Regulatory Impact Statement

KiwiSaver Governance and Reporting Issues

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by the Ministry of Economic Development

It provides an analysis of options to improve the governance arrangements for KiwiSaver schemes and to provide for the ongoing disclosure of fund performance information in a consistent manner.

The analysis here builds on the work done by others over recent years in identifying the nature of the problem and the types of solution required. This includes reports by the IMF, Morningstar and the Capital Market Development Taskforce (the Taskforce).

This RIS relies on that work and other changes under way in the finance sector regulatory environment to provide the framework within which the problem definition is articulated and the options developed. For example, this RIS assumes that, in deciding to progress the Securities Trustees and Statutory Supervisors Bill (currently before the Commerce Select Committee), the Government has effectively already determined the level of supervision of trustees that it deems to be required.

In analysing the options around the level of ongoing information provision, this RIS assumes that, given the lack of action by industry to date, and their repeated request for regulation in this area, that a co-regulatory model is not likely to be effective. The RIS also assumes that the consultation process that will be followed in developing the proposed regulations will deliver some of the benefits of a co-regulatory model.

The proposals in this RIS are consistent with those in the Taskforce report and have been consulted on in a limited manner. The lack of detailed consultation with all stakeholders (including the public) is primarily due to the request to develop the proposals rapidly. In addition, the response to earlier reports in this area suggests that the direction of travel is clear and agreed. Consultation on the detail of the information provision requirements will occur as part of the development of regulations.

While the proposals will impose some direct costs on industry, it is arguable that there will be an overall reduction in fees for scheme members because these changes are designed to introduce a more transparent and competitive market for KiwiSaver schemes.

Bryan Chapple,Manager, Investment Law, Ministry of Economic Development

[Signature of person] [Date]

STATUS QUO AND PROBLEM DEFINITION

Status Quo

The market and the place of KiwiSaver within it

The KiwiSaver Act 2006 came into force in October 2007. The purpose of the Act is to encourage a long-term savings habit and asset accumulation by individuals for the purpose of retirement. Prior to this, New Zealand had no Government-sponsored superannuation schemes for the general public. Superannuation schemes were either offered by employers as part of an employee's remuneration package or individuals joined and invested in a retail scheme. In all cases, there was no Government incentive to join a superannuation scheme. Along with unit trusts, superannuation funds are the largest and most popular type of managed investment in New Zealand.

In order to attract participants into KiwiSaver, the Government has underwritten a number of benefits which accrue to members upon joining. These are a $1000 kick-start signing bonus and an annual tax credit of up to $1040. In order to accrue these benefits, prospective members must invest through a registered KiwiSaver scheme. There are a number of features unique to KiwiSaver such as:

- All persons entering a new job (subject to some exclusions) are automatically enrolled in KiwiSaver unless they actively elect to opt out;
- A person must be enrolled in KiwiSaver for one year before they can apply for a contributions holiday. Their contributions are then locked in until they reach the age of entitlement for NZ superannuation, although exceptions can be made in cases of financial hardship, serious illness or withdrawal to buy a first home; and
- Employers can choose a preferred KiwiSaver scheme without needing to exercise any particular skill or duty of care.

The importance of KiwiSaver

In the three years since the start of KiwiSaver, the number of members of registered schemes has increased rapidly to reach a current level of 1.33 million (as at February 2010)[1]. Funds under management are currently $4.9 billion[2] and growing at a rate of $2 billion per annum. Immediately following the introduction of KiwiSaver, funds under management of registered superannuation schemes (excluding KiwiSaver) totalled $18.6 billion (as at 31 December 2008)[3]. Membership numbered 550,947 (split 283,284 in employer schemes, 267,417 in retail, 192 in private) and the number of schemes totalled 540 (as compared to 2,863 as at 31 December 1990).

The uptake by New Zealanders in KiwiSaver has far exceeded initial projections. Its reach is wide and extends to those who have not previously invested for their retirement or even invested per se.

[1] http://www.kiwisaver.govt.nz/statistics/ks-stats-10-02-28.html
[2] Figures supplied by Inland Revenue Policy Division as at 31 March 2010
[3] http://www.isu.govt.nz/upload/70503/superannuation-annual-report_2009.pdf

KiwiSaver is regarded as a secure form of investment with many members incorrectly assuming there is a government guarantee. A recent UMR poll indicated that as little as 15 percent of KiwiSaver members understood that there is no government guarantee if a scheme fails[4].

Many New Zealanders have not been well served by the financial sector in recent decades. Many investors exited from the stock market after the fall in prices in the 1980s. The more recent failure of finance companies has contributed to a further loss of confidence. It has been estimated that around $6 billion of investors' savings has been lost[5] due to the recent finance company failures. The resultant cost to the economy in terms of wealth destruction and associated human costs are substantial[6].

Failure in the KiwiSaver sector would likely lead to a further loss of investor confidence in New Zealand's capital markets, the impact of which would be substantial because so many New Zealanders are members. For many members, this will be the first and biggest investment they will make outside of purchasing their own home. It is therefore important to ensure that a robust regulatory regime is in place.

Existing governance arrangements for KiwiSaver

The principal legislation governing KiwiSaver is the KiwiSaver Act. The Superannuation Schemes Act 1989 also applies, with modifications, to KiwiSaver schemes. The Securities Act 1978 also imposes duties in terms of conduct and disclosure prior to investment.

