Understanding the DPB

- the default provider benefit

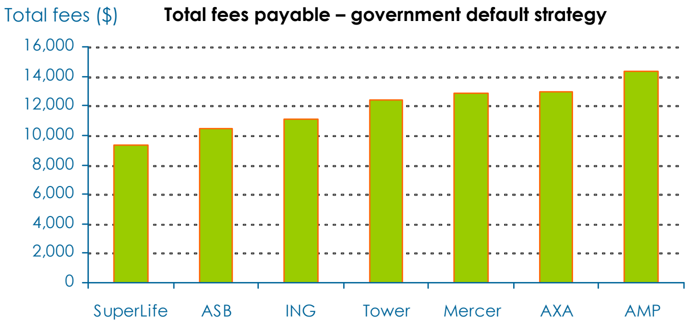
make your life a SuperLife

11 October 2010

One issue that limits KiwiSaver's ability to achieve its full potential is the current role of the Default providers. While the concept solved the problem of what to do with employees who are enrolled without making a decision, it was a solution that came with significant costs in terms of achieving the best retirement savings outcomes. The problem is that it allocated "free" business and reduced the incentive for true competition, except at the margin. Also, their status is often misinterpreted as being the providers who are the "best" providers. They were, after all, chosen by the government.

- The best solution is to remove auto-enrolment.
- If auto-enrolment is retained, all approved KiwiSaver providers should become default providers after 3 years.

Fees have been higher

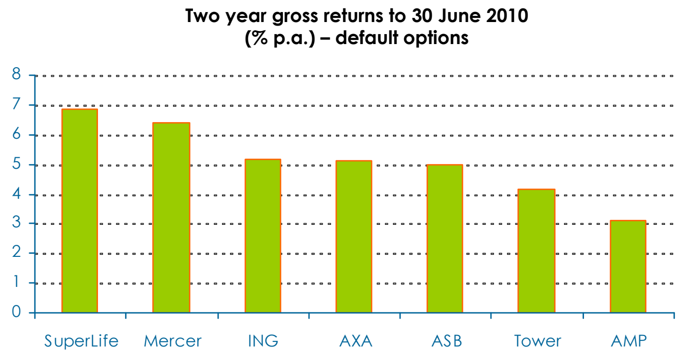


Source: www.sorted.co.nz

The default providers on average have total costs higher than they need be. About $2,500 higher over the period to age 65 for a 35 year old employee earning $40,000 a year. This difference is about one month's pay. Taking this as an average extra cost, with 420,000 people allocated to Default provider schemes, the additional cost of the government not focusing on competitive fees is over $1.1 billion.

Returns have been lower

For a member in KiwiSaver in the government-defined default option, the returns have been about 2% a year lower, on average, than SuperLife's. With $1.7 billion estimated to be invested under the default option, this has probably cost $35 million a year in lost retirement savings for those New Zealanders allocated by the IRD to Default providers.



Source: SuperLife, Morningstar, Fundsource, AON and provider websites

This transfer of wealth by the government and members to Default providers is a conservative estimate. As these providers have a stranglehold on the KiwiSaver market, their management cost inefficiencies extend to all their memberships. This means overcharging could exceed $3.9 billion in fees for all KiwiSaver members over the terms of their average membership and a loss of over $114 million each year in uncompetitive investment returns.

Is it reasonable that the KiwiSaver industry should collect over $3.9 billion more than necessary in fees and credit $114 million p.a. less in investment performance? It must also be remembered that most of these overpayments add to the profits of offshore owned companies.

It is time to start a debate on:

- Getting rid of auto enrolment. This eliminates the need for Default provider status,

or

- Opening up the Default provider status to true competition. Why aren't all KiwiSaver approved schemes not granted Default provider status. If an approved scheme doesn't meet the standards, it should not be approved in the first place. As a minimum, an approved scheme should be given Default provider status after three years' operation, unless it chooses not to accept it.

Either of these changes will not eliminate overcharging but it will force the industry to be more competitive; thus, pushing costs down and improving returns.

Default provider regime

The Default providers are the government-appointed providers that employees are randomly allocated to when they join in KiwiSaver because they have not made an active decision.

