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Financial Markets Policy
Building, Resources and Markets
Ministry of Business, Innovation and Employment
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Review of KiwiSaver Default Provider Regime

1. Smartshares Limited (**Smartshares**) is writing to provide a submission in response to the discussion paper 'Review of the KiwiSaver Default Provider Arrangements' (**the Discussion Document**) published by the Ministry of Business, Innovation and Employment (**MBIE**) and The Treasury. We would like to thank MBIE for the opportunity to provide this submission.

About Smartshares

2. Smartshares has a reputation for excellence within the superannuation industry. Our history in corporate superannuation spans 15 years and has delivered great value to our 50,000 customers through our SuperLife workplace savings scheme and the SuperLife KiwiSaver scheme. We also manage a number of low cost investment schemes, including the Smarthsares Exchange Traded Funds and SuperLife Invest. We frequently rank highly in KiwiSaver consumer reviews, in part because of our wide range of investment options, our willingness to grow and excellent customer service.

3. Smartshares has experience in managing a life stages product 'SuperLife Age Steps', which automatically changes the asset allocation of a member's investment based on an investor's age, and is a 'set and forget' type solution for those members saving for retirement. 'Age Steps' reallocates a member's investment to a more conservative asset allocation, as the member ages (up until around 95 years old) and has a shorter investment time horizon, which means that members invest productively, with reducing risk, throughout their lifetime.

Submission

4. As a general comment we wish to note our support for the recommendations for KiwiSaver set out in the Growing New Zealand's Capital Markets 2029 report. In particular, we support the discontinuance of the current default provider regime to allow all managers to be eligible to provide a standard default fund. It is our view that the current framework which exclusively permits default providers to access default members, limits competition and innovation, and drives poorer member outcomes.

5. Our submission is provided in the template requested by MBIE. We set out our answers to the consultation questions below.

Your details

6. Please contact Hugh Stevens (Chief Executive Officer, Smartshares) or Kristin Brandon (Head of Policy and Regulatory Affairs, NZX Limited) in respect of this submission.

7. We are not requesting confidential treatment of this submission.

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

8. Smartshares considers that the proposed objective for the review is appropriate and aligned to the aims of the KiwiSaver Act 2006. We also see an important benefit to the wider capital markets through the review criteria, including growth in the capital markets, which we support.

9. We note that the review does not address the position of many KiwiSaver members who are allocated to a scheme by their employer's chosen provider. While these members do not currently fall within the default regime, we consider that they should be afforded similar protections because they have not actively chosen their KiwiSaver scheme or provider. We note that the number of members in this category of KiwiSaver customers will increase, as providers increasingly focus on sales and marketing. We would like to see this matter considered in any future reviews on KiwiSaver.

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

10. The criteria for the review are appropriate, given the objectives of the review. The most important criterion (in our view) is 'Better financial position for KiwiSaver default members, particularly at retirement'. However, we also consider 'Promote innovation, competition and value for money across KiwiSaver' to be of significant importance. This will allow for greater product innovation and competition amongst KiwiSaver providers, delivering a higher quality KiwiSaver experience for all default members.

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

11. Smartshares agrees with the problem definition and the 'parking space' analogy. It is difficult, and possibly unrealistic, to drive disengaged default KiwiSaver members to make active decisions. We believe that a life stages approach that keeps an investment portfolio allocation in-step with changes in a person's life circumstances, will assist in delivering a better outcome for disengaged members.

12. We are aware of the low levels of financial literacy in New Zealand. In response, Smartshares is delivering on an ambition to produce financial products and services that are intuitive and that do not require financial literacy to use effectively. SuperLife Age Steps is one such product where, if we assume KiwiSavers are saving for retirement, there is a more realistic and limited need for member engagement.

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?

13. Often default funds have lower fees than non-default funds for the same identical offering. If a member decides to stay in their default fund, they should be regarded as having made an active choice but should be left within their existing fund, and receive the benefits of lower fees. It seems unreasonable that a default fund member should be penalised with higher fees for deciding to engage with their investment options. All members of a default fund should be treated the same. It will otherwise introduce additional complexity if there are two categories of default fund membership – active choice and disengaged.

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

14. Smartshares agrees with the proposal to introduce the life stages approach as a default fund for members. Members tend to stay with their default fund provider, but not make active investment allocation decisions. Therefore, the fund they have been allocated needs to move with their age and stage in life. We support this approach because it will leave members less exposed to shocks as the life steps product becomes more conservative as members reach the age where they are starting to withdraw their savings (compared to a pure growth fund).