Most KiwiSaver superannuation schemes are run in an identical manner to managed funds. A fund provider sets up a fund with a manager and appoints a trustee to act as a supervisor. The legal obligations of trustees and managers are, however, quite different:

a. A managed fund set up under the Unit Trusts Act 1960 must have a unit trustee and a manager. The manager is the issuer of the securities, and so is primarily liable for misleading statements under the Securities Act. The unit trustee is independent of the manager and acts as a supervisor on behalf of investors. Under the new trustee and statutory supervisor regime being considered by Parliament, the Securities Commission will licence unit trustees and have the power to revoke that licence, where trustee obligations have been breached; and

[4] http://www.radionz.co.nz/news/stories/2010/03/10/1247f7d99d48

[5] http://www.listener.co.nz/issue/3647/features/15195/you_are_in_safe_hands.html;jsessionid=628F4E5D4BA9A41BABEC172D1C315E1D

[6] http://www.parliament.nz/NR/rdonlyres/16F22058-8DD8-4541-B9A9-064848076239/100892/DBSCH_SCR_4272_6521.pdf

b. For superannuation schemes, including KiwiSaver, there need only be a superannuation trustee. The trustee is, in law, the issuer and so is the main person liable under the Securities Act for misleading statements. The trustee can, but need not, contract out management of the fund to an investment manager. The investment manager is only liable for misleading statements under the Securities Act if it is a "promoter", which carries much more limited liability for the manager and its directors.

Different types of superannuation schemes have different trustee requirements. There are six default KiwiSaver funds which scheme candidates are randomly allocated to if they do not actively select a fund themselves. They are appointed by a Deed of Appointment following a competitive tender process and the current term of appointment is until 30 June 2014. The default funds are subject to additional obligations under the Act, including a requirement to have one of the trustee corporations as the trustee.

Non-default KiwiSaver schemes are required to have an "independent" trustee. Amongst other things, independence requires that the trustee is not connected with a promoter of the scheme. It is the trustees who have, in law, the authority to decide how members' funds are invested. The Superannuation Schemes Act 1989 does not have this independent trustee requirement and, therefore, non-KiwiSaver superannuation schemes (including complying schemes) have no qualification requirements attached to the role of the trustee.

KiwiSaver was regulated differently from other superannuation funds and managed funds because KiwiSaver was intended to be a long-term savings vehicle, with funds locked in until (in most cases) the age of eligibility for NZ superannuation. There were stronger parallels to superannuation schemes than to typical managed funds where members can usually withdraw and deposit funds at their discretion. Therefore, it was decided that the superannuation schemes regulation was the most appropriate regime to align KiwiSaver with.

However, there are some differences between KiwiSaver schemes and superannuation schemes. In particular a greater level of scrutiny was sought for the six default providers for 3 reasons:

- Members in default schemes make no active choice but are automatically enrolled and so need a higher level of protection;
- Default funds must align to a Government directed investment portfolio (i.e. 75 – 85% in conservative assets), and so Government wanted to be able to monitor this; and
- A significant amount of Government (via tax-payers) money would be invested into these funds.

Therefore a requirement was imposed on the six default funds that they provide quarterly reports to the Government Actuary. A sample reporting template is attached as Appendix 1. These reports are reviewed by a panel of experts.

With respect to non-default KiwiSaver schemes, there are few differences to the regulatory regime imposed on superannuation schemes apart from:

- The requirement to have an independent trustee: This requirement was not imposed on superannuation schemes at the same time because of the then current Review of Financial Products and Providers (RFPP) process. It was decided that this should be left to be considered under the RFPP (rather than at the same time as KiwiSaver, which was fast-tracked) so that the appropriate consultation could be undertaken;

- Disclosure - there are a few differences in the annual reports provided to investors. In addition to an annual report though, KiwiSaver providers are required to provide investors with an annual personalised statement. In Superannuation Schemes, personalised information is only provided to investors on request. With respect to the annual report, there are no additional legislative requirements but some modifications to prescribed content (schedule 2 of the Superannuation Schemes Act 1989) to tailor it to KiwiSaver; and

- There is an additional requirement to provide an annual return – but this is more for statistical purposes to help inform policy rather than to give information to investors.

There are two distinct types of KiwiSaver schemes (and superannuation schemes generally):

a. Retail schemes available to any person. These are established and run by fund managers and include the default providers (e.g. AMP, ASB) and non-default providers such as Gareth Morgan Investments and Huljich Wealth Management. Retail schemes represent the majority of the market and are run like managed funds; and

b. Non-retail schemes such as those available only to employees of a specific company or companies, or members of particular unions, professions or religions (and their relatives). Non-retail schemes tend to have several individual trustees. The trustees, with the advice from an adviser, usually contract out investment management to one or more fund managers. Many employer superannuation schemes are exempt from the requirement to have a prospectus under the Securities Act.

