THE UNIVERSITY OF AUCKLAND
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Retirement Policy and Research Centre

Submission on the:
Review of KiwiSaver Default Provider Arrangements

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Background to this submission

The first appointments to the role of *default providers* to the KiwiSaver scheme were for seven years ending on 30 June 2014.

The Ministry of Business Information & Employment ('Ministry') is seeking submissions on a Discussion Document of November 2012 ('Discussion Document') that asks, in essence, what we will have learned from the experience of the first seven years of KiwiSaver.

The RPRC

The Retirement Policy and Research Centre (RPRC) of the University of Auckland is an academically focused centre specialising in the economic issues of demographic change including public and private provision of retirement income (New Zealand Superannuation, and e.g. KiwiSaver, respectively), and both the accumulation and decumulation phases of retirement provision.

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  Declaration of interest: Michael is an independent, external director of SuperLife Trustee Limited that was, until October 2012, the trustee of the SuperLife KiwiSaver scheme. The SuperLife KiwiSaver scheme is not a default provider.
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This submission is divided into two sections:

- **Part A** summarises the recommendations of a *PensionCommentary* published by the RPRC on 4 April 2012. The *PensionCommentary* itself is attached as Appendix 1.

- **Part B** offers some further observations based on the questions raised in the Discussion Document.

The RPRC suggests we should have learned some lessons from the first five years of KiwiSaver experience. We hope that the scope of the discussion on those lessons is widened beyond the topics covered in the Discussion Document.

Michael Littlewood
For the Retirement Policy and Research Centre

Part A: *PensionCommentary* on the default provider regime

In April 2012, the RPRC published a *PensionCommentary* that anticipated the current review. In summary, it suggested that the *status quo* was the least preferred option, even if current gaps in the default regime were remedied. *PensionCommentary 2012-1* 'KiwiSaver: changing the default provider regime' is attached in the Appendix to this submission.

As noted in the *PensionCommentary,* the default provider concept is a necessary consequence of auto-enrolment. Employees who have not chosen to join KiwiSaver have to be put somewhere until they choose a provider, if they ever do that. Each default provider must also have a default investment option because, by definition, auto-enrolled members have not actively decided to join and so cannot have turned their minds to the investment strategy to be used for their savings. The savings have to be invested somewhere until they choose their strategy, again if they ever do that.

Recommendations of the *PensionCommentary*

The following Recommendations A1 to A4 are in order of preference, with Recommendation A4 being the RPRC's least preferred option.

Recommendation A1: No default enrolment

When the appointments of the current default providers end on 30 June 2014, KiwiSaver will have been running for seven years. Given the membership penetration to date, there should then be a strong case to suggest that the current appointments not be renewed and that there be no default enrolment process – see the *PensionCommentary,* p. 14. That means there would be no need for any default KiwiSaver providers.

The RPRC understands that this would require amendments to the KiwiSaver Act 2006 but that should not be an impediment. KiwiSaver has already been through four major iterations since the first legislation was passed in late 2006 (see the *PensionCommentary*, pp 2-3).

The RPRC was disappointed to see that the possibility of ending default enrolment was not raised in the Discussion Document.

Recommendation A2: Inland Revenue as time-limited default provider

If default enrolments on becoming employed are to remain a feature of KiwiSaver, default providers are required,and each must have a default investment strategy (there is more on this latter issue in paragraph B1 below).

The *PensionCommentary* suggested that the Inland Revenue should take on this role by extending the current initial eight weeks (following a new employment) to 52 weeks. By the end of that year, the member has the right to choose a KiwiSaver provider. If no decision has been made, the member will automatically go on a contributions' holiday and both member and employer contributions will cease. In the meantime, interest will be added to the member's account at, say, the Treasury 90 day bill rate.

This recommendation has a number of advantages:

> **A2.1 – few changes:** It requires only minor modifications to the Inland Revenue's current administration arrangements.
>
> **A2.2 – reduces government involvement:** The government does not need to choose default KiwiSaver providers and would also avoid conferring a

commercial advantage on a favoured group and exposing itself to an implied selection risk.

A2.3 – a learning opportunity: Members will have a low-cost, risk-free first year of membership during which they will have the opportunity to learn how KiwiSaver works and whether remaining a contributing member might suit their needs. The current complete withdrawal within the first eight weeks would be retained.

A2.4 – reduces costly churning: The proposal will eliminate the current relatively costly churning of default-allocated members who want to move providers within a realtively short period of joining.

A2.5 - education on provider choice: During that initial membership period, members can be educated as to the issues they face in choosing a provider. That information cam come from providers themselves, from the employer or from other information services. There will be an in-built incentive for providers as any affected member can transfer as soon as they have made a decision to transfer from the Inland Revenue-administered arrangement.

A2.6 – clear incentive to act: If the member refuses to make a decision by the end of 12 months, that would indicate a lack of interest in membership, despite contributing. A contributions holiday, with no loss of entitlements already accrued seems justified in that context.

An alternative, positive way of expressing this is that default-enrolled members will have a clear incentive to make a decision in their own interests before the end of the initial auto-enrolment period.

Again, the RPRC acknowledges that Recommendation A2 will require changes to the KiwiSaver Act 2006. It would have the great advantage of removing much of the Act's current complexity.

Recommendation A3: All 'qualified' KiwiSaver providers

Given the requirements with which all KiwiSaver providers must comply for approval under the KiwiSaver Act 2006, it is difficult to justify selecting six (or any number) for the favoured default provider status. The RPRC understands that from a political perspective, the government wished to reduce the risks of the failure of a default provider during the start-up period. However, that imperative has now disappeared.