15. As noted in the consultation paper, life-stage funds also align with the risk profile a member has as they age, preventing a person in a default fund being as exposed to a market downturn when they enter their retirement years. These products also provide about the same return as a balanced growth fund. A life stages approach aligns the risk of a member being negatively affected by a market downturn to the likelihood of the member needing to access their investment. We consider that this alignment is better than balanced funds, because a member's need to access their investment increases as a member ages.

16. A life stages approach will need mandated standard criteria for KiwiSaver providers. It would be undesirable for a provider to purport to offer a product as a life stages product unless it readjusts itself at appropriate points in a member's life. The paper states it envisages that the Government would set the investment mandate of each stage and the ages at which the stages would apply. Smartshares considers that the Government would be creating additional risks if it implements a highly prescriptive investment mandate and rebalancing dates that are not sufficiently frequent.

17. Instead, the Government could apply the setting used within the SuperLife AgeSteps options. SuperLife AgeSteps varies the asset allocation annually (rather than every ten years or other frequency). The frequent rebalancing means each rebalance is a small, incremental shift in asset allocation each year. These small frequent changes ensure there is much less risk of the rebalancing having a material and adverse impact on the members' funds, compared to significant shifts in asset allocation at infrequent milestones that crystalize losses during a market downturn.

18. SuperLife AgeSteps varies asset allocation between growth, income and cash investments from age 18 until age 93. The steps have been calculated through an actuarial model to track the expected cashflow requirements of typical investors as they move through their retirement years. It is clear that life expectancy for many investors at retirement age is still significantly longer than one typical market cycle and so an

allocation to growth assets remains appropriate for a period after retirement. SuperLife AgeSteps has been tested as a default option as it is the default option for employee members whose employers have 'chosen provider arrangements' within the SuperLife KiwiSaver scheme.

19. Smartshares does not support a nursery stage as this is likely to add unnecessary complexity, cost and confusion for fund managers. Again, we note that default members tend not to make active decisions about their investments at any stage even if they are given the opportunity to. If a life stages approach were adopted, default members would be automatically allocated the appropriate risk profile which would be aligned with the appropriate fund from day one.

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

20. The terms 'Balanced', Growth, and 'Income' are becoming widely understood by investors but there is wide scope for these labels to mislead, as some fund managers provide high allocations to cash and other variations within these types of funds. These terms should be clearly defined, and funds not complying with the prescribed allocations should be required to change their funds' names. Smartshares supports the CFFC definitions and proposed asset allocation ranges for 'Defensive, Conservative, Balanced and Growth' fund options. We prefer the term "High Growth" over "Aggressive".

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

21. See above.

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

22. See above.

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?

23. Smartshares proposes that a life stages product could apply to all members, other than those who indicate that they are saving for their first home withdrawal. A member could identify that they are saving for a first home withdrawl could indicate this on the IRD form that needs to be completed on entry. Such members could be allocated to a defensive option as a default setting initially, and then allocated to a life stages product following their first home withdrawal. We also consider that the time of a first home withdrawal provides an opportunity for a Default Provider to engage with its members.

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

24. Smartshares' experience of operating a life-stages product is that the systems and operations, and therefore the costs involved, are similar to those for other standard managed fund products. The legal obligations under relevant legislation are the same or

very similar. The barriers to entry for providers who wish to become involved in offering a life stages product are therefore low.

25. As permitted under FMCR, Smartshares reports Fund Updates for only a representative sample of AgeSteps options (being AgeSteps at age 20,30,40,50 etc).

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?

26. We support a life stages approach. As per our answers above, for the disengaged investor a product which balances their risk and return profile automatically and provides better retirement savings will be most appealing.

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?

27. We note that default fund providers are subject to additional obligations and associated additional compliance costs. We consider that default fund providers should be allowed to charge fees that compensate for these costs. Although we acknowledge that default fund providers do receive the benefits of scale from their member status, we note that these benefits are likely to be less significant in future, as the number of members to be prospectively allocated to default funds decreases.

28. Smartshares submits that as active funds do not, on average, out-perform passively managed funds over the long term, it is not reasonable for managers of active default funds to charge higher fees than managers of passive default products.

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

29. We support Option 4 and Option 5 as it is important to promote a culture of investing and good savings habits which are beneficial to those New Zealanders, and the markets in the long-term.

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?

30. Smartshares supports a structure that includes both a fixed fee and a fee based on the percentage of funds under management.

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?

31. Our preferred fee option is Option 2. We provide our views on the different options suggested below.

<u>Option 1:</u> The Government could set the fee, fee range or impose a fee cap for default fund providers. This would enhance consistency and may lower funds. The Review seeks comment on the methodology for this*.*

32. If the Government were to prescribe fees, this would go against criterion 5 ('Promote innovation, competition and value for money across KiwiSaver') by removing the element of competition from the fee setting process. This may dis-incentivise providers from offering lower fees. Anecdotally, experience in other markets has been that fee caps incentivise providers to increase fees to sit just under the fee cap, even if they would otherwise charge lower fees. Fee competition is reduced or eliminated.

