrument of Appointment.

Responsible Investment

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

19.1 All else equal, developing and implementing a responsible investment policy imposes higher investment costs on providers than not doing so due to the more active management and additional third-party costs required. The extent of these costs, and the expected contribution to lower net returns depends on the approach taken by providers. As noted in the Discussion Paper, there are a variety of approaches to responsible investing within the KiwiSaver, and the broader investment market.

19.2 Broadly speaking, responsible investing is undertaken with the expectation that it will, over the long term, contribute to higher net returns. Please refer, for example, to the Principles of Responsible Investment (PRI) summary 'What is responsible investment' for an example of global thought leadership on this topic (https://www.unpri.org/pri/what-is-responsible-investment). This is consistent with the Clark et el (2014) and O'Connor et al (2015) papers referenced in the Discussion Paper.

19.3 However, certain approaches to responsible investment are unlikely to result in higher expected returns. In particular, restricting responsible investment activities to simple sector exclusions for ethical or moral reasons involves incurring opportunity costs as evidenced in the Trunks and Scholtens (2015) paper referenced in the Discussion Paper.

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

20.1 As noted in the response to Question 19 above, a comprehensive approach to responsible investment is generally undertaken with the aim of increasing expected returns. The extent of the actual positive return will depend on the specific approach taken, how it is implemented, and prevailing market conditions for the time period in question. Research in the area suggests that, in general, responsible investment is consistent with positive returns over time.

20.2 Ethical and moral exclusions vary widely. As such, exclusions made purely for non-investment reasons should not generally be expected to have positive impacts on investment returns. Such exclusions may be easy to understand and as such capture public attention, however, should be considered as a relatively minor sub-set within a much broader responsible investment framework.

20.3 For diversified portfolios asset allocation is the key driver of returns. For KiwiSavers, contribution level represents another second key driver of ensuring a positive outcome at retirement. The extent of any contribution (increase or decrease) from responsible investing should be considered relatively small by comparison, with the proviso that portfolio diversification is not materially diminished.

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

21.1 Responsible Investment is still an emerging area and, while the PRI promotes a useful set of principles, as noted in the Discussion Paper there is no standard practice for responsible investment in the wider managed fund industry. We therefore think it would be premature to set a responsible investment approach for default provider arrangements.

21.2 That said we do believe that there would be benefit in standardising the definitions of certain terms within responsible investment. This would enable more consistent reporting on responsible investment, but we think the market is better placed to lead this than the Government.

21.3 Our approach to responsible investment has three components to it: a) ensuring that Environmental, Social and Governance (ESG) factors are incorporated into the investment decision-making process; b) active ownership – which includes engaging with companies to effect positive change; and c) exclusions. Rather than considering responsible investment solely in terms of exclusions, we believe that a more holistic approach is likely to lead to better investment outcomes for default members.

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

22.1 We acknowledge that there is public interest in responsible investment and default members may wish their funds to be invested 'more' responsibly, but the challenge is it is unlikely that default members, as a group, share a common definition of what investing 'more' responsibly looks like.

bnz

22.2 We believe that, for the majority of default members, their interest in responsible investing is of second-order importance, relative to their retirement goals.

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

23.1 We believe that default members have access to sufficient information about whether their investments are made responsibly. There is a lot of readily available information, e.g. through provider websites, default provider engagement with members, and via the Disclose website. There are also third parties such as Mindful Money which offer additional information. The issue does not appear to be the lack of available information, but behavioural disengagement and a lack of understanding on what 'responsible' investing is. We do not think that having more information available to default members in relation to responsible investment is likely to increase engagement. Given that complexity of information is a reason that some people do not engage, more information may actually be detrimental to engagement.

23.2 As mentioned, we believe there would be benefit in standardising responsible investment definitions across the wider KiwiSaver market place. Without this there is a risk of making responsible investment so varied that it is becomes meaningless or misleading. We already see different providers making "responsible investment" statements that would not align with what is widely accepted. As mentioned above, we believe that a standard industry definition of responsible investment needs to incorporate more than exclusions.

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

24.1 It is difficult to ascertain what default members expectations are in relation to responsible investment exclusions. Various providers offer different kinds of exclusions and default members are free to join these or choose to remain in default schemes. With this in mind, to the extent current exclusions do not meet default member expectations, they have the option to change providers.

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

25.1 As noted in our response to Question 21, we prefer an approach to responsible investment that is not focused solely on exclusions. Exclusions should be thought of as a relatively small subset of a much broader policy framework. We would like to see more weight being placed on the incorporation of ESG factors into investment decision making, and active ownership activities.

