16th July 2018

Open letter to:

Rob Everett
Chief Executive Officer
Financial Markets Authority

Adrian Orr
Governor
Reserve Bank of New Zealand

Hon Grant Robertson
Minister of Finance

Hon Kris Faafoi
Minister of Commerce and Consumer Affairs

Dear Sirs,

You sent a letter to the banks and to the insurance companies asking them to prove that consumers, regulators and other stakeholders can have full confidence in the financial services sector.

You have not asked the public or independent financial advisers. Hence this letter from a group of independent authorised financial advisers concerned about a financial issue, to which we wish to draw your attention.

It is the earnings which KiwiSaver default fund members have missed

It was identified at the commencement of KiwiSaver and repeatedly during the years following that KiwiSaver assets are for a very long-term purpose, retirement funding. It was identified at commencement that selecting conservative default funds to limit (or even eliminate) the possibility of short-run negative yields would be costly to the default members in the long-run if the default option turns out to be for the long-term. That is exactly what has and is happening, and it should never have occurred.

Default members missed out on $830 million

It is impossible, given the lack of publicly available data, to exactly calculate the loss of potential earnings suffered by default KiwiSaver members, but if a balanced fund rather than a conservative fund strategy had been selected for KiwiSaver default funds, the default members would have been better off by at least $830 million over the six years ending 31 December 2017. The primary reason was that in the five years preceding, the default conservative funds average earnings was 6.0% pa, but the average of the KiwiSaver balanced funds for the same period was 9.5% pa according to Morningstar. Meaning the default members lost on average 3.5% p.a. compounded in those five years.

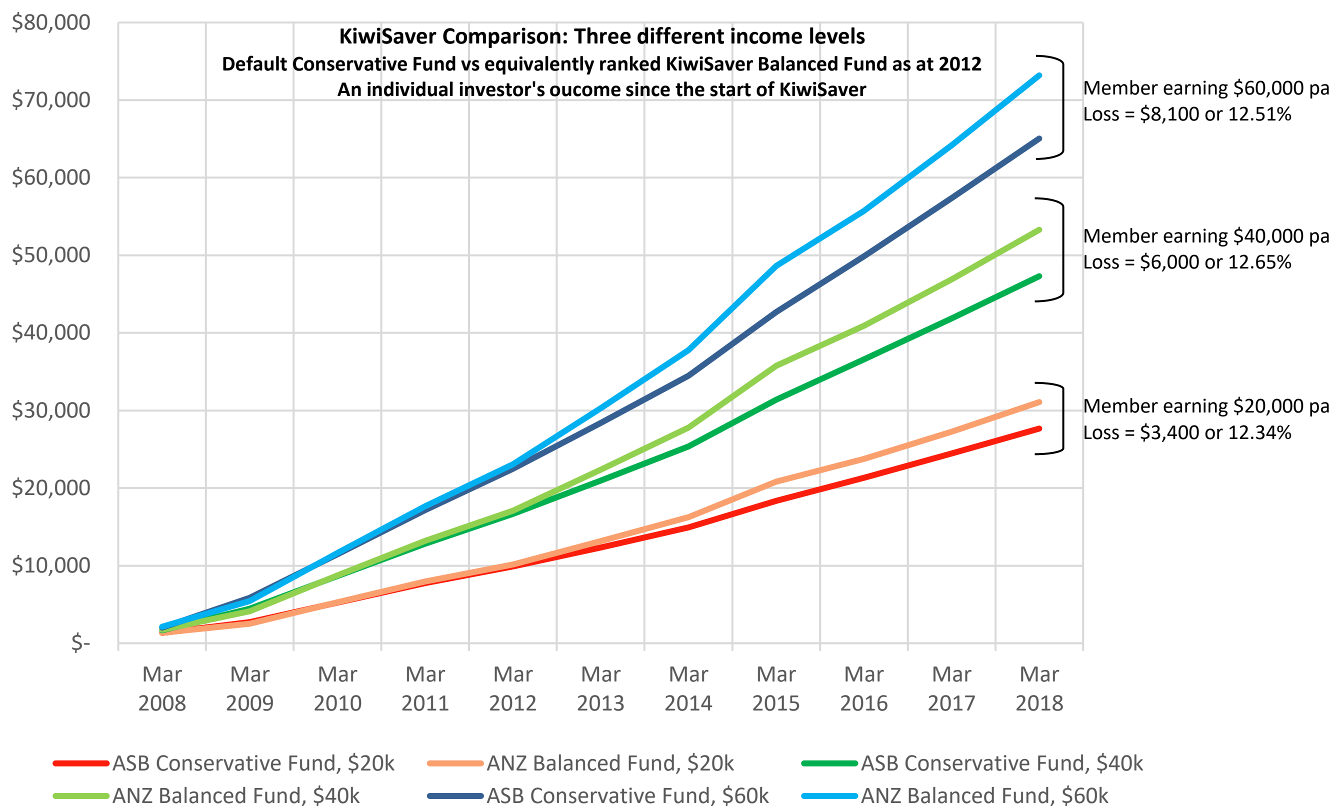
This situation may have continued in this year and could be approaching or exceeding $1 billion if the overpayment of PIE tax by most default members since the scheme commenced was included in the numbers.