33. Smartshares considers that market providers should set their fees based on their desire to innovate to compete to secure members.

34. One way in which the Government could seek to set limits on the market place would be to set a cap on all KiwiSaver fees for both default and non-default funds. We note that many providers offer similar funds as default and non-default options. Non-default funds often have higher fees. This may have a chilling effect on those seeking to make an active choice about which funds to invest in.

<u>Option 2:</u> Fees are a secondary consideration in the procurement process, allowing fees and services to be considered separately. The Review suggests that this could promote trust and confidence.

35. Smartshares suggests that this approach would best promote competition and innovation between KiwiSaver providers. We support this as the best option.

<u>Option 3:</u> Percentage based fees reduce as providers funds under management increase.

36. Smartshares does not support price control for KiwiSaver fees due to the adverse unintended impacts on competition, innovation and member servicing.

<u>Option 4:</u> No fees for Under 18; <u>Option 5</u>: No fees for low balances; and <u>Option 6:</u> No annual fees

37. Smartshares supports all of these options for providers to choose voluntarily. We note that these options have already been implemented by some providers as a competitive market emerges.

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?

38. Smartshares agrees that nine providers is a large number, causing lack of economies of scale, higher monitoring costs for the regulator, and wide variation in services. The current approach has not allowed for innovation and evolution in the KiwiSaver provider market place.

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?

39. See above.

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

40. Smartshares supports an unrestricted number of providers who can offer a default fund (subject to satisfying certain minimum criteria). New default members could be allocated by carousel to any KiwiSaver provider whose fund met the default requirements. The report Growing New Zealand's Capital Markets 2029 supports this approach. The report recommended that the current approach be disestablished in favour of a more competitive approach which engages the whole market of KiwiSaver providers.

41. This new proposed approach would ensure that more providers could engage in the Default Fund marketplace, levelling the playing field for all.

42. In the alternative, Smartshares would support lowering the number of providers to encourage a competitive approach, especially if paired with fee model 'Option 2', to encourage New Entrants and lower the cost of fees for members. This would provide better value for money for members.

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

43. Smartshares has recently, on 6 June, established five ESG exchange traded funds that are priced identically to the equivalent standard funds. This development demonstrates that core ESG or responsible investing funds can be delivered at a low cost. The core funds implement ESG principles only through screening and exclusions. For more sophisticated ESG strategies that optimise portfolios to enhance exposure to companies making positive contributions to the environment, society or governance, the costs are higher. These more sophisticated strategies are still usually able to be implemented through systematic, index-tracking investment approaches.

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

44. While differences in returns do appear in the short term, it is important to note that investors often choose ESG funds because they have a view that companies acting responsibly and sustainably will, over the long term, outperform companies acting to the detriment of the environment, society or with poor governance.

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

45. No comment.

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?

46. We do not consider that this is appropriate for default members, because investing ethically should be an active choice. Member views on what is ethical or socially responsible may differ, and therefore it is difficult to mandate these requirements given this subjectivity. KiwiSaver should focus on members' returns on investment, particularly for default members who are not making choices for themselves. A better approach would be for a provider to establish separate funds that are either non-KiwiSaver options or a check-box within KiwiSaver schemes that can be actively selected.

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?

47. We do not consider that offering more information about responsible investing would work to incentivise default members because they are already actively disengaged, although it may have broader utility for other agencies in developing regulatory settings in this area. This view is supported by the conclusions in the report 'Impact of behavioural insights on KiwiSaver enrolment communications' released by the FMA in August 2019. The report found that inserting a flyer or IRD letter made no difference to the active decisions – the same number of people made a fund choice, opted out or transferred to another KiwiSaver provider regardless of the communications received.

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

48. No comment.

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?

49. No comment.

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?

50. No comment.

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?

51. No comment.

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?

52. All default members have been placed traditionally in more conservative funds, which has given little benefit to New Zealand's capital markets. Default funds have had minimal exposure to NZX listed companies which might have otherwise provided liquidity for the capital markets.

53. There is a key issue preventing further KiwiSaver investment in less liquid assets in New Zealand (including smaller listed companies and any unlisted investments including forestry and real assets). The KiwiSaver investor has an investment horizon that is often decades long and of sufficient length to capture any illiquidity premium that might be available from investing in illiquid assets. On the other hand, the KiwiSaver manager has an investment horizon of 31 days, or even 10 days in the case of a default fund. This is because any KiwiSaver investor can request to transfer their KiwiSaver balance to another manager at any time, and the manager must make that transfer in cash. While some cash is available for a small number of transfers, if larger numbers of investors decide to switch (perhaps following a reputation issue in a manager's business), then there will be insufficient liquidity available to complete the transfers and the fund may need to be closed for redemptions. A decision to close, or freeze, a KiwiSaver fund is likely to cause a significant negative impact on trust in KiwiSaver generally.