The role of the regulators

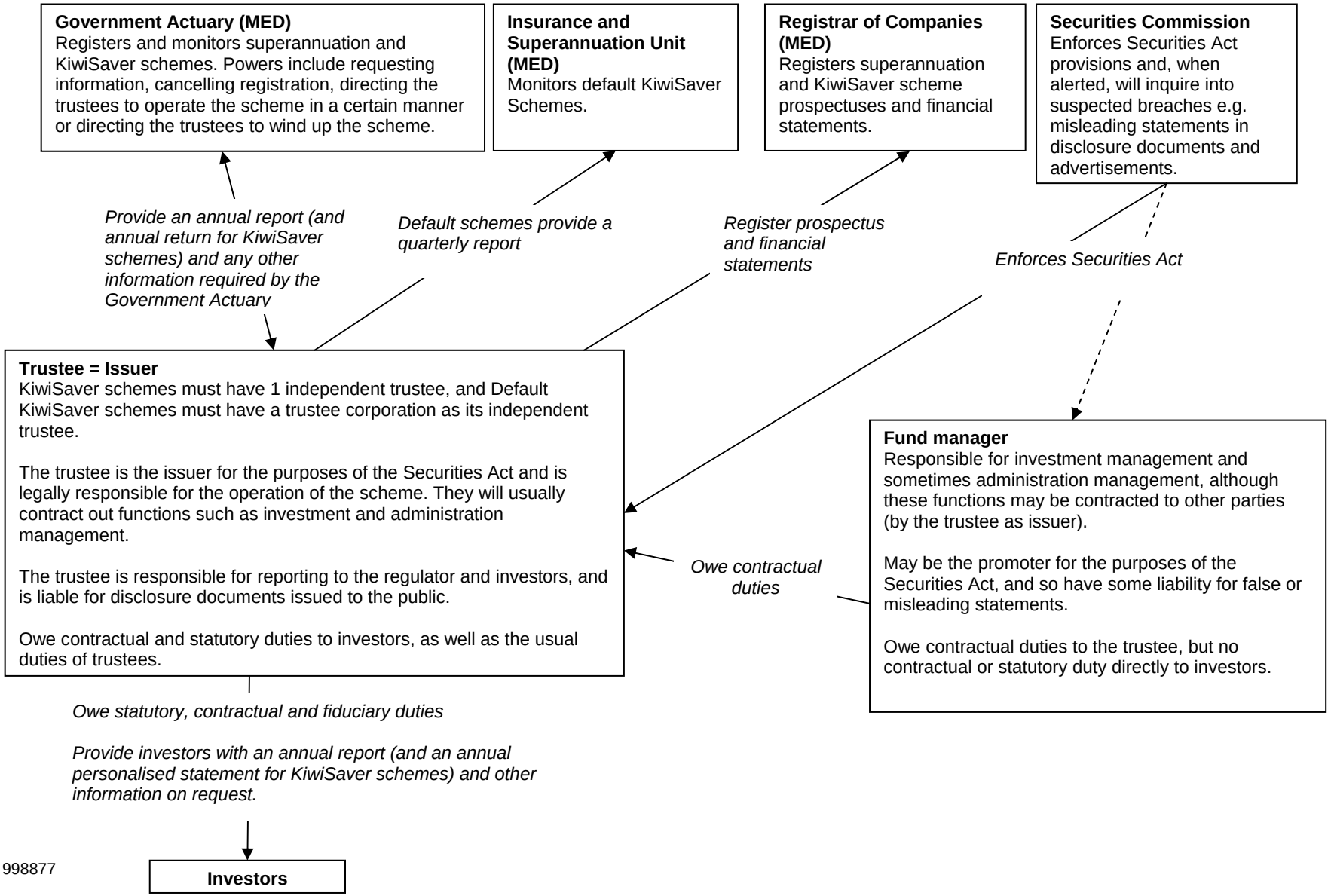
Registration, enforcement and oversight of KiwiSaver schemes are currently split across several agencies including:

- the Registrar of Companies (Registrar) with whom a scheme must register its prospectus;

- the Government Actuary (GA), who registers schemes and has a prudential role in overseeing the financial management of the schemes and has some enforcement powers with regard to this role [s169 (5)]; and

- the Securities Commission, which has a supervisory role focussed on market conduct. Its responsibilities include ensuring market integrity and enforcing the regulations pertaining to documents issued by providers that fall under the Securities Act.

The following is a diagrammatic representation of the current governance arrangements:



The GA only receives an investment statement for a new scheme at the point of registration. There is no on-going requirement for any updated investment statements to be registered with any of the regulatory authorities. The Securities Commission is responsible for enforcement of breaches of the Securities Act, such as false or misleading disclosure in scheme prospectuses and offer documents. The Securities Commission currently takes a risk-based approach and relies on the Registrar vetting KiwiSaver prospectuses at the point of registration. Beyond that, it will investigate where concerns have been raised with it.

Under the KiwiSaver Act, KiwiSaver scheme trustees must complete an annual report and fully audited accounts within five months of the end of the financial year. This must be supplied to the GA and scheme members within 28 days of completion. A copy of the audited accounts must also be lodged with the Registrar of Companies as per the Financial Reporting Act 1993 [s18]. The annual report must comply with the information requirements specified in Schedule 2 of the Superannuation Schemes Act 1989 plus additional requirements as per s123 of the KiwiSaver Act.

For information provided to investors, the current regime relies heavily on initial disclosure of information (i.e. prior to investment), but requires little meaningful information to be provided that allows for the assessment of ongoing performance. The mandatory ongoing reporting requirements for KiwiSaver funds to provide to their members are as follows:

1. An annual personalised statement of contributions and accumulations for members can be provided at any date, but providers have tended to peg this to their balance date; and
2. A copy of the annual report of the trustees in respect of that year must be provided within 6 months of the close of the financial year of the scheme.

Members also have the right to request additional information such as copies of reports relating to any actuarial examination undertaken or an estimate of their current benefits. Members must exercise this right before information is provided but most will likely be unaware of its existence.