Because an employer's new employees who are not in KiwiSaver are auto-enrolled without their agreement, there needed to be a mechanism for allocating them to a provider and assigning them an investment strategy. To address this need, the government appointed six providers and gave them "Default" status and defined rules as to how the employees are allocated and how their money was to be invested. When an employee does not choose a provider (i.e. a scheme) and where the employee's employer has not chosen its own default scheme, the employee is randomly allocated to one of the six Default providers and allocated to the default investment option.

Having many people not knowing which provider they are with is one issue. Having these same people invested in an investment strategy that is less likely to be optimal for their retirement savings, has a cost to them and the economy. These problems are made worse as the provider is, in effect, incentivised to do nothing to improve the position. They have little incentive to service and educate these members. It is better for them for their default-enrolled members to do nothing – if the members thought about it, they might change provider and that business would be lost.

The concept of Default providers does not apply to non-employees, children and employees that choose their own KiwiSaver scheme. While employees allocated to a Default provider are not locked-in, most stay with the provider allocated because they do not care or may not be aware that they can change or should make a decision. If they were, they would have exercised their decision rights initially i.e. in their first three months.

It would be reasonable to expect that the Default providers would be "quality" schemes of "quality" managers and that they would offer a "quality" product to investors. "Quality" in this instance should include:

- **Lower fees.** After all, they (the Default providers) are given business by the government and do not have the marketing costs of other providers. Because the Default providers are the largest, you would expect economies of scale and therefore lower total management fees.
- **Greater range of investment options.** In fact, all default providers offer similar options and none offers full flexibility. Many have also established alternative KiwiSaver schemes for their other clients.
- **Greater investment expertise and outcomes.** Size should allow greater resources and expert advice. The performance results to date do not demonstrate this from the current Default providers.
- **Better communication, information and service.** As a rule, the Default providers have less frequent communication than other providers and have no incentive to improve.
- **Greater security.** The Default providers should be required to adopt best practice principles, with independence between the roles of the investment management, governance and promotion/administration. This should reduce the risks associated with conflicts of interest and incentivise the provider to use the best managers.

For Default providers, the issue is that superannuation and KiwiSaver are not their main businesses. They were not the best providers and were not the best superannuation service organisations prior to the advent of KiwiSaver.

By allocating auto-enrolled employees to the Default providers, the government has, to date, not done KiwiSavers any favours. They are probably in the wrong investment option, have higher fees and will therefore get lower long-term average returns.

Default investment strategy

An employee allocated to a Default provider is put in the government-defined default investment strategy. This allocates these employees to a strategy of 15% to 25% shares/property and 75% to 85% cash/bonds. For most, this makes little sense unless they are very close to retirement.

* A principled based approach focused on the expected outcome, would result in a better default investment strategy.

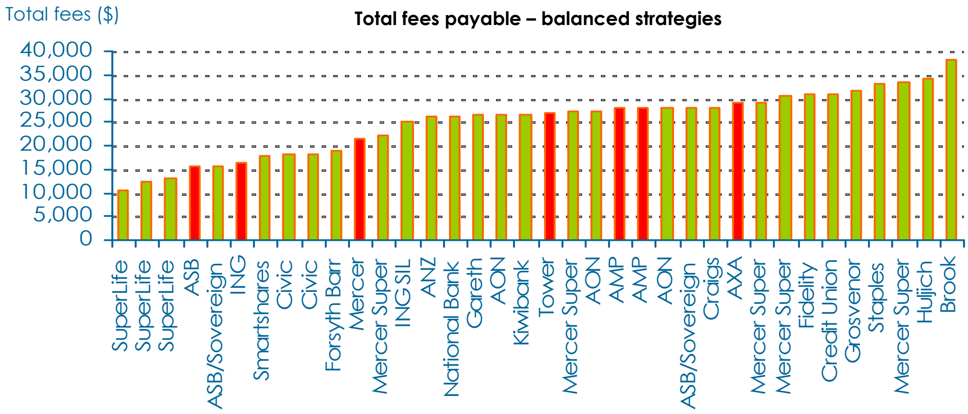
The government would have been better to adopt a principles-based approach focused on the nature of the expected return outcome and left the provider to set the strategy and investment policies. Instead it adopted a rules-based approach focused on an actual strategy.

If it had been an outcomes focused approach, it would have been up to the provider to determine the appropriate strategy for the environment and the defined profile for the return outcome, given the defined objective. The Default providers may not have wanted this responsibility, as it shifts accountability to them, but the risk and accountability for outcomes should fall on the provider than the member, who, by definition has not been involved in the decision. It is hard to see how the government has the skill or experience to set a strategy but it could have easily defined key principles.