25.2 Imposing a set of sector exclusions would require significant resources and costs to monitor and define which sectors were 'in' or 'out' and whether sectors needed to be added to (or removed from) the list at regular intervals. Therefore, we do not support

adopting Option 1: Require mandatory exclusions of certain industries or companies for the reasons set out above.

25.3 We refer to the PRI website mentioned above as a useful articulation of the appropriate role exclusions may play within a comprehensive approach to responsible investment.

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

26.1 We are supportive of the standardisation of certain definitions in responsible investment, but we do not consider that Option 2 as currently proposed e.g. a statement listing excluded companies by sector would be helpful for members. For example, it may be confusing to a member to see a large, well-known, commercial aircraft manufacturer on an exclusion list without understanding the rationale for its exclusion. Compiling and monitoring the list would result in a significant increase in compliance costs and it is not clear whether this is information default members want or require.

26.2 Requiring a list of sectors rather than companies would be less onerous but on balance, we do not think this would be of benefit to members. It promotes focus on investment exclusion to the detriment of other important factors in responsible investment.

26.3 Our preference would be to report on engagement activities (investment stewardship) which can have long-term positive benefits through strengthening corporate governance.

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

27.1 The Discussion Paper is focussed on sector exclusions, which are a relatively small part of responsible investment activities. Thus, the assessment of costs and benefits is likewise somewhat limited.

27.2 Option 1 would impose costs and processes without clear benefits to providers or members. It also elevates the relative importance of exclusions and is likely to encourage even more confusion among default members about what constitutes responsible investing. Option 2 would likewise elevate the importance of exclusions to member outcomes and involve additional costs with little clear benefit. It would also run the risk of setting disclosure rules which would not be fit for purpose or rapidly become obsolete, given the continuing evolution of best of practice in this area.

27.3 In general, we would encourage the adoption across providers of a ‘common language’ when discussing responsible investing. This would ensure members could more clearly understand the difference in approaches taken and make more informed choices between providers. It is our view that this inconsistent use of language is the key source of confusion in the market about responsible investing.

bnz

Capital Markets

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

28.1 We agree that there are significant problems with New Zealand's capital markets. This has been recognised by the wider industry and is the subject of the NZX and FMA's industry led review of New Zealand's capital markets – Capital Markets 2029 that is designed to deliver a ten-year vision and growth agenda for the sector. As mentioned above, we agree with the view of the Capital Markets 2029 report that default funds ought not to be used for capital market development.

28.2 In our view the issue with New Zealand's capital markets does not appear to be a demand side issue but supply side – default providers have shown their commitment to investing in New Zealand. There is, however, a lack of availability of suitable investments due to a range of New Zealand specific issues e.g. most New Zealand business are small to medium sized, primary industries are not set up as companies and listing is perceived as complicated and expensive.

28.3 In addition, given the size and location of New Zealand, there are different risks to increased investing here compared with other OECD countries. We're a small, open economy which relies heavily on our trading partners. We have significant sector concentration risk in agriculture and tourism and are geographically isolated. Arguably, default providers are already disproportionately invested in New Zealand. The NZ equity market makes up less than 1% of the global equity market. That said, according to the June 2019 MJW Investment Survey, the average KiwiSaver Growth fund allocated 24% to Australasian Shares and 44.8% to Global Shares.

28.4 We would support a focus on alternative investment, for example building out a healthy Public Private Partnership ecosystem that would enable easier investment into key infrastructure. However, this would require a recalibration of fees for the default funds as this does require more active management.

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

29.1 As set out above, we do not agree that the default settings are the right mechanism to develop New Zealand's capital markets.

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

30.1 As above.

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

31.1 The management of BNZ's default fund is primarily carried out by New Zealand entities – all New Zealand cash, bonds and equities are managed in New Zealand. The supervisor of the funds is based in New Zealand. In addition, asset allocation decisions, currency hedging decisions, registry services, accounting services and member servicing functions (for example contact centres) are based here. We do use some international managers to manage overseas investments, and our asset consultant is based in Australia. Custodial services depend on where the assets are held, but there are a number based in New Zealand.

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

32.1 We do not think that Option 1 is necessary as most activities associated with the investment process already take place in New Zealand. Overseas providers are only engaged where necessary to support specific requirements.

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

33.1 We do not support Option 2, a targeted investment requirement of 0.5% in alternative New Zealand assets. Investing in a new alternative asset class would result in providers incurring significant one-off and recurring fixed costs. Such a small allocation would mean those costs could only be spread over a small investment. We note that it is unusual to see any asset allocation at such a small level within a diversified fund, either in New Zealand or elsewhere. Depending on the asset class we also have concerns around the ongoing consistent availability of sufficient high-quality opportunities, given the reasonably steady investment inflows into default funds which need to be deployed on a regular basis.