Accordingly, the RPRC's third-ranked recommendation is that all KiwiSaver providers that satisfy whatever requirements are considered necessary should be on the default provider list (see *PensionCommentary*, pp 13-14). It does not matter whether that list is 30-40 providers long because the process of allocating default-enrolled members is already automatic.

The following comments on this recommendation:

A3.1 – reduces selection risk: As the *PensionCommentary* notes, the government's own review of the default provider issue found that the initial process lacked transparency and conferred an endorsement of the default providers' brand (see *PensionCommentary* pp 5-6). Having a much fuller list and allowing any provider to potentially join that list reduces the selection risk to the government.

A3.2 – limits exposure to market changes: Under the present process, the government is exposed to market risk as the KiwiSaver provider market changes. In the last five years, we have already seen the takeover of one default provider by another (AXA by AMP) and the acquisition by another of part of a joint venture (ANZ and ING). There has been no official reaction to those significant changes, despite the care with which the initial selections were made. The RPRC's recommendation would automatically see the default status lost with the withdawal /amalgamation of a provider.

A3.3 – consistent with approval regime: The default provider appointment process would be a relatively modest extension of the current approval process.

Recommendation A4: a limited selection of default providers

The least preferred option is to continue with a modified version of the current selected list of default providers.

Given the commercial advantage conferred on the selected list, the RPRC suggests that providers should pay for the privilege of being on that list. The cost would be calculated on the basis of the number of members delivered through the default enrolment process and who remain with that provider. This would therefore be an annual calculation, rather than an upfront lump sum. Some providers pay commissions to sellers of KiwiSaver memberships and there seems some justification for applying the same process to the favoured providers. Currently, default status delivers members at no direct cost to the provider.

If the Ministry decides to recommend this approach, the RPRC suggests that the list be reduced from the current six to three or four. The Treasury seemingly recommended that four default providers should be appointed and the reasons for that 2006 recommendation should be re-visited.

Option not supported

The RPRC does not support the single provider (recommended by the Savings Working Group) – see the *PensionCommentary* pp 8-10. The United Kingdom, Sweden and Chile have all adopted versions of the single supplier regime. That would represent a significant departure from the current commercial regime and would necessarily involve a relatively deep intervention by the government into the superannuation business. There seems little justification for such a change.

Part B: Discussion Document – some questions answered

The following addresses some of the questions from the Discussion Document that are not already covered by Part A of this submission.

B1 Default investment strategy
Much of the Discussion Document is cocerned with the design and implications of the default investment option. The RPRC suggests an alternative approach to this issue.

Each default provider must have a default investment option because, by definition, the member has made no active decision to join KiwiSaver. Until the member has addressed the issue, the provider must know where to put the contributions made by and in respect of the member.

Recommendation: That each default provider make its own decision about the default investment option with no official constraints. The following comments on this recommendation:

> **B1.1:** There seems no compelling reason for the government to set the default investment option, as it does now. In fact, it has no expertise on this topic yet, by becoming involved in this process, the state is representing itself as 'knowing' what is appropriate for a very large and disparate group of members. A government-determined minimum set of conditions for the provider-set default avoids the need to become involved in issues associated with:
>
> - life-cycle strategies;
> - risk/volatility;
> - target-date investment strategies;
> - first home withdrawals;
> - passive versus active, and
> - so-called 'aternative assets'.
>
> Such considerations occupy eight of the Discussion Document's 24 substantive pages. The RPRC's recommendation avoids the need to consider the 16 questions associated with those issues.
>
> **B1.2:** The same kinds of issues that seemingly affect the government's own policy decisions on this also affect each default provider itself but the provider does at least have some expertise. The RPRC suggests that the government should leave those issues to providers.

B2: On fees
As noted in the *PensionCommentary* (paragraph 14.2, p 12), there seems to have been little follow-up on the performance of the current default providers; nor any published comparisons on fees, investment performance or standards of administration. A key gap is on the question of fees, something the Discussion Document acknowledges.

The Discussion Document suggests that the default provider regime brings 'competitive pressures to bear on non-default products through benchmark setting in the market for fees and for governance" (Discussion Document, para 75). The RPRC wonders, therefore, why the Ministry has published no work on fees, investment performance or governnance of even just the default providers. The RPRC suggests that the KiwiSaver public has been let down in this regard.

In the absence of any published data, how can anyone conclude whether "a balance has been struck between an efficient fee structure …[and] ensuring that service and perfomance are not compromised" (Discussion Document, para 77)?

B3: On financial literacy

The RPRC supports the concept of developing financial literacy programmes and it will certainly be appropriate for there to be linkages between such programmes and KiwiSaver as a financial product.

However, KiwiSaver is just one of many concepts that might be covered in a well-designed programme and for many, it will be one of the least significant topics. There will be many other more directly relevant topics to many New Zealanders such as:

- budgeting;
- cost of credit arrangements and the particular characteristics of no-interest student loans;
- effective management of debt;
- home-ownership (that will include but not be restricted to the first home deposit arrangements associated with KiwiSaver);
- other types of saving and investment.

The RPRC suggests therefore that there be no direct linkage (as implied by questions 30 and 31) between the default provider status and financial literacy programmes.

B4: Transition to new default provider status

We have made a number of possible recommendations in connection with the default provider regime (Recommendations A1 to A4 above). For each of the recommendations, there is no need to address existing default members. They belong to their current default provider as the result of the default enrolment process.

The RPRC recommends that, following a decision on any changes to the present regime, each current default provider be obliged to write to each current default member, explaining the change (if any) to the default regime and pointing out that a member is free to choose another KiwiSaver provider. That is their current entitlement.

