Briefing Note on KiwiSaver, Default Provider Fees and Proposals for a Single Default Provider

Background

KiwiSaver has been the most successful public private partnership in New Zealand's recent history and has persuaded more than 1.7 million New Zealanders to commit to long term savings for retirement, well beyond the initial expectations of Government.

When KiwiSaver was launched in 2007, the Government decided six private default providers would be selected to manage funds while KiwiSaver investors were deciding what investment style and provider they wanted to meet their long term needs.

In order to become a default KiwiSaver provider, investment managers were required to invest in substantial new systems to manage these accounts.

The Government and officials were concerned that KiwiSaver balances were not seen as being Government guaranteed and private providers were selected for that reason. Six private default providers meant there was a diversity of investment managers spreading this risk.

After negotiating with the private default providers the Government set the fees that were allowed to be charged. Initially the Ministry of Economic Development (in conjunction with the Government Actuary) and subsequently the FMA were given the task of monitoring and reporting on the appropriateness of the default fund fees.

Fees for the default funds are reviewed for reasonableness every year. In this regard the default funds are the most scrutinized funds in New Zealand. The Government Actuary recently completed the third such review of these funds with every fund once again passing this review.

They, along with the account holders, have recognised the value of the existing arrangement which combines the maximum choice with constrained fees.

On average, KiwiSaver investors in the default funds pay their fund manager just under $60 p.a. to manage their retirement savings. This amount not only pays for investment management, it also covers trustee costs as well as costs associated with safe custody of assets, annual reports, compliance, regular member reporting, and the provision of websites and call centres.

The Government also set the conservative investment strategy that was to be managed by the default funds.

This means the default provider option gives individuals a low risk holding place for their funds until they can choose the investment style and provider that best meets their long term investment needs.

According to the FMA's KiwiSaver report for the year ended 30 June 2011, only 24.5% of total KiwiSaver funds are now invested in the 6 default funds, indicating that the default funds are working exactly as they were intended to.

Today there are many more providers than simply the organisations that operate the default funds, so KiwiSaver investors have a wide range of providers with differing investment styles and fee levels that they are able to move their funds to if that is their choice.

Recent Trends

The very low risk investment strategy and the default funds have served KiwiSaver default fund investors well over the last 4 years, the most challenging investment environment in 80 years following the Global Financial Crisis.

The current fees charged by default providers are low by Australian standards given that New Zealand fund balances are much smaller than for similar schemes in Australia. This is similar to a bank account where the administrative fees are the same regardless whether the account has $100 or $10,000 in it.

As the amount of money being managed within each account rises, fees will drop as a percentage of investment income. In a period of very low investment returns following the Global Financial Crisis and 40 year low interest rates, fees are currently an artificially high proportion of current investment income. As the amount of money in each account increases and investment returns improve, these percentages will reduce dramatically.

However, it is worth noting that the number of non-contributing KiwiSaver accounts is also growing. The latest FMA report shows that non-contributing KiwiSaver accounts were 23% in 2009, 40% in 2010 and 45% in 2011. While these accounts do not add regular new investment funds, they still consume the same fixed cost services, compliance obligations as other accounts where members are contributing.

Any KiwiSaver investor unhappy with the fees being charged by their provider has the option of moving to another provider.

KiwiSavers do not invest in order to pay fees, but to increase their long term net wealth. In the longer term investment style and returns matter more than fee structures in terms of net investment earnings achieved and the final account balance delivered at retirement.

To date most KiwiSaver default fund providers are yet to break even on their large investment in new systems and will not do so until the funds in each account and the number of investors in KiwiSaver grows.

A Sole Default Provider – It's Not Just About the Fees

Over the last few weeks there has been a debate about the fees of KiwiSaver default providers and whether fees could be lowered by introducing another public default provider, or replacing the existing six default providers with a single provider such as the New Zealand Superannuation Fund (NZSF).

The Green Party policy proposes that a 7th publically owned default provider be added to the existing private default providers, prior to the review of default arrangements in 2014, and subsequently having a sole public provider, the NZSF, after that date.

If there were to be a change in the default provider arrangements before 2014, it is likely some of the default providers may seek compensation for their investment in new systems that was predicated on there being 6 and not 7 default providers. This is not consistent with the original agreements entered into with default providers and neither is it consistent with the desire to build a robust capital market that attracts participants to offer funds management and other related services to New Zealanders.