33.2 We also note that early-stage companies in particular are a relatively specialised asset class. The skills required to make quality investment decisions in this area are not likely to exist within all default providers and even successful early-stage investors will typically lose money on a large number of ventures. Given this level of risk, it is difficult to justify forcing default members to hold even a small allocation. We think this might be more attractive if there was a requirement to grow this target overtime, but this would need further thought. There is also a risk that NZ may be over invested in limited opportunities.

33.3 As an alternative, we consider that the New Zealand Superannuation Fund would be best placed to lead this type of investment perhaps via a specific investment entity that KiwiSaver providers could invest in. For this to work effectively we consider that there needs to be the right scale e.g. large infrastructure projects and this is likely to be beyond the capacity of individual KiwiSaver default providers.

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

34.1 We consider that the cost consequences of both options are difficult to reconcile with the downward pressure on fees for Default Providers, e.g. costs of moving overseas management to New Zealand is likely to be more expensive and a targeted investment requirement will incur significant costs with limited returns if this is introduced on such a small scale.

Transfer of members

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

35.1 We consider that the transfer of members is intrinsically linked to fees. There are significant costs associated with transferring members and trying to engage with default members. In addition, there is a significant cost associated with members being out of the market while such changes are implemented. We consider that this could erode confidence in the KiwiSaver brand.

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

36.1 We do not support Option 1. In our view, this would create significant and unjustifiable disruption to the New Zealand market. A receiving default provider would need plenty of lead time to allocate resources to deal with the influx. There could be a market impact, which could affect the value of underlying funds. In addition, the transaction costs associated with the movement between providers would be great. We think the overall experience would impact negatively on the KiwiSaver brand.

36.2 A better option would be to cap the number of members that a default provider may have and not allocate new members to default providers that have reached their cap.

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

37.1 We prefer Option 2 – Default members from default providers not reappointed would be transferred. This seems the fairest option to us and the most likely to reflect public expectations i.e. if you lose your status as a default provider you lose your default members.

37.2 In such a situation, the existing default provider *could* try to engage with members as per their existing engagement methods for example by giving a 90-day notification period for the member to opt out of the change. BNZ agrees that it is impossible to distinguish between default members that are happy with the default provider and those that are just disengaged. However, it is not clear to us that the benefits of this engagement outweigh the costs to the retiring default provider. Default providers will have contacted members when they joined the scheme and advised members that they have the option to move providers. Any new default provider will have a similar obligation.

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

38.1 We consider that Option 2 is a fair outcome given that most default providers have had plenty of time to engage with the members and attempt to move them. However, we still have concerns that this option would have a material impact on the market that needs to be considered.

38.2 We consider that "Trust and Confidence" is a key criterion for assessing these options and this would be undermined by both Option 1 and Option 3. We also think it is important to consider transition times as part of the administration and compliance costs criterion. Option 1 would require significant scaling up in advance.

38.3 In terms of alternative options, as discussed above, we think it would be helpful to introduce a cap on the number of members a default provider can have. We think that this would help default providers focus their resources to engage those members and attempt to achieve the best outcomes for them.

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

39.1 We agree that the factors outlined in the review should be considered when determining the transition timeframes.

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

40.1 We do not agree that active default members should be considered default members for the purposes of the transfer. The decision that active defaults have made to stay in a default fund should be respected.

Member engagement

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

41.1 We agree that the FMA's guidance on sales and advice is a helpful starting point for what providers should talk to their members about and we agree that default providers should educate their members on:

a) how KiwiSaver works and why it is suitable for many New Zealanders;

b) how to choose a contribution rate and ensure that the member contributes enough to get the full member tax credit; and

c) how to choose the right fund for them.

41.2 However, we disagree that the default providers should talk to their members about how to choose the correct tax rate – we consider that the Inland Revenue Department is better placed to provide information in relation to a member's tax status.

41.3 We agree that default providers should be able to evidence how they are meeting the above member information requirements, but they should have flexibility in how they do this. We think that this would be an appropriate question as part of the rolling review and that guidance as to what would be considered satisfactory should be given, but there needs to be some freedom for default providers to determine their own approach. Some examples that we think would be helpful as guidance are:

a) reporting on the volume of contact attempts/campaigns;

b) having a dedicated KiwiSaver engagement team; and

c) providing evidence about what type of engagement method is most effective.

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

42.1 We are broadly comfortable with the criteria and weighting that was used during the last appointment process. However, we think that the fees weighting may be too high and that is working to the detriment of fees outside of the default funds (see our comments in paras 12.1 -15.5 above about fees), and the capitalisation of a default provider needs to be given an express weighting.