Appendix

PensionCommentary: 'KiwiSaver: changing the default provider regime

pensioncommentary

THE UNIVERSITY OF AUCKLAND BUSINESS SCHOOL

An article from the Retirement Policy and Research Centre

KiwiSaver: changing the default provider regime

Michael Littlewood

PensionCommentary 2012-1[1]

4 April 2012

The government must decide in the next two years whether to renew appointments of default providers under the KiwiSaver Act 2006. The initial six default providers were appointed in 2007 for seven years. This *PensionCommentary* looks at the lessons to date and suggests a major change to the way in which default enrolments happen after 2014.

The *status quo* is the least preferred option, even if tidied up. Default enrolment should preferably cease. If it continues, the Inland Revenue should run a 12 months' 'holding' enrolment followed by a contributions' holiday if the member doesn't select a provider. Default providers would then not be needed.

1. Introduction

KiwiSaver was the world's first national, auto-enrolment, opt-out retirement savings scheme. It started on 1 July 2007 and the KiwiSaver Act 2006 (the 'Act') stated KiwiSaver's objectives as follows:

> "…*to encourage a long-term savings habit and asset accumulation by individuals who are not in a position to enjoy standards of living in retirement similar to those in pre-retirement*".

Although KiwiSaver was not specifically designed to increase national saving, it certainly proceeded from a feeling that New Zealanders were not saving enough. Superficially, KiwiSaver may appear a success with about 1.8 million members and total assets of more than $11 billion.

A major feature of KiwiSaver was the auto-enrolment process. Under that, every person aged 18-64 and starting a new job must be enrolled into KiwiSaver (unless already a member) for at least two weeks[2]. Each new member is then given eight weeks to opt-out

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[1] An RPRC *PensionCommentary* is an opinion piece designed to provoke discussion on an issue of public significance. The author thanks Susan St John and Claire Dale for their helpful comments and suggestions on earlier drafts. However, the views expressed in this commentary remain the sole responsibility of the author. ***Declaration of interest***: Michael Littlewood is an independent director of SuperLife Trustee Limited, the trustee of the SuperLife KiwiSaver scheme. That scheme is not a default provider.

[2] 'Exempt employers' that have a qualifying superannuation scheme are exempt from the auto-enrolment requirement (section 24 of the KiwiSaver Act 2006) as long as that scheme is available to new employees (section 25). Exempt employers are now a closed group.

and must do so by advising either the employer or the Inland Revenue. In the meantime, contributions (currently 2% of pay[3]) are collected from both the employee and employer until the opt-out is effective. If employees do not opt-out, they must contribute for at least 12 months.

If an employee opts-out, the Inland Revenue returns the contributions to the employee and employer. Otherwise the money is passed to a KiwiSaver provider (default or chosen).

2. Why the auto-enrolment/opt-out process?

The 2004 report from the Savings Product Working Group or SPWG (Savings Product Working Group 2004) noted with approval the overseas research based on the principles of 'behavioural economics'.

> "Evidence from other countries suggests that on its own, neither education nor mandatory offering of access to schemes by employers generates significant increases in participation rates. Evidence also indicates that there is a substantial "status quo" bias, with savings behaviours heavily influenced by what individuals are doing at any time. If the impact of that bias is reversed, so that the status quo is participation in a savings plan ("opt out" rather than "opt in") there are good reasons to believe that savings rates will rise." (Savings Product Working Group 2004, p.4)

In 2005, the government responded with KiwiSaver that, in its first iteration, provided a very modest 'nudge' in the direction of what the SPWG's report suggested was a more appropriate set of behaviours by New Zealanders. The first principle suggested by the SPWG was:

> "(a) automatic enrolment in the savings system at the point of engagement with a new employer, with the right to opt out or to suspend contributions;" (Savings Product Working Group 2004, p.6)

The government adopted the report's recommendations when KiwiSaver's design was first announced in the 2005 Budget (Cullen 2005).

> "KiwiSaver's basic features are:
>
> • automatic enrolment in a savings scheme at the workplace for new employees aged 18-65, with the ability to opt out….
>
> The new employee can opt out by notifying IRD between weeks two and four after starting a new job. In this case IRD notifies the employer, otherwise deductions begin the next pay day after eight weeks with a new employer." (Cullen 2005, p.4)

3. A short history of KiwiSaver I, II, III and IV (2005 to 2011)

The Budget 2005 proposals were subject to scrutiny but the essential auto-enrolment/opt-out structure has survived significant changes[4]. The following summarises the key developments:

- **KiwiSaver I**: as announced in the 2005 Budget – auto-enrolment, opt-out; minimum contribution period 12 months; minimum employee contribution 4%

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[3] Increasing to 3% of pay from each of the employee and employer, effective 1 April 2013.

[4] There is a more detailed look at KiwiSaver's changes and outcomes in St. John, S., Dale, M. Claire and Littlewood, M (2011).

of pay; government 'kick-start' $1,000; government subsidy of $40 a year to cover membership fees. A late addition was that matching employer contributions of up to 4% of pay were tax-exempt.

- **KiwiSaver II**: as announced in the 2007 Budget – introduced a so-called 'Member Tax Credit' that matched contributions to $1,046 a year; compulsory matching employer contributions starting at 1% of pay (4% by 2011); the so-called 'Employer Tax Credit' reimbursed the employer's contribution of up to $1,046 a year.
- **KiwiSaver III**: as announced by the new National-led government in March 2008 – the $40 a year fee subsidy was dropped; the minimum employee contribution was reduced to 2%; the compulsory employer contribution was capped at 2%; and the Employer Tax Credit abolished.
- **KiwiSaver IV**: as announced in the 2011 Budget – employer contributions are taxable (by being subject to Employer Superannuation Contribution Tax - ESCT); the maximum Member Tax Credit is halved; the minimum employee and matching employer contributions increase to 3% from 1 April 2013.