Although not mandated, it is common practice for managed fund providers to publish reports on their funds' performance. However, there is no agreed standard among scheme providers as to how performance is calculated and reported, in particular whether the returns are calculated net of all fees and tax.

Other work stream considerations

This Regulatory Impact Statement is a companion to a statement prepared regarding the possible consolidation of market conduct regulators, which is being considered as part of the same Cabinet paper.

Currently underway is a review of the Securities Act that is scheduled for completion and implementation by the end of 2011. Discussion documents are presently being finalised and combine the substantial body of work and consultation undertaken in the previous four years via the RFPP (2006) and the Taskforce (2009). The proposals here reflect the broad consensus that emerged from that.

In addition, the Securities Trustees and Statutory Supervisors Bill is before Parliament. The objective of this Bill is to protect the interests of investors, and enhance investor confidence in financial markets, by:

- requiring persons who wish to be appointed as trustees, statutory supervisors, and unit trustees to be capable of effectively performing the functions of trustees, statutory supervisors, or unit trustees;
- requiring trustees, statutory supervisors, and unit trustees to perform their functions effectively; and
- enabling trustees, statutory supervisors, and unit trustees to be held accountable for any failure to perform their functions effectively.

The Bill is designed to regulate trustees and statutory supervisors more effectively by requiring that they be licensed. Licensing will be overseen by a regulatory authority, currently proposed to be the Securities Commission. The decision was initially made to not require KiwiSaver and superannuation schemes to have a licensed trustee for the present. This is because the existing legal structure of superannuation funds (including KiwiSaver) deems the trustee to be the issuer. This structure is counter to the separation between trustee and issuer that the Securities Trustees and Statutory Supervisors Bill proposes.

It was decided that the most pragmatic course of action would be to revisit KiwiSaver and superannuation schemes and trustee requirements during the scheduled review of all collective investment schemes (within the Securities Act review).

The Securities Trustees and Statutory Supervisors Bill is before the Commerce Select Committee and regulations are being drafted for consultation. It is expected that the relevant authority (at present the Securities Commission) will exercise discretion in determining an applicant's suitability but will consider suitability under the following broad criteria:

- corporate form;
- good character;
- registration under the Financial Service Providers (Registration and Dispute Resolution) Act 2008;
- experience, skills and qualifications;
- monitoring systems;
- financial resources;
- other resources;
- independence;
- governance structure; and
- professional indemnity insurance.

Inland Revenue are also in the process of introducing new trade-mark licensing documentation which is consistent with this proposal.

Problem Definition

The problem with KiwiSaver funds is two-pronged. There is an issue with the form of the investment vehicle KiwiSaver funds are legislated to be (a superannuation scheme) and the governance associated with that particular legal structure. There is also an issue with the type and level of detail of information required to be provided by the funds to both investors and the relevant regulatory authorities.

The lack of meaningful, ongoing information regarding the performance of funds results in an inability to accurately assess the extent of the problems in the market currently. While concerns regarding one provider have recently been raised in the media, problems may be more widespread but may not come to light for some time. Given the importance of KiwiSaver in the market, problems with even a few schemes are unacceptable. Effectively, the regulator is unable to monitor scheme performance (outside of the six default funds). The GA considers that he is unable to use powers to obtain information unless he is investigating a specific issue that has come to his attention. The current reporting requirements for funds mean that it is difficult to obtain or substantiate the necessary evidence in the first place.

Problem definition re governance

The current regime relies almost exclusively on ongoing supervision by trustees, and on the trustee being primarily liable for anything that goes wrong with the scheme. However, under existing proposals, KiwiSaver trustees and those of other superannuation schemes will not be subject to the enhanced supervision of the Securities Trustees and Statutory Supervisors Bill, currently before the Commerce Select Committee. As a result, the relevant regulatory authorities do not have the ability to replace the trustee for poor performance and there are no competency requirements on the trustee. Excluding KiwiSaver schemes from this new regime will exclude a major and rapidly growing part of the managed funds market.

In addition, the KiwiSaver trustees are technically the issuer for KiwiSaver schemes (as is the case with superannuation schemes). Fund managers have few direct duties to investors and significantly less liability for misleading statements than the trustee. This contrasts with unit trusts which are structured in a very similar manner, but where, in law, the manager is the issuer and both managers and trustees are accountable for their actions to investors. There is no good reason for managers to be subject to a lesser standard of accountability, given that for retail schemes, they are effectively the driving force behind those products.

The deficiencies in our governance regime have been noted by the Taskforce and by the International Monetary Fund in its Financial Sector Assessment Programme.

Problem definition re provision of information

Information asymmetries exist in all markets and are particularly acute in financial markets. This is because the benefit of disclosure is not always captured by the issuer, who therefore may have little incentive to disclose. In investing in a financial product, investors often have very limited means of assessing the capacity of the issuer to meet the promise implicit within that product.

Investors also often rely on, or expect, the issuer's capacity to be maintained over the duration of the investment (which with superannuation schemes could be a significant period of time). During this time an issuer's capacity to deliver could radically change. This is especially relevant to a scheme such as KiwiSaver because of its extended reach and the large number of members who are likely to be financially unsophisticated.

More broadly, competition within markets is facilitated by a consumer's ability to easily assess and compare products based on reliable information. The Taskforce found that, in order to ensure a competitive market exists for KiwiSaver scheme providers, members need to be able to make their scheme selection based on readily accessible and easily comparable information. Information is also required for market commentators to be able to play a role in filtering and processing information to aid consumer decisions.