A sole provider is being proposed on the basis that fees could be reduced and net returns increased for KiwiSavers.

While scale does provide some reduction in costs, a recent study from Australia by Rice Warner Actuaries, October 2011 “Superannuation Fund Expense Analysis” would imply that such economy in administration costs has only been achieved there when funds under management in a *single* fund (with individual account holders) exceed $A 10bn. Total funds under management across *all* KiwiSaver providers is currently just over $NZ9bn, well below the point at which Australian funds appear to achieve economies of scale in administration costs.

A second issue is investment style. Looking retrospectively at the experience in Australia, while passive funds are cheaper on average to operate, the best returns have been achieved by funds that also invest in illiquid assets that have had higher management costs and thus fees but have delivered greater net investment returns.

It has been suggested that the NZSF would be the appropriate entity to manage a single default provider fund. There are other local alternatives to having the New Zealand Super Fund as a monopoly provider. During the time that the NZ Super Fund has operated, the ACC investment management team has achieved higher investment returns than the NZSF along with a lower expense ratio.

However, these funds also operate very different investment profiles to the default KiwiSaver funds with more aggressive and illiquid investment strategies adopted in line with their longer term investment horizons (i.e. they do not need to be concerned about being short term “parking lots” for investors’ funds).

As such, both the ACC and NZSF have the advantage that they do not face redemption risk in their current roles. They therefore do not have to hold as much cash as would a KiwiSaver default provider where any fund member can move their account elsewhere at short notice. This tends to depress returns for a KiwiSaver default provider.

Should any of these existing public funds become default KiwiSaver providers they would need to make significant investments in registry, custody, trustee services, as well as provide mandated retail reporting, prospectuses, annual reports, compliance obligations, and create call centres, websites, and direct mail facilities. These would be new costs for these funds and would need to be recovered through a higher fee structure than what is currently in place.

APPENDIX 1: THE 42% KIWISAVER DEFAULT FUND FEES MYTH

There has been much debate about the cost of fees within the default KiwiSaver funds, with some analysis suggesting that as much as 42% of investment gains are being absorbed in fees.

However, a number of inaccuracies exist within such an analysis:

- Of the 42% in "fees", almost half (20.8%) is actually tax paid by the funds to the Government;
- Of the remaining 21.2%, the analysis has included the fees charged by all funds managed by the default providers, not just the default funds themselves. This means that higher fees from more actively managed funds with higher risk profiles have been included; and,
- Many KiwiSaver accounts currently have very low balances so the fixed fees are high relative to returns (at a time when returns have been at 80 year lows). This is especially true for 45% of the people in the default funds who have frozen contributions and are not currently contributing any new funds into their accounts. As balances grow and returns improve the fees will become lower relative to returns.

Given current balances are relatively low, the average KiwiSaver in a default fund pays just over $1 a week in fees. This is comparable to the sort of fees many people pay to their banks for operating a savings account.

APPENDIX 2: SUPERANNUATION FUNDS EXPENSE ANALYSIS RESEARCH

The following is an excerpt (Executive Summary, pages 4 & 5) taken from the report: "Superannuation Funds Expense Analysis Research", undertaken for the Association of Superannuation Funds of Australia (ASFA) by Rice Warner Actuaries, October 2011.

Executive Summary

This report summarises the results of research into the cost structure of superannuation funds carried out for ASFA by Rice Warner Actuaries. The research is based on a survey of superannuation funds conducted by Rice Warner in late 2010 and also on fund level data published by the Australian Prudential Regulation Authority (APRA).

The intention is to undertake this research annually to provide a longitudinal study of expenses. Rice Warner has already contacted funds to collect the 2011 data.

Components of operating costs

In regard to the components of operating costs, the costs related to the category 'administration' together with 'trustee support/general management', make up the bulk of operating costs. Costs associated with 'technology infrastructure' are also substantial.

Defined benefit funds have higher unit costs for operating expenses than other funds. However, these costs are effectively paid for by employer sponsors rather than by fund members.

Administration expenses have a number of components. The largest components relate to contribution processing and member contact centres, which together make up around half of fund administration expenses.

The costs of contribution processing can be as low as $2.85 a member per year, while the highest recorded figure was $21.20. On average the cost was around $8.90 per member per year. There was also a significant variation in the cost of member contact centres.