Changes to KiwiSaver have not finished. The government has said that "as part of its programme to build genuine national savings", and subject to returning to surplus, the government will require KiwiSaver auto-enrolment for all non-member employees in 2014/15 (English 2011). This would be a one-off exercise, with details finalised after public consultation in 2012.

In the meantime, the government must decide whether to renew the appointments of the current six default providers. These were first appointed under section 177 of the KiwiSaver Act 2006 for terms starting on 2 April 2007 and expiring in each case on 30 June 2014. Section 177 allows the Minister of Finance to appoint one or more providers on whatever terms the Minister decides, after seeking the advice of the Financial Markets Authority (FMA).

4. Allocating auto-enrolled members

The KiwiSaver Act 2006 requires the Inland Revenue to allocate auto-enrolled members to a default KiwiSaver provider. That allocation is initially provisional (section 50) and is carried out on a 'sequential' basis amongst the six appointed default schemes (section 50(3)(a)). The allocation is confirmed as 'final' if the member does not notify the Inland Revenue of a specific choice of KiwiSaver provider. The provisionally allocated default provider must then accept the member (section 52).

5. The current default providers and their appointment

The formal default provider appointment process started in 2006 with expressions of interest being sought from potential providers, followed by written submissions by interested organisations. These were specified on a very prescribed basis.

The government described the process as follows:

> "An open competitive tender process was undertaken to select the companies to be appointed as default providers, where Ministers were assisted by advice from

> independent external experts who carried out detailed evaluation of potential providers." (Dalziel 2007)

A government-appointed expert panel reviewed the submissions. It created a shortlist for interview. The interviews were conducted on a prescribed basis and followed up by 'due diligence'. The expert panel then made a recommendation to the Minister who made the decision.

The government said at the time (Dalziel 2007) that:

> "The default providers have been selected on a number of criteria, including their:
> - Security and organisational credibility;
> - Organisational capability;
> - Proposed design of the providers Default KiwiSaver Scheme[5];
> - Administration capability;
> - Competitive fee levels; and
> - Investment capacity/capability."

These were high profile appointments and there were risks to the government in making them. It was important that KiwiSaver was a success as the government had invested significant political capital in its design. The Minister of Finance did not give reasons for the appointments but, retrospectively, risk aversion seemed to be an important influence in the selections. The government wanted to be sure there would be no mishaps in KiwiSaver's first seven years.

Before the selection process began, the market understood that the Treasury initially recommended either four providers be appointed or all providers that satisfied minimum criteria. The expert panel did not have to explain its decisions but anecdotally, initially chose four. However, following direct representations to the government by interested parties, two additional providers were apparently added to the group recommended by the panel.

The six successful providers were:

- AMP Services (NZ) Limited
- ASB Group Investments (NZ) Limited
- ING (NZ) Limited, a joint venture between ING and ANZ
- Mercer Human Resource Consulting Limited
- National Mutual Corporate Superannuation Services Limited, trading as AXA New Zealand
- Tower Employee Benefits Limited.

Copies of all six appointment agreements (and amendments) are available here. They were effective from 2 April 2007 and all will expire on 30 June 2014. The government could renew the appointments but has indicated that it wishes to review the default provider framework.

In the meantime, the agreements have been amended as follows:

- to clarify the definition of a 'conservative investment product' (AMP, Mercer, AXA, Tower);
- to approve changes to fees (ASB, One Path, AXA);

[5] What the minister meant was the "provider's default investment option".

- changing the names of the default investment option or scheme (Mercer, Tower).

5. Default investment option

The default provider concept is a necessary consequence of auto-enrolment. Employees who have not chosen to join KiwiSaver have to be put somewhere until they choose a provider, if they ever do that. Each default provider must also have a default investment option because, by definition, auto-enrolled members have not actively decided to join and so cannot have turned their minds to the investment strategy to be used for their savings. The savings have to be invested somewhere until they choose their strategy, again if they ever do that.

This meant that each default provider had to have a prescribed default investment option[6]. Here is clause 12 of each of the original 2007 agreements:

> "**12 Default investment product asset allocation**
> Subject to the relevant requirements, the default provider in relation to the default investment product may not invest less than 15% or more than 25% of default members' assets in growth assets without the prior written approval of the Minister."

There are some issues with respect to these restrictions:

- The specified strategy has a very low exposure to shares and property and so, fortuitously, coped relatively well with the global financial crisis and its impact on investment returns.
- A default provider is in breach if the allocation moves outside the 15-25% range. Because market movements can trigger that breach, providers will in practice want to maintain a safety margin at either end.
- Even if market conditions indicate that the growth assets should be more or less than the approved outer bounds, the provider is unable to move those without the Minister's approval.

The default investment strategy of a default provider effectively applies to someone who has not chosen to join KiwiSaver but rather has either allowed it to happen or who does not understand what is happening. Then the option itself probably applies to a member who has made no decision about investment strategy. There is therefore a political justification in setting the default investment option to limit the risks of negative returns. This can be seen as a 'no surprises' basis for when (or if) the member decides on an alternative investment strategy.