There are currently few meaningful, ongoing reporting requirements on KiwiSaver schemes or other managed funds. There is no requirement for schemes to provide information to investors or to market commentators in a manner which allows for easy comparison between funds on key dimensions such as returns, fees and asset allocation. Related party transactions are also not required to be disclosed to existing investors. New Zealand is one of the few OECD countries to not prescribe ongoing disclosure in these areas. While funds regularly publish information on returns, fees and asset allocation, there are no requirements as to how they do so – meaning methodologies can vary sufficiently to alter relative performance across different funds.

Morningstar routinely publish league tables ranking fund performance and fees.[7] However, they have acknowledged that they have little means of verifying the information supplied by the funds and that their assessments are not robust. Recently, Morningstar ranked the transparency of managed fund disclosure in New Zealand as the lowest among the 16 countries examined[8]. Morningstar observed that New Zealand and Australia were the only countries that do not require disclosure of portfolio-holdings and that there is no uniform presentation of fees and expenses.

This Government has publicly stated its support for the recommendations arising from the Taskforce in relation to managed funds and has directed officials to investigate how best to implement these.

[7] http://www.morningstar.net.nz/files/kiwisaver_survey100223.pdf

[8] Rekenthaler, Swartzentruber, Sin-Yi Tsai, "Global Fund Investor Experience," (May 2009), Morningstar Fund Research.

Maintaining the status quo with regard to KiwiSaver will lead to a compromising of market integrity likely leading to a loss of investor confidence and ultimately reduced investor participation. This will be driven by:

- An inability on the part of the regulator and investors to hold those responsible (i.e. the directors and investment managers) to account;
- An opportunity for regulatory arbitrage and related party lending by unscrupulous fund managers; and
- A signal sent to unscrupulous fund managers that it is a lightly regulated area.

Furthermore the market will remain uncompetitive if investors are unable to make informed comparisons and choices as to which KiwiSaver fund to invest in. The current lack of transparency and comparability around fees, returns and other charges discourages the development of a robust market in published information on fund performance and other key indicators. It also discourages New Zealanders from taking an active role in managing their financial future and advancing their levels of financial literacy.

The benefits of maintaining the status quo with regard to KiwiSaver are:

- No additional compliance costs on KiwiSaver scheme providers incurred through regulatory change and increased reporting requirements;
- Possible reduction of 'moral hazard' whereby investors abdicate their own due diligence to the Government (although at present they are unable to undertake robust due diligence themselves due to the lack of information made available to them); and
- Avoiding possible risks of compromising a fully cohesive Securities Act review by separating out and fast tracking parts of the process.

Objectives

The primary objectives against which the options are assessed below are:

- Clear governance arrangements for KiwiSaver schemes;
- Consistency with other parts of the managed funds regime to avoid confusion amongst investors regarding standards they can expect;
- Consistency with international best practice;
- Provision of sufficient ongoing information to allow investors to make informed decisions regarding their KiwiSaver investments; and
- Sufficient ongoing information to allow regulators to be alerted in a timely manner to any potential breaches of the law regarding KiwiSaver funds.

The necessary inputs required to deliver these objectives are:

- Accountability and responsibility for ensuring good stewardship of a KiwiSaver scheme resides with the scheme promoter;

- Governance and supervision of retail KiwiSaver schemes is with a trustee who exercises a high duty of care;
- KiwiSaver scheme members are able to access accurate and comparable information about the performance of the funds they have invested in, which includes:
    - All fees and charges (for example, in the form of a Total Expense Ratio);
    - Asset holdings (including, for example, disclosure of top ten portfolio holdings);
    - Conflicts of interest (for example, investments in related parties); and
    - Fund returns (ideally both gross and net of fees and taxes).
- Publishing of quarterly reports by fund managers which provide information to a minimum standard required to engender an open, transparent and competitive market in managed funds.

REGULATORY IMPACT ANALYSIS

This section of the RIS is divided into two parts.

In developing the options consideration has been given to identifying where the current system has failed, why it has failed and what the most effective and cost-efficient options are for redressing these failures.

Part 1 considers the options available to address concerns relating to the current governance arrangements for KiwiSaver schemes. We have looked at how KiwiSaver funds are currently structured and identified that there is no duty of care owed to investors by the fund manager who in a retail scheme will, invariably, be the promoter. The duty of care currently resides with the trustee who is contracted by the promoter and must operate within the boundaries of the trust deed set by the promoter. We have sought to consider the options available to redress this issue.

Furthermore, the regulators do not have access to adequate information to enable them to monitor fund managers. Part 2 considers the options available to address the concerns relating to current information provision requirements, in particular from the point of view of investors. The current opacity in the market around fund performance, fees and investment strategies has constrained competition and innovation. The primary objective for fund managers (and especially so in New Zealand) is to grow funds under management (FUM). Fees are charged as a percentage of FUM, so the greater the FUM the greater the revenue.

When there is no means available to the market of objectively assessing and verifying fund manager performance (as well as fees and investment strategies) then there is little incentive on fund managers to invest in delivering superior returns. There is every incentive to direct effort to attracting funds using other methods such as advertising and commissions. A very small improvement in average performance of KiwiSaver funds (e.g. 10 basis points) would mean total returns to investors of almost $50 million more per annum, and the dollar gains from improved performance will increase as funds in KiwiSaver grow. The most efficient and effective way to drive improved fund performance is to create an open and competitive market, which requires more comparable information on fund performance.