Unless decisive action is taken now to remedy the current operation of the default KiwiSaver funds, the lost potential earnings are likely to continue into the future.

What does that mean for individual default members?

To test our hypothesis and to identify the impact for individual members we calculated the outcome for three default members with different income levels, assuming they joined at commencement of KiwiSaver and remained invested through to 31 March 2018. We then calculated, for each income level, the result if

a balanced fund had been used. It assumes that the individuals were taxed at their correct tax rate throughout which was often not the case. The results are shown on the following graph.



Simulated investor experience using monthly fund performance figures obtained from the Companies Office Disclose Register
Assumes member's gross earnings as stated in 2007, increasing at 3% per annum, 4% employee contribution rate, minimum employer contributions, taxed at the member's applicable PIE tax rate. Kick start and Member Tax Credits received.
Tax calculations estimated only.
Rankings determined by Morningstar, both KiwiSaver funds operated by default providers, and ranked 7th in their peer group as at 31 December 2012.

Who is responsible for these default members missing out?

The number one reason was that MBIE and the FMA retained in 2014 a conservative fund strategy for all default fund providers. The original intention with default KiwiSaver funds was that they were a "temporary holding place" while default providers rapidly engaged with those members and switched them to more appropriate funds.

By 2012 four years after the commencement it was very clear that the default funds were not operating as temporary holding places, managers were not switching default members to other funds at the speed or in the volumes expected. Default conservative funds had accumulated significant funds ($2.9 billion) and members (447,274).

MBIE reviewed this problem and stated in their 2012 request for submissions that "If retirement income maximisation is the agreed objective" then there are "three broad types of investment strategies under this objective" (namely aggressive, balanced and life-cycle) recognising that continuation of a conservative strategy for default funds was incompatible with that objective. Of the 29 submissions received (and published on their website), there was strong support for a change away from the conservative strategy. Only two existing default fund providers supported staying in a conservative, one of whom (AMP) admitted that by doing so it "goes against our recommended portfolio construction." The other (ASB) made the claim in their submission that based on their own survey, "our global observation is that people want to be in conservative funds" – a statement which seems to be more about its own interests, rather than those of its KiwiSaver clients.* Tower however in its submission stated "our

experience to date is that members have not been overly concerned with volatility", contradicting ASB's statement.

Why did the strategy not change? The Commerce Minister when announcing the new default suppliers in 2014 stated "the purpose of the default funds is as temporary holding fund." As at 31 March 2017, the number of default fund members was 446,534, five years earlier in 2012 it was 447,274. In those five years despite lower volumes of enrolments in default schemes the total number of members declined by only 740, while the value of funds increased from $2.9 billion to $4.6 billion in default funds, compounding the regulators conservative default fund selection error.

The number two reason was the failure of the default fund providers, particularly the original default providers, to meet their obligation to switch members out of the default funds. The default funds were meant to be 'temporary holding funds" for default KiwiSaver members. Their responsibility was to engage promptly with new default members and switch them to more suitable funds. It was presented by the authorities throughout as a key responsibility of the default KiwiSaver fund providers.

Several of the default providers had a serious conflict of interest which possibly explains their failure to switch default members to more suitable funds. Were they acting in their own interests by dragging their feet with this requirement? Statistics suggests they were acting in their own interests. There was a sudden large spike in switching activity in the run-up to the review of default suppliers and their re-appointment in 2014, which tailed off immediately after re-appointment.

The potential conflict of interest is demonstrated by the portfolio composition comparison between default conservative funds and KiwiSaver balanced funds. On average, bank owned default conservative KiwiSaver funds in April/May 2018 had 22.4% more of their portfolios invested in bank products than they did in their own balanced funds. In 2018 the five bank default KiwiSaver providers on average had 34% of their default funds invested in bank products. Effectively charging default members for investing in their own and typically other Australian banks products. Refer the following portfolio composition table:

	Total Fund Value	Total bank exposure in default fund		Balanced Fund Total Bank Exposure	Difference
Default Fund	(000,000)	%	$000,000	%	%
AMP	1,388	43.5%	603	16.40%	27.1%
ANZ	1,064	29.9%	319	22.14%	7.8%
ASB *	3,663	32.1%	1,173	12.50%	19.6%
Booster	1,372	42.1%	577	17.28%	24.8%
BNZ *	495	36.8%	182	1.18%	35.6%
Fisher Funds	732	36.7%	269	29.34%	7.4%
Kiwi Wealth	144	42.6%	62	15.18%	27.4%
Mercer *	1,090	35.8%	390	14.00%	21.8%
Westpac	143	29.3%	42	7.51%	21.8%
Bank average	1,102	34.1%	356	11.7%	22.4%

* This includes non-default members as it is not exclusively a default fund

Data sourced from during April/May 2018 from:
https://disclose-register.companiesoffice.govt.nz/
https://fundfinder.sorted.org.nz/

The number three reason for the undisclosed losses was the performance of the regulators, MBIE and the FMA. What did they do to ensure that default fund managers met their obligations? A common theme in many of the annual KiwiSaver reports from the FMA was expressions of concern at the poor performance of the default providers in switching clients out of the default funds. Yet no effective action was taken by the regulators against the poor performing default fund providers when it was clearly required. It could easily have been taken to quickly resolve the problem. Why were the original default providers re-appointed for a seven year term given their poor track record with switches? If they were re-appointed why were they not given a rolling one year term subject to performance on switching rates? Who advised or was involved in those contracts?

If members had been switched out rapidly and in sufficient volume the outcome for default members would have been dramatically improved.

We estimate that it would take six years at the current rate of switch outs from the default funds for all members to be removed, provided no new default members were added.

The regulators appear to have had too much faith in the default provider's financial education tools, as a potential solution to the problem for so many years, yet these are clearly failing for many default members. What testing and standards were set for these tools, as some produced results that could hardly be described as fit for purpose? The ASB risk profiler, for example, tells someone aged 50 years that they should be in a balanced fund based on no more information than they are 15 years away from retirement presumably on the assumption that they will withdraw everything when they retire, hardly good advice or a "financial tool". Default members need to talk to an adviser to get personalised advice that's right for them.

At a communications level the regulators also failed. For example, they did not enforce standard naming conventions for default funds. So, some default funds are not called default funds and have other investors, while other KiwiSaver funds are called default funds when they are not default funds. A significant portion of New Zealanders are confused enough about KiwiSaver funds without allowing these issues. So, a member is meant to recognise that they are in a default fund even though it is not called that? Perhaps a KiwiSaver member is meant to feel more comfortable in the ANZ default balanced fund rather than another provider's balanced fund because it is a "default fund," even though, in reality, it is not.

Finally, why have the regulators not sorted out the tax rates applicable to members in the default schemes? The onus was placed on the default fund providers to sort out the new default member's tax rate, probably the least qualified party to do so. The default fund providers receive their information about new default members from the IRD but strangely the IRD does not provide them with the member's tax rate. So the highest rate of tax has to be applied by the default fund manager to the default member's account from commencement i.e. 28%. Employers cannot add the employee's right tax rate information to the KS1 sent to the IRD to enrol their employee in KiwiSaver, - because there is no space for it on the form. The result is that some of the lowest income earning KiwiSaver members have and are paying tax at the highest possible rate 28%, when they should have been taxed at 10.5% or 17.5%. The regulators failed to exercise a proper duty of care for those default KiwiSaver members – as did the default KiwiSaver fund providers and the Inland Revenue Department. PIE tax is a final tax which means that overpaid tax is unrecoverable for members. Losses because of this problem have not been included in our estimate of undisclosed default member losses. If included, the loss figures would simply be larger.

In conclusion, yes this is a serious financial issue that has not and is not, being resolved.

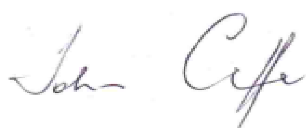
There are clear conflicts of interest with some default KiwiSaver providers. Some of the default providers have acted in their own interests, not in their default KiwiSaver client's interests. Yes, it has cost some of the most vulnerable New Zealander's significant sums. It is both an inexcusable and a continuing problem. The ethical standard required of our industry has not been met by some of its most important institutions and Government bodies.

As Authorised Financial Advisers and signatories to this letter we have done so because we feel that this issue must be resolved. Our Code of Conduct requires us to "place the interests of the client first, and [that we] must act with integrity". Also "not to do anything … that would … bring the financial advisory industry into disrepute", something we feel has been done by these parties. We do not believe it is in the best interests of New Zealanders for the regulators to be on "good terms" with the major banks" particularly given recent events at the Royal Commission in Australia. To claim it is different in New Zealand is disingenuous and does not reflect the reality of bank culture and operations.

If we don't speak out for these default members, who are not our clients, who will, because so far who has acted in the best interests of these members? Attached is our recommended ten point program to resolve this issue.

If you would like further details of our calculations and supporting information, please email john@cliffeconsulting.co.nz.