While that may make political sense, there is no investment justification for such an approach. The KiwiSaver asset is a very long-term investment for most members so that investing to limit (or even eliminate) the possibility of short-run negative yields will be costly to the member in the long-run if the default option turns out to be for the long-term.

7. Ministry of Economic Development's 2008 review

[6] Other KiwiSaver providers will also probably have a default investment option as they may be nominated by a particular employer as that employer's chosen provider under section 46 of the KiwiSaver Act 2006. Employees are first enrolled into that provider until they choose their own, as with the default provider.

The Ministry of Economic Development asked the accounting firm PriceWaterhouseCoopers to review aspects of KiwiSaver's operations, including the default provider issue in 2008 (Snively and Rhodes 2008).

The report summed up providers' responses on the 2006 process of appointing the default providers:

> "It is clear that a number of Providers, particularly those that were unsuccessful in the initial round of default Provider selection, regard the default Provider designations as providing a significant competitive advantage. They will pursue this accreditation in the future. Some Providers felt the process of granting default status and the reason for a set number of default Providers lacked transparency. They believed consideration should be given to reviewing the process, including re-examining how default Provider status is achieved, with one possibility being the establishment of a clear set of quality standards, if maintained, would enable Providers to automatically qualify (or renew) as a default Provider. The government could consider levying a fee for the attainment of default status and use this to promote financial literacy, and/or to include the production of investor education material as criteria for default Provider status." (Snively and Rhodes 2008, p.35)

The report found that default provider status was regarded as significant by the providers themselves:

> "Being selected as a default Provider was seen by those interviewed as an endorsement of their brand."

The report recommended the establishment of an "explicit and transparent performance framework for incumbent and new default Providers prior to 2014" (Snively and Rhodes 2008, p.106). That has not happened yet.

8. Retirement Commission's 2010 review

The Retirement Commissioner looked at the default provider arrangements in her 2010 review (Crossan 2010). She concluded that the "…rationale for having six default providers was never particularly obvious, although in the early days of KiwiSaver it might have been appropriate to limit them to major institutions."

> "This could be reviewed as part of the next selection process. As public knowledge of KiwiSaver has grown and the requirements of fund providers become better understood there is perhaps less justification for an arbitrary limit on the number. However it remains important to set minimum standards for potential default providers." (Crossan 2010, p.98)

The report also looked at the appropriateness of the default investment option strategy, observing that, although members were most directly affected by the requirement, there was also a political dimension to its setting. The report's recommendation 5.1 on this was:

> "That KiwiSaver default funds should continue to be based on products with a conservative risk profile and that KiwiSaver default fund providers be encouraged to provide members with information to help them to make a more active choice of investment, even if this means that they choose to stay where they are." (Crossan 2010, p.107)

9. Inland Revenue's 2011 KiwiSaver evaluation

Each year until 2013, the government is obliged to report on KiwiSaver (a joint effort by the Inland Revenue, Ministry of Economic Development and the Department of Building and Housing). The fourth such report as of 30 June 2011 (Inland Revenue 2011) showed total membership of 1.76 million with new enrolments averaging 25,000 a month during the year.[7]

Since the scheme started, 36% (623,513 individuals in total) became members either through Inland Revenue directed auto-enrolment (26%) or auto-enrolled directly through their employers (10%). However, "…there are still 56% of the eligible KiwiSaver population[8] who have not enrolled in the scheme." (Inland Revenue 2011, p.9)

The opt-out rate for those auto-enrolled has fallen "…over the past three years from 34% for 2009 to 28% for 2011." (Inland Revenue 2011, p.13)

Approximately 120,000 members (7% of total members) transfer between providers each year. That includes members who transfer from allocated default providers.

The importance of default settings can be illustrated by member contribution rates. Until 1 April 2009, the default member contribution rate (for those on a salary or wages) was 4% of pay. That fell to 2% from 1 April 2009. The report notes that:

- 62% of members who joined before 2009 are still contributing 4% despite being able to reduce that.
- On the other hand, 80% of those joining after 1 April 2009 are contributing at the new default rate of 2%.

The basis on which employers are contributing has probably had little impact on the pre-2009 decisions: 91% of employer contributions rates were the minimum of 2% at 30 June 2011 (Inland Revenue 2011, p.21).

The report then examines the rationale for KiwiSaver's existence as quoted on page 1 above – whether it had achieved its twin original objectives to:

(a) "…encourage a long-term savings habit and asset accumulation

(b) "by individuals who are not in a position to enjoy standards of living in retirement similar to those in pre-retirement".

The auto-enrolment, default provider process was an important part of KiwiSaver's architecture in that regard.

With respect to the first objective (encouraging savings habits), the report cited the findings of a Treasury investigation[9] that, after noting its limitations (based on KiwiSaver in 2010 and a 'snapshot' review) concluded:

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[7] As an aside, only 63,707 members were on a contributions holiday at 30 June 2011 (3.6% of all members). Inland Revenue report page 18.

[8] Defined as "those who are New Zealand citizens or residents and under the age of 65 years … with income for the 2010 year.": Inland Revenue (2011, p.11)

[9] Scobie, Law and Meehan (2011), a paper prepared for the 52nd NZAE Conference, Wellington, 29 June – 1 July 2011. The report was based on KiwiSaver as it existed in 2010 (before the 2011 reductions in tax incentives).