Part 1: Optimal governance arrangements for KiwiSaver funds

Option 1: Make no changes until the full review of securities law scheduled for passage through Parliament in late-2011.

This option would allow changes to all managed funds to be considered in a consistent manner at the same time.

Costs

The main disadvantage is that this delays changes which are already needed for an important and growing part of our managed fund regime.

Benefits

The advantage of this option is that problems identified which go beyond the retail KiwiSaver schemes can also be dealt with in those other schemes and it allows for broader consultation.

Nevertheless, for retail KiwiSaver schemes, there is broad agreement as to the sorts of changes that need to be made and the details regarding information provision will be consulted on in the process of developing regulations.

Risks

Given the significance of KiwiSaver in the market, it is important to ensure investor confidence is maintained. A key risk of waiting until the full review of securities law is that this might send a signal to both providers and investors that ensuring robust regulation of KiwiSaver is not a priority. This might exacerbate the damage to investor confidence caused by recent events highlighted in the media.

Option 2: Give the industry time to improve, with the threat of regulation if it does not.

Recent events have highlighted failings in the current regime and, from our initial discussions with key stakeholders, it is likely only a matter of time before another such event occurs. This option is a “do nothing” scenario and would, in effect, maintain the status quo although using the threat of regulation as leverage in convincing industry members to resolve identified issues themselves.

This option raises the following issues:

- Through the process of managing the situation with regards to the Huljich KiwiSaver scheme, it has become evident that there are a number of inherent flaws in the current scheme design. Primarily this is around the limited oversight of trustees and therefore limited ability to ensure they carry out their roles properly. In addition, as the trustee is deemed to be the issuer, fund managers can abdicate responsibility for how the scheme operates and the statements made by the scheme;

- There are also multiple agencies responsible for monitoring and enforcement of the regime. This appears to have allowed those fund managers employing dubious practices to escape attention for longer than they should. Furthermore, once such funds are identified, it is unclear as to how to censure and prohibit such behaviour or whether appropriate legal powers exists; and

- There is no one industry body representing all KiwiSaver scheme providers. Some are members of the Investment Savings and Insurance Association (ISI), some are members of Workplace Savings NZ and some are a member of neither. Therefore scheme providers remain a disparate group and unlikely to collectively come together to better self-regulate.

Costs

There would be no additional costs imposed on the scheme providers by Government although self-regulation would likely incur costs.

There would likely be a cost to some scheme members as those funds that would be captured and censured by improved regulation are unlikely to improve in the absence of any such regulation. As noted above, a minor improvement in average fund performance has substantial benefits for investors.

Benefits

There would be no disruption to the current regime.

Risks

Making no changes would effectively condone current arrangements and dissuade current providers from raising their standards. It is difficult to see what incentive there would be for a scheme provider to expend time and resources on improving their own governance when there will be no discernable benefit likely to accrue from that as long as the rest of the market remains self-policing. There would likely be a race to the bottom by providers rather than a race to the top.

Investors will not be well served and the integrity of KiwiSaver will remain compromised. The Government has signalled that it has seen a cause for concern that it wishes to address. Failure to effect any change will be seen as an inadequate response, the impact of which would be to send a clear signal to the market, industry stakeholders and investors that there is little appetite on the part of government and its agencies to properly regulate this area and address issues such as:

- conflict of interests on the part of trustee corporations and the provision of back-office services;
- trust deeds that serve the interests of the provider/promoter, not the investor; and
- the abdication of fiduciary duties to investors on the part of the promoter/provider to the trustee.

An important consideration is the expressed desire by the Government to establish a managed funds domicile in New Zealand. Initial scoping work to ascertain what is required to attract international investors has expressly commented on the need for a 'hygienic' and robust regulatory framework and that New Zealand currently falls far short of the standard. Ultimately, failure to deliver this would result in significant cost to the New Zealand economy as both domestic and international investors lose further confidence in New Zealand's capital markets and the ability and/or willingness of the government and relevant regulatory agencies to police them. Given the predominance of KiwiSaver in our managed fund market, it is important that it is seen as well-regulated.

*Option 3: Amend the structure of **all** KiwiSaver and superannuation funds to that of unit trusts and extend the Securities Trustees and Statutory Supervisors regime to **all** KiwiSaver schemes and superannuation schemes.*

Or

Option 4: Amend the current structure of retail KiwiSaver schemes to align with that of unit trusts and include all retail KiwiSaver schemes within the scope of the Securities Trustees and Statutory Supervisors Bill.

There are two distinct groups of KiwiSaver schemes: Retail schemes available to any person and non-retail schemes such as those available only to employees of a specific company or companies, or members of particular unions, professions or callings (and their relatives). Under the present regime, the trustee is technically the issuer for all KiwiSaver schemes (as is the case with superannuation schemes) and fund managers have few direct duties to investors and significantly lower liability for misleading statements than the trustee. This contrasts with unit trusts which are, in practice, structured in a very similar manner, but where, in law, the manager is the issuer and both managers and trustees are accountable for their actions to investors.

Extensive consultation with industry stakeholders over the past four years (through the RFPP, 2006, and the Taskforce, 2009) have highlighted concerns with the current structure of KiwiSaver and superannuation funds, in particular the lack of accountability investment managers and promoters have to the fund investors.