The results indicate that insurance administration can involve substantial amounts per claim (typically in excess of $2,000), and pension administration is more costly than contribution processing.

Impact of outsourcing

Many funds outsource part or all of their administration service provision. Most of the differences between the operating costs of outsourced funds and the self-administered are not statistically significant, particularly given that self-administered funds are more likely to be defined benefit funds than outsourced funds. The notable exception is in regard to technology infrastructure. This is likely to be due to information technology (IT) systems costs being relatively high.

Impact of scale

Fund size has a notable impact on the per member cost of administration. Each component of administration expenses tends to decrease as fund size increases.

Funds with less than 25,000 members commonly, but not always, have significantly higher expenses than larger funds. The bulk of the reduction in operating expenses flowing from scale is generally achieved with a fund membership of 500,000 or more.

Funds above $10 billion in assets have lower investment expenses than smaller funds.

Investment expenses

More than half of investment expenses are fees paid to external fund managers.

There are scale benefits in the areas of custodian and asset consultant services.

There appear to be scale benefits from leveraging fund size in negotiating fees for the management of listed shares (both Australian and overseas), but no such benefits are obvious for the other asset classes examined.

Policy and other implications

Initiatives to reduce administration costs, such as the SuperStream proposals relating to contributions and rollover processes, have the potential to significantly reduce the cost of processing contributions and rollovers. However, such costs only form a part of overall administration costs and only a relatively small proportion of overall fund expenses.

The considerable variability in operating costs between specific funds is a topic deserving further investigation. While some of the variability is likely to be explained by differences in benefit design and the level of services provided, there are also likely to be differences in the levels of cost efficiency between funds.

Call centres and member communication form a large part of fund operating expenses. Fund expenses are likely to increase if there is greater provision of intra-fund and scalable advice through call centres and the like.

Fixed costs associated with IT provision are significant. Outsourcing administration appears to be one way that a smaller fund is able to reduce costs in this area.

Costs such as those relating to trustee and general management support and compliance and risk management appear to not vary much with the size of a fund. Fund mergers offer potential cost savings in these areas for funds.

Many of the benefits from increasing scale appear to be achieved in regard to operating expenses when a fund has more than 500,000 members, and in regard to investment expenses when it has more than $10 billion in assets under management. The greatest cost savings from fund mergers are likely to be obtained when they involve funds with member numbers or assets under those amounts. However, some smaller funds have cost levels which are competitive with those of larger funds and in these cases, the pressures for mergers on cost grounds alone are less.

Currently, funds are not required to report much detail on investment expenses to APRA and a large part of investment expenses are netted off investment returns rather than forming part of the detail in the financial accounts of funds.

Source: ***"Superannuation Funds Expense Analysis Research", undertaken for the Association of Superannuation Funds of Australia (ASFA) by Rice Warner Actuaries, October 2011.***

APPENDIX 3: SAVINGS WORKING GROUP

Suggestions made by the SWG last year included: (pp15-16, SWG Report *Saving New Zealand: Reducing Vulnerabilities and Barriers to Growth and Prosperity,* 3 recommendations relating to KiwiSaver)

- Recommends reducing costs, fees and expenses – thus increasing returns, including by creating a single low-cost default scheme.
- Recommends rationalising the default scheme so it invests only in index-based shares and bonds and offers a limited number of basic combinations for such investments. Members are then able to select one mix or default to an age-related transition programme through the different mixes; and,
- Recommends creating an additional low-fee, ultra-low-risk fund that invests only in short-term government securities.

APPENDIX 4: GREEN PARTY FLYER

A copy of the Green Party's paper can be found here: "Incentivising Saving: A Public Option for KiwiSaver".

A number of discrepancies with the Green Party analysis of the current situation with the KiwiSaver default funds need to be highlighted:

- The Green Party analysis looks at the average fees across *all* KiwiSaver funds, not just the lower cost default funds. This means that their analysis includes funds that individuals have chosen to invest in – these funds are more actively managed, often adopt a more aggressive investment strategy, and charge higher fees in return for the prospect of greater investment returns. The effect of this is to significantly over-inflate the true average cost of the default funds; and,
- The default fund fee proposed by the Green Party in their document (0.4%) is the same fee that some default funds (e.g. ASB's Conservative Fund) already charge.