> "The analysis examined whether KiwiSaver membership was associated with additional savings, as distinct from members diverting funds from other savings or debt reduction. It found that members reported that on average they would have applied 64% of the money they were contributing to KiwiSaver to other forms of saving and/or debt reduction, while 36% is, on average, money that would have otherwise been consumed, mainly for daily activities and outgoings." (Inland Revenue 2011, p.25)

As to the second objective (aimed at a particular group of individuals), the report summarised the findings of Scobie *et al*:

> "The analysis found that target effectiveness was a third for those who had an expected shortfall in retirement income relative to their basic needs or a half if living comfortably…. Leakage [where members other than the targeted audience benefitted] was estimated as being as high as 93% when the measure was based on retirement income shortfalls with respect to meeting basic needs, and 78% based on being comfortable."

The Inland Revenue's evaluation concluded that:

> "Although successful in encouraging additional saving by some individuals, the effect of KiwiSaver on retirement income and national saving is uncertain at this early stage." (Inland Revenue 2011, p.31)

10. Savings Working Group's report

The Savings Working Group (SWG) was appointed by the government in 2010 and presented its final report in January 2011 (Savings Working Group 2011) on saving issues generally, as well as KiwiSaver[10]. The report focused on what it saw as inefficiencies in the current arrangements including the default provider arrangements. In summary, the SWG concluded:

> "The SWG does not recommend making KiwiSaver compulsory at this time, but it has made several recommendations likely to increase KiwiSaver performance and membership. While these recommendations would increase KiwiSaver expenses for a cash-strapped government, there are ways to compensate for this. Other recommendations suggest the establishment of a single default scheme with lower fees, and an ultra-low-risk fund." (Savings Working Group 2011, p.10)

It also recommended (amongst other things):

- the auto-enrolment of all employees over age 18 who are not currently members;
- spreading the initial $1,000 'kick-start' over the first five years of membership;
- increasing the default member contribution to 4% but the member could choose to contribute at least 2%;
- taxing all employer contributions (since adopted by the government);
- preventing employers from building the employer's contribution into 'total remuneration'. (Savings Working Group 2011, p.15)

Significantly, from this *PensionCommentary's* perspective, the SWG also recommended "…a single low-cost default scheme" managed by the government that then invested "only in index-based shares and bonds and offers a limited number of basic

[10] The SWG had no connection to the 2004 Savings Product Working Group (SPWG) already referred to.

combinations for such investments." The point of this was to reduce complexity and lower costs, so improving expected benefit outcomes for members.

> "The SWG estimates that the economies of scale that could be achieved by aggregating the current 6 default schemes into one, together with that scheme making more use of Inland Revenue as a means of communicating with members, there is a potential for the scheme's costs/fees to be closer to wholesale scheme than retail scheme levels. Those lower costs/fees would translate into a material increase in member returns over time (with the potential for default-member balances being up to 6% higher in 20 years)." (Savings Working Group 2011, p.100)

The SWG's report effectively accepted that KiwiSaver in its present form was not making much difference to issues covered by its terms of reference. If KiwiSaver were to make any real difference to saving rates, the SWG thought that more direct action, short of compulsion, seemed needed to make it "more effective".

11. The Chilean model

The Chilean model provides a useful comparison. There is no choice for employees in Chile about joining an *Administrador de Fondo de Pensiones* (AFP), a defined contribution, Tier 2 (compulsory, supplementing a basic pension) retirement savings scheme with attached insurance benefits. Nor is there any choice about the amount to be contributed or the way in which the benefit emerges. For 27 years government-registered AFPs sold their memberships as financial products through commission-driven sales forces. That changed in 2008. Now the AFPs compete for the business of being the sole provider to enrol new entrants to the workforce. On 30 January 2012, the AFP Modelo "…was once again selected as the pension fund management company (AFP) to cover all new entrants to the labor force beginning in August" (Social Security Administration, March 2012).

Modelo offered the lowest monthly administrative fee in the bidding process that began last November.

> "The bidding process, a provision of the 2008 pension reform to improve competition among the AFPs and lower costs for account holders, is held every 24 months. The AFP selected must maintain the same fee (the winning bid) for 2 years for all of its account holders. New workers must remain with the winning AFP for 2 years unless (1) another AFP offers a lower fee for at least 2 consecutive months; (2) another AFP provides a higher rate of return sufficient to make up for a higher administrative fee; or (3) the winning AFP does not maintain the required minimum rate of return, is declared insolvent, or must liquidate its assets. Workers already in the system may switch to the winning AFP." (Social Security Administration, March 2012)

Apparently Modelo has been able to offer the lowest fee because it does not advertise or have a sales force; it has only the minimum required 15 branch offices, and it provides many services online.

There are two striking aspects to the Chilean treatment: first, the complex rules associated with the process and secondly, a recognition that competition had to be forced on the providers. It was not clear from the report whether the winning bidder had to pay to obtain the compulsory initial provider role.

12. The state as purchaser? – NEST in the United Kingdom

New Zealand's Savings Working Group proposed the establishment of a single, state-owned default provider that offered low-cost, passive investment options. The United Kingdom's National Employment Savings Trust (NEST) takes the 'single purchaser' concept further.

NEST starts for the largest employers in 2012 and is, like KiwiSaver, a national, auto-enrolment, opt-out, defined contribution retirement saving scheme that is subsidised by employers. As with KiwiSaver, anyone can join. Unlike KiwiSaver, NEST is a superannuation scheme rather than a framework and employers with 'as good as' schemes can offer that scheme instead of NEST.

Also unlike KiwiSaver, the state is the direct provider of NEST services. Members join a state-run, non-profit entity that is under the control of a trustee body called NEST Corporation. As with private schemes, the trustee sets the investment strategy:

> "NEST Corporation will set an investment approach for NEST that's specifically designed for the needs of a target market largely new to pensions saving." (National Employment Savings Trust, 2011)

NEST buys services for the scheme as a whole and, at the current date, there are:
- Tata Consultancy Services to administer members' records;
- State Street Corporation for asset record-keeping and nominee services;
- UBS Global Asset Management, State Street Global Advisers UK and BlackRock UK for investment management services.