These options consider either extending the scope of the proposed Securities Trustees and Statutory Supervisors Bill to include all KiwiSaver and superannuation schemes or only those KiwiSaver schemes designated as retail. Under the Bill's current proposals, any scheme that falls within its remit requires a licensed trustee.

KiwiSaver and superannuation schemes are currently excluded from the proposed Trustees and Statutory Supervisors Bill. The reason for this is because the existing legal structure of superannuation funds (including KiwiSaver) deems the trustee as the issuer. This structure is counter to the separation between trustee and issuer that the Securities Trustees and Statutory Supervisors Bill proposes.

Because of the scheduled review of all collective investment schemes (within the Securities Act review) it was decided that the most pragmatic course of action would be to revisit KiwiSaver and superannuation schemes and trustee requirements then. However, that was prior to recent events occurring that have served to expose significant flaws in the current regime.

The manner in which non-retail schemes currently implement the trustee requirements tends to be through the appointment of a cross-section of representatives associated with the scheme (union representatives, company directors etc). Extending the scope of the proposed Trustees Bill to include such schemes will add significant complexity and cost to such schemes. Such schemes tend to be small and are a 'bolt-on' to an existing superannuation fund, many of which form an intrinsic part of an employee's total remuneration package. They are formed with the intent of providing a benefit to their employees. This intent is significantly different to that of a professional fund manager offering a KiwiSaver fund as part of a suite of fund products that they are in the business of selling for profit. That is not to say that the governance arrangements are ideal, but that the costs of fast-tracking changes to these governance structures could outweigh the benefits. These schemes comprise less than 2% of the total KiwiSaver market.

The most pragmatic approach is to target the most readily identifiable gaps existing in the market, and where the improvement in the regulatory regime will lead to the greatest gain. This is the retail KiwiSaver funds.

Bringing retail KiwiSaver schemes within the model set out in the proposed Securities Trustees and Statutory Supervisors Bill will improve the ability of the regulator to supervise the trustees of retail KiwiSaver schemes and hold them accountable for fulfilling their obligations. The incentives also increase for a trustee to exercise a greater duty of care given that their ability to be a trustee will now be contestable through the proposed licensing regime.

As part of this change, the provider of a retail KiwiSaver scheme will become the issuer for the purposes of the Securities Act and the *de facto* fund manager/trustee supervisor split should be formally reflected in law. This will require a number of consequential adjustments to the KiwiSaver regime, including the requirement to have a manager with direct obligations to investors, based on the model in the Unit Trusts Act.

Deeming the provider (promoter/fund manager) of retail KiwiSaver schemes as the "issuer" for the purposes of the Securities Act will better align the interests of investors with that of the provider. Under this proposed governance structure, both the provider and the trustee have obligations to investors. Currently only the trustee can be held liable. A provider/promoter would no longer be able to abdicate their investor duties to the trustee.

There are good policy reasons for regulating these types of KiwiSaver schemes in the same manner as other types of managed funds in terms of trustee obligations. These include providing consistent levels of assurance between like products and limiting opportunities for regulatory arbitrage. Further, in most cases the current trustees (or an associated organisation) will be licensed to carry out funds management trustee work in any case, so will not have to change. Therefore the costs associated with widening the scope of the Trustees regime to include retail KiwiSaver schemes will be limited.

Costs

The likely costs to KiwiSaver scheme providers of this proposed option will be:

- Legal fees, particularly those associated with changing trust deeds and legal structures (estimated to be up to $50k per scheme and amortised over life of the scheme);
- Reporting systems (cost unknown but should be in place anyway as a matter of best practice); and
- Appointment of a licensed trustee this includes:
    - A one-off cost of approximately $6000-$7,000. Trustees will have to pay this fee to become licensed, regardless of whether they act as trustee for a KiwiSaver scheme, so this is not necessarily an additional cost imposed;
    - An annual levy which is yet to be determined. This is an additional cost as the annual levy of licensed trustees will depend on the number of different types of securities they supervise; and
    - There will also likely be indirect costs associated with up-skilling trustees in order for them to meet the criteria to be licensed. However, the exact standards imposed will be at the discretion of the regulator and so it is difficult to quantify these costs.

For most retail KiwiSaver schemes, these costs would largely fall within the 'cost of doing business' and will likely be passed onto members. Given the large number of members, any additional fee is likely to be small at a per-member level, and more than offset by the improved outcomes due to a more transparent and competitive KiwiSaver market. For non-retail schemes and other superannuation schemes, these costs could have a greater impact and may force some smaller schemes out of the market. Including such schemes at this stage would not necessarily deliver sufficient benefit to outweigh the likely costs.

Benefits

Including all KiwiSaver and superannuation schemes within the scope of the new Trustees Bill, as well as amending the Securities Act to provide that the manager is the issuer, ensures better governance of all retirement saving schemes. It would also preclude opportunities for regulatory arbitrage.

Currently there is a lack of proportionate penalties against KiwiSaver trustees who fail to carry out their role to the required standard. Bringing trustees or retail KiwiSaver schemes within the new Trustees Bill will ensure that trustees can be more effectively held to account, by providing the regulator with the power to seek pecuniary penalties and compensation orders against trustees who fail to carry out their obligations to the required standard.

Risks

The risks of these options are that retail KiwiSaver schemes will be treated differently from non-retail KiwiSaver and non-KiwiSaver schemes and investors in the latter schemes will not receive the same duty of care. However, it is our view that addressing the category of scheme with the largest reach and impact is a prudent approach given the rationale previously stated.