Comparing fees

Fees are very difficult to quantify, calculate and compare. The best website is still the Retirement Commissioner's Sorted site (www.sorted.co.nz). However, it is not totally accurate and understates the fees of many providers.

Based on an employee, age 35, earning $40,000 (about 4/5ths of the national average wage), the comparison of fees over the person's future membership for the balanced investment options ranged from just over $10,000 to just under $40,000. A balanced investment option is the option with between 50% and 65% in shares and property and 45% and 50% in cash and bonds.



* Low fees are best.

Source: www.sorted.co.nz

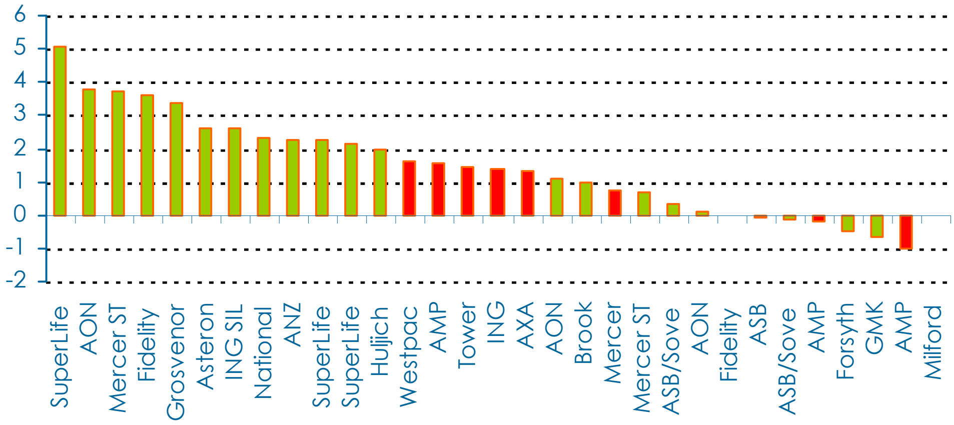
Not all of the above bars are truly comparable as the fee differences are explained by different strategies and different expected returns. A "balanced" strategy with a higher allocation to shares will usually cost more than a "balanced" strategy with a lower allocation. It does show, however, that unless you have confidence of getting a higher return, the fees of the more expensive providers are significant. Imagine what you could do with an extra $30,000 tax-free at retirement. Even if some strategies produce higher returns, going to the provider with lower fees and a similar strategy is a sensible basis for selection. The graph clearly shows that the Default providers are not the cheapest and the traditional insurance companies (AMP, AXA and Tower) tend to be more expensive.

In the context of this paper, what is more relevant are the fees of the options that meet the government-defined default investment strategy – after all many end up with this option. The graph on the first page showed these for the default providers and SuperLife's equivalent (the D fund).

Investment performance

There is no accurate and reliable single source of investment performance numbers. However, using the published data from Morningstar, Fundsource, AON and Mercer and the published returns of other providers not in these databases, the historical returns, after fees but before tax, to 30 June 2010 of the "balanced" options are:

Two year gross returns (% p.a.) – balanced options to 30 June 2010



⋆ Fee differences explain part of the return differences.

Source: SuperLife, Morningstar, Fundsource, AON and provider websites
Note: several providers have several "balanced" options.

While it is accepted that some providers may have made up their returns and the published returns cannot be relied on, they paint a picture of relatively poor returns for the Default providers. Importantly, the combination of the return graphs and the fees graphs highlight the potential value of low fees.

The benefit of choosing the provider with low fees was also shown by the performance and graph on the first page plotted the returns of the investment options that comply with the government defined default strategy.

Conclusion

Overall, an employee allocated to a Default provider should not expect to have as good an outcome as many of those who chose their own provider. They pay more in fees, have less flexibility and are likely to have lower long-term returns. The government would be better to shift the governance of KiwiSaver to focus on improving the future experience of investors and remove the need for Default providers (the best option) or open the Default provider regime to true competition.

In the meantime, employers should consider choosing their own default provider, so that at least their own employees who are auto enrolled end up with a provider and in an investment option, more likely to meet the employees' retirement savings needs.

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