Signed by John Cliffe on behalf of the parties listed below:



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The signatories to this letter operate independently and the companies have no ownership links

Ten point programme

1. Change all the default fund options to balanced, not conservative fund types
KiwiSaver's primary objective is to help New Zealanders fund additional income in retirement. A conservative fund is incompatible with that objective. It is also worth noting that risk profiling to determine fund selection is based on normal population distribution statistics. Roughly for every one person in a conservative fund there should be three others in balanced funds, and another one in a growth fund. It is not a choice between three equally appropriate fund types. The default suppliers have for more than a decade been unable to meet the expectation that these funds were temporary holding places for members. Far too many default members have had little or poor interaction with the default fund suppliers. Many of the same default suppliers though have been highly active in marketing to and switching KiwiSaver clients from other KiwiSaver suppliers.

2. Ensure IRD provides default fund managers correct member tax rates for all default members
Self-evident and long overdue.

3. Progressively remove all default members still in a default fund after 12 months by switching them out
If a fund manager is unable to contact a default member over a 12 month period and not get them into another more appropriate fund for their needs then that default member needs to leave that fund manager. Two practical options would be to go to another default fund manager who may make a better job of making contact or to a different option (see recommendation 4 below).

4. Establish a low cost white labelled Government balanced fund into which all longer-term default fund members are switched
If the Government is going to establish a KiwiSaver Fund it would make sense if that fund could add some attractive aspect to the KiwiSaver structure rather than just being another KiwiSaver fund differentiated only by a government guarantee. In our opinion exactly the wrong party to run a Government scheme is another Government department. We believe that there are at least two, probably more, KiwiSaver platforms available that could effectively set up and easily support a white labelled government scheme which could operate efficiently and at low cost, offering a range of diversified investments and a help desk service for members. The government could control the scheme via contractual arrangements. The member could stay as long as they like and could transfer out if they wish. Taking over the long-term default members would solve some of the current problems with default funds. It would also give the Government scheme enough critical member mass to mean that it could easily operate on a full cost recovery basis.

5. Stop new default member flows to any default fund provider who does not adequately meet specified contractual engagement and switch out rates for default members.
Self-evident and should have be done in 2014.

6. Instruct the white labelled Government balanced fund to reduce member investments in Australian owned bank securities
The Government has effectively operated as a marketing arm for the original default fund schemes. A steady stream of clients was supplied at no cost to those parties giving them

significant market advantages. To additionally have invested so much of these funds in themselves and the other related parties was a lost opportunity. That investment could be used more effectively for New Zealand. *See Recommendation 8*.

Some default suppliers, and specifically the ASB, have argued strongly for retaining the conservative default funds although it goes against investment theory and the best interests of those default members.

7. Require default fund providers to keep default KiwiSaver funds separate from other funds and to not use the word "default" in the description of any other fund they operate

Investigating and obtaining statistics and an understanding of default fund performance is not transparent. If you go to the ANZ website you discover there are "Default" KiwiSaver Growth Funds and "Default" KiwiSaver Balanced Funds. It is not surprising that many in the public are confused about how KiwiSaver operates. This is simply a marketing idea to give more credibility to funds that do not have that status by the bank. No KiwiSaver fund should be able to use the word default unless it is a Government approved default fund.

Default fund managers also need to keep their default funds completely distinct from their other funds from a public perspective and information flow. Incorporating members into those funds who have nothing to do with the default fund process means data collection and analysis on those funds is not transparent or in many cases possible. Just like having "active" members in any default fund should not be accepted. If the member wants to stay in an equivalent type to the default fund they should be required to switch to the equivalent fund from that fund supplier. This type of marketing strategy by default suppliers is cynical, muddles public understanding and reduces effective scrutiny. In the background the default fund may well be run as part of another fund, but all the data should be presented to the member and the public as if it is a separate fund.

8. Investigate KiwiSaver fund managers that have significant conflicts of interest in security selection or in the way they determine what fund types to recommend to members.

If four or five KiwiSaver suppliers can get together and invest 34% of their default fund holding into themselves and the other members of the same group, that creates issues of risk management and cartel-like operations. There are numerous, or could easily be numerous, other avenues for investing in New Zealand (e.g. local authorities, transport, infrastructure etc that would benefit by greater local funding).

9. Require default fund managers to refund management fees charged in relation to placing and keeping investments in their own issued securities

In our opinion, it is inappropriate to be running a fund and charging manager and administration fees for putting substantial amounts of money into your own company securities. That portion should be credited back to the member.

10. Require on-going disclosure of such conflicts to fund members

Transparency is fundamental. Vertically integrated suppliers often go to lengths to hide just how connected they are many of the underlying investments. It is a practise that must be stopped so investors can make better informed decisions.