NEST is the outcome of several reports[11] which concluded, in summary, that savers were not receiving value for their retirement saving schemes and also that not enough employees were saving for their retirement. Those conclusions led to the adoption of KiwiSaver's concept of auto-enrolment, opt-out; of 'nudging' employees into a retirement-specific saving scheme. The 'value for money' issue was resolved by the state's becoming a provider in competition with private providers.

13. Single provider, multiple supplier: the case of Sweden

Sweden offers another example of the state's direct involvement in the provision of superannuation services. Part of the overall pensions framework includes a state-run, Tier 2, defined contribution 'Premium Pension' where the earner can choose the investment provider. There is no choice about membership (unlike KiwiSaver); nor about which scheme to join – there is only one. From 2000, when the Premium Pension began, members could choose up to five from more than 600 investment options. There was also a government-run default fund and another selectable government-run fund.

Initially, two-thirds of members made an active selection; one year into the scheme, only 18% of new participants made any choice[12]. The rest go into the default investment option. The Swedish scheme is often portrayed as an example of what goes wrong when there is too much choice. The more significant issue is whether the state should become a commercial competitor to private sector providers.

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[11] That process was summarised in Hills, J. (2006).

[12] See Turner, J. (2003) for a detailed review of the early experience in Sweden.

14. Some reflections on KiwiSaver's default process to date

Here are some observations on the New Zealand experience, in the context of international experience:

14.1 Property rights conferred

The default provider appointment process conferred valuable property rights on the chosen six providers but without any direct return to taxpayers. Firstly, the 460,000 auto-enrolled members (as at June 2011) have a value to the schemes that receive their savings. Secondly, the default providers can expect to attract voluntary opt-in members because of the reputational value conferred on them by the government. Those members might assume the government had done 'due diligence' for them and the default providers themselves acknowledge that advantage.

New Zealand could, perhaps, ask potential providers to bid for the right to enrol members in this way. Chile provides an example of one way this might work.

The 'bid' could be based on 'value for money' to members rather than a success fee to the government. In other words, the government could use its leverage to drive costs down for the benefit of future default scheme members.

There is a case to suggest that the government should not have allowed banks and other established distribution channels to be given free business in the way that has happened for KiwiSaver. That has strengthened their position in the market effectively at no cost to them.

14.2 The appointment process

The initial selection process seemed to be a 'tick the box' affair where appearance appeared more significant than competence. That reflected the political significance of the process.

Providers themselves believe that the 2006 process was not very transparent. Anecdotally, the Treasury recommended originally that either four default providers be appointed or that default status would be available to any provider, having satisfied minimum requirements. Given that background, it is unclear why 2006 expert panel recommended that six providers be appointed.

14.3 The outcomes

The process made it almost inevitable that the outcome would be 'big is best'. The six default providers, as originally appointed, could be described as part of the following organisations:

- Australia's largest retail and corporate superannuation provider (AMP);
- The world's largest banking, insurance and financial services group[13] (ING);
- The biggest external provider of superannuation services to the State sector (ASB);
- The world's biggest insurance broker[14] (Mercer);
- The biggest New Zealand-listed insurer (Tower);
- The world's largest insurer (AXA)[15].

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[13] *Fortune* magazine in 2010 ranked ING as the largest banking/financial services & insurance conglomerate in the world by revenue; and the world's 12th largest company by revenue.
[14] According to *Business Insurance* accessible here - Mercer is owned by Marsh & McLennan Inc.
[15] According to *Insurance Networking News* accessible here.

It might look as though this really wasn't about the capability to deliver KiwiSaver to the benefit of members; rather it looked as though the aim was to reduce the government's exposure to risk. That may have been a reasonable basis to protect the government's interests but in this case, the members' best interests were not necessarily aligned with the government's.

Very little seems to have been done with the default providers by the regulatory authorities since their 2007 appointment. For example, the fact that AMP has acquired the superannuation business of AXA, thus effectively reducing the default providers from six to five seems to have gone unnoticed. Also, ING (formerly a joint venture with ANZ Banking Group in New Zealand) is now wholly owned by ANZ and re-named One Path NZ Limited.

Both those changes should have provoked a public review of the appointments of AMP, ANZ and AXA.

14.4 Lack of follow-up

Despite the statements made when the six were first appointed, the process didn't really focus on standards, quality or capacity. Also, there has been no follow-up on standards of administration or the delivery promises made at the outset. How do the default providers compare amongst themselves on fees, investment performance and administrative responses and how do those standards compare with the rest of the KiwiSaver providers? We should really have that information after nearly five years of KiwiSaver.[16]

The ongoing communication and disclosure regime for default providers was not agreed in advance and has seemingly not been monitored since. Before the appointments are renewed or a new process undertaken, the experience of the last five years must be documented.

14.5 The number of providers

There should be a public discussion on the number of default providers and even on the form of the default membership process:

> **(a) New Zealand is too small for six:** As part of the review process, it would be interesting to discover which of the providers is making a profit from its KiwiSaver operations[17]. Unless a KiwiSaver scheme provides a profit to its promoter, its future as a stand-alone scheme must be at least doubtful. The default process is mandated and the private benefit generated by that mandate justifies an open process that examines the return from the benefits conferred, especially when the providers make no payment for the privilege.
>
> On the face, there is a case to suggest that six default providers was the wrong number to choose and that the Treasury's apparent original recommendation of four default providers was more commercially sustainable in such a small market like New Zealand's. Despite the apparent success of KiwiSaver, there are probably not enough New

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[16] Snively and Rhodes (2008, p.52) note that: "Default Providers are required to report quarterly to the MED. Many commented that this was a fairly substantial undertaking, on which they received little feedback."