54. For this reason, Smartshares considers it appropriate to maintain the current settings for investment of default funds, and to increase oversight of liquidity levels within KiwiSaver funds. To permit allocations to less liquid investments, Smartshares proposes that a transition process be implemented for distressed or illiquid assets in the event of a fund switch. This process would be facilitated by a change to the KiwiSaver rules to allow members to invest through multiple KiwiSaver providers. The side-pocketed assets could then remain with the original KiwiSaver scheme, while other, more liquid assets are transferred to the new provider. This change would be in line with recommendations from the report Growing New Zealand's Capital Markets 2029.

55. We consider a life stages approach for default funds would ensure a greater number of members investing in riskier assets earlier in their lives. As a person ages, their funds would be moved out of riskier assets and into more conservative ones. This would provide a measured solution, without the need to create a complex scheme to bolster certain areas of the capital markets.

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?

56. SMEs (and in particular unlisted SMEs) can pose a higher risk to investors and could preclude default members from maximising funds at retirement. We consider that the default settings may not be the most suitable mechanism through which to develop this part of New Zealand's capital markets. Other levers, such as investor choices and commercial activities, such as those described in paragraph 33, would be more appropriate to achieve this aim. There are more suitable classes of investors who could help generate growth in the capital markets. This view is reflected in Capital Markets 2029.

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?

57. We are in favour of this in principle, but only if it maximises retirement savings too.

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

58. Our understanding is that the management and operation of default funds is primarily carried out by New Zealand domiciled managers who are generally subsidiaries of their parent company. While management of the asset allocation of the funds is generally performed in New Zealand, we note that most funds invest into underlying funds or portfolios that are often managed offshore.

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?

59. We consider that it is appropriate for default fund providers to have a New Zealand manager because they are more likely to invest in New Zealand listed companies. This is beneficial to boost overall growth in the capital markets and the New Zealand economy. Kiwis are also more likely to engage with a KiwiSaver manager where there is physical proximity, compared to a fund manager who is based overseas, because there is a perception that a New Zealand based manager will better understand the member's needs.

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)?

60. We do not agree that there should be prescribed targeted investment in alternative assets or SMEs. As noted above, most managers that conduct pricing on a daily basis could face difficulties in accurately pricing unlisted assets. There could also be tension with the transferability settings under the KiwiSaver Act, which currently require a member's entire investment to be transferred to another provider under a short time-frame (as noted above).

61. We consider the better approach is to offer SME investment as actively selectable options. We note that around 17% of members also invest in SuperLife Invest when they open a SuperLife KiwiSaver account.

62. Smartshares is doing development work in respect of ETFs, S&P SME index, Dairy Derivatives and research and development on primary production index. This work is helping to encourage innovation and evolution in the capital markets. We consider that government regulation is not necessary to help foster growth in alternative assets and SMEs and that other commercial measures are more appropriate.

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?

63. We prefer Option 1 because it is more straightforward and unlikely to affect member's retirement savings.

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?

64. Smartshares supports the proposal to reallocate and transfer default members. It is likely that a change such as a transfer may provoke a proportion of these members to engage with their KiwiSaver provider at this point, having not done so since they joined KiwiSaver.

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

65. A random selection process would be appropriate.

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?

66. KiwiSaver members always have a choice of provider so if, during the transfer process, they decide they wish to remain with their current provider they can instruct their current provider to initiate a transfer. This is a current existing feature of KiwiSaver, that is used frequently during the KiwiSaver transfer process when providers call to 'retain' departing members. If the member decides to remain with their current provider, the current provider initiates a transfer back from the new provider that, in effect, cancels the transfer.

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?

67. Smartshares supports the reallocation of existing default members. With a refresh of the KiwiSaver default arrangements, this reallocation presents an opportunity to engage with these members.

What factors should the review consider in deciding transition timeframes?

68. See comments above for a proposal on the treatment of transfer of illiquid assets.

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?

69. All members of a default fund should be treated the same. It will otherwise introduce additional complexity if there are two categories of default fund membership – active choice and disengaged. The objective should be to ensure that default options remain as simple as possible so they can be explained to and understood by as wide a section of the membership as possible.

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?

70. We consider this is a natural and meaningful way to increase financial literacy and develop a conversation with default members about saving for retirement.

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

71. No comment.

General

72. Thank you for the opportunity to provide this submission, we would be pleased to discuss the matters we have raised further with you.