[17] According to Snively and Rhodes (2008, p.48), based on interviews with KiwiSaver providers generally, "In most cases, however, it will be several years before KiwiSaver in itself meets its own running costs, and several further years to repay initial set-up costs."

Zealanders to spread the default market on a sustainable basis amongst more than four providers.

(b) The SWG's recommended single provider: The Savings Working Group's recommended single, government-owned, default provider has a number of difficulties. The main one is that, so far, the government has been able to distance itself from KiwiSaver outcomes, despite the impact of the global financial crisis (GFC). That 'distance' would disappear if the government gets involved in delivering KiwiSaver services directly to the public. Aside from size, and the absence of a profit motive, the government has no competitive advantage in delivering superannuation services. On those grounds, the government could justify involvement in any business activity. That does not mean it should and any such justification seemed, for example, absent from the UK's decision to adopt the NEST framework.

If the government were worried about the level of fees, expenses and/or inappropriate strategies under the default investment options offered, the more appropriate response should be to regularly inform savers (and providers) what is going on. There is no current indication of official concern on any of these issues.

The government does have a regulatory and information role that it has so far stayed away from. That should change. It is time for a more 'hands-on' approach from the government in this regard.

14.6 An alternative, Inland Revenue 'extended holding' status

An alternative approach to the current default provider arrangement might see the Inland Revenue extending its current eight-week involvement to 52 weeks. On that basis, it would receive and account for the first year's contributions for all auto-enrolled members. During that period, the Inland Revenue would be responsible for educating members as to the active choice of a provider at the end of 12 months. At that point, the member must choose a provider if contributions are to continue. If the member refuses to choose, contributions would stop and a contributions holiday would start until the decision is made. In the meantime, the savings will attract interest at the 90 day Treasury bill rate.

Under this regime, there would be no need to appoint default providers.

14.7 The default investment option

The default investment strategy is too restrictive. As it turns out, the government has protected itself against political criticism that could have followed the investment fall-out from the GFC. However, that should not be a measure of 'success'. Instead, the government should define the required outcome (the risk and return objectives) and allow each default provider to set the investment strategy to achieve those. In a way, the present basis is like 'keeping a dog and then barking yourself'. The government seemingly does not trust providers to offer an appropriate default investment option and so makes the decision for them[18].

[18] Australia has adopted a similar approach with respect to default options under its compulsory, Tier 2 arrangements. Legislation to implement 'MySuper' was introduced in November 2011. MySuper will replace current default investment options in compulsory 'SG schemes' from 1 July 2013. The government will impose minimum standards on providers when members themselves have made no decisions. Those standards cover not just investment strategy (as with KiwiSaver) but also attempts to

14.8 An alternative approach – all qualifying KiwiSaver schemes

If it is not possible to reduce the number of default providers to four for the future or to have an 'extended holding', Inland Revenue-administered scheme as outlined above, the better answer might be for the government to prescribe a set of standards that any KiwiSaver scheme might reach and then allow all providers that achieve those standards to be added to the list of default providers.

A failure to constantly maintain those standards would see the scheme removed from the list until it re-satisfied the requirements. Constant monitoring will almost certainly be better for members than the present 'set and forget' basis.

This alternative would see the government defining principles-based standards in a way that hasn't happened to date, not even for the six default providers. But that should be the government's role because it has created the default provider framework. Having set those standards, there seems to be no reason to limit the number of default providers as long as they meet the minimum standards.

15. In conclusion: an alternative default provider regime

If auto-enrolment continues to be a feature of KiwiSaver, there needs to be some kind of default provider regime. A default investment option is also needed because employees who are auto-enrolled will, by definition, have made no decision about how their savings are to be invested.

The first question that therefore needs to be addressed is whether auto-enrolment is still needed. Given the 'kick start' provided to establish KiwiSaver as part of New Zealand's retirement savings landscape, there is a strong case to suggest that seven years of auto-enrolment (by 2014) has achieved its purpose and that it can then be dropped. In this case, the government will simply not renew the six current appointments in 2014. It is under no obligation to do so though dropping auto-enrolment would itself require an amendment to the KiwiSaver Act 2006.

If auto-enrolment continues, the government should not give a commercial and marketing advantage to a small group of financial service providers, especially if they do not pay for the privilege. Nor, for the reasons already described, should the government adopt the SWG's suggestion of a single default provider of the kind the UK's NEST regime has implemented.

Of the two possible alternatives this *PensionCommentary* has suggested, the less disruptive to the current regime would be to extend the number of default providers to any that achieve a set of minimum standards. As suggested here, compliance with those standards should, unlike now, be a continuous requirement to hold default provider status. A failure to meet those standards at any time would see default provider status automatically suspended.

However, it would probably be better for auto-enrolled members to join the extended holding scheme administered by the Inland Revenue. As suggested above, the Inland Revenue would have 12 months to educate members as to the choices facing them at the

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regulate fees and reporting requirements. Scheme trustees must apply for a licence to offer a MySuper option (Australian Government, 2011). As with KiwiSaver, the government owns the MySuper brand.

end of the minimum contribution period. A failure to decide would see the members start a contributions holiday.

The current regime of six privileged providers should not continue beyond 30 June 2014.

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