KiwiSaver has several unique characteristics (automatic enrolment, employer scheme selection, Government contribution, locked-in contributions) which, by their nature, imply that greater care and oversight should be accorded it.

Part 2: Optimal level of reporting requirements for KiwiSaver funds

Option 1: Make no changes until the full review of securities law scheduled for passage through Parliament in late-2011.

This option would allow changes to all managed funds to be considered in a consistent manner at the same time.

In our assessment, while the full review of securities law may recommend replicating the proposals here across other parts of the managed fund regime, there is little likelihood of that altering the details of the information proposed here. What is being proposed is along the lines of what some parts of industry are currently seeking to develop.

Costs

The main disadvantage is that this delays changes which are already needed for an important and growing part of our managed fund regime.

Benefits

The advantage of this option is that problems identified which go beyond the retail KiwiSaver schemes can also be dealt with in those other schemes and it allows for broader consultation.

Nevertheless, for retail KiwiSaver schemes, there is broad agreement as to the sorts of changes that need to be made and the details regarding information provision will be consulted on in the process of developing regulations.

Risks

Given the significance of KiwiSaver in the market, it is important to ensure investor confidence is maintained. A key risk of waiting until the full review of securities law is that this might send a signal to both providers and investors that ensuring robust regulation of KiwiSaver is not a priority. This might exacerbate the damage to investor confidence caused by recent events highlighted in the media.

Option 2: Give the industry time to improve, with the threat of regulation if it does not.

This option would, in effect, require no action on the part of Government apart from inviting industry members to resolve identified issues themselves. The threat of regulation being imposed on them would, arguably, provide sufficient leverage to convince them to improve. A recent guidance note issued by the Securities Commission also emphasised the need for more consistent reporting by funds.

The current level of reporting required by law falls far short of that demanded of managed funds by other jurisdictions within the OECD. This is despite many scheme providers in NZ being subsidiaries of global entities. Therefore, they are required to provide such reports to investors in other countries yet consider it unnecessary to provide the same level of reporting to investors here.

Within the OECD, only New Zealand and Australia do not have a legal requirement for funds to report their portfolio holdings and New Zealand is the only jurisdiction to not require funds to disclose their Total Expense Ratio. While some current KiwiSaver schemes provide comprehensive reports to scheme members, the majority do not. In the present situation, investors cannot make a fully informed choice of scheme provider based on the performance tables compiled by market commentators. These market commentators readily acknowledge their ability to accurately assess a fund's performance is limited and that the information they compile and publish is not consistent across the various schemes they report on.

As noted previously, there is no one industry body representing all KiwiSaver scheme providers. Some are members of ISI, some are members of Workplace Savings NZ and some are not a member of either. Therefore scheme providers remain a disparate group and unlikely to collectively come together to better self-regulate.

Over the past 12 to 18 months, the ISI have been working with their members to develop an agreed standard for the calculation and disclosure of fees and expenses in managed funds. However, they have expressly stated their desire that the introduction of these standards be backed up by regulation. They consider the adoption of such standards important for improving the reputation of New Zealand's capital markets internationally. Because not all KiwiSaver scheme providers and fund managers are members of their group, the standards are unlikely to be adopted across the industry unless regulation requires them to. The probable lack of consistency across fund providers is likely to reduce the value attached to the standards.

The paucity of information that funds are required to provide to the public and regulators means that regulators and investors have very limited visibility over the actions, undertakings and performance of the schemes. The regulators consider that the current reporting requirements for all KiwiSaver funds (excluding the six appointed default funds) are insufficient to enable them to give proper effect to their role. The information they do receive is historic (up to 18 months), often well after the fact and providing little recourse in the event of wrongdoing. More timely, consistent and detailed reporting requirements would allow regulators to identify issues as they arise, not up to 18 months after they have occurred, as is currently the case.

Costs

There would be no additional costs imposed on the scheme providers by Government, although self-regulation would likely incur costs.

There would likely be a cost to some scheme members as those funds that would be captured and censured by improved oversight are unlikely to undertake to provide true and accurate performance statistics in the absence of regulation.

There would likely be a cost to consumers as they continue to be impeded in their ability to make informed judgements around KiwiSaver fund providers, performance and fees. As noted above, a minor improvement in average fund performance has substantial benefits for investors, and any such gains would be foregone in this option.

There is also likely to be a cost in continued impediment to the regulators' having access to relevant and material information in a timely manner.

Benefits

There would be no disruption to the current regime.

Risks

The managed fund industry has to date not made these improvements. In response to some of the criticism of industry standards, they have argued that poor regulation is the cause of these poor standards. Many within the industry recognise the need to improve and have made endeavours to do so. However, they have specifically requested that such moves be supported by regulation so as to ensure compliance across the whole industry.

Option 3

A variant of this option would be to develop a form of co-regulatory model with industry. For example, industry could be tasked with developing an information disclosure regime which government could then support or agree to adopt.

Costs

Costs to industry are likely to be lower under this option than in options 4 and 5 below as industry will be able to develop a regime that is appropriate for it.

However, there will continue to be costs to scheme members if the industry-designed regime is less robust than a government-designed regime.

Benefits

The advantage of this option is that it provides the opportunity for industry to take the lead in developing appropriate standards which it would then follow.

Risks

The difficulty with this option is that is has been clear over recent years that industry does not agree on the need for, or extent of, a consistent information disclosure regime. It is therefore unlikely that they would reach a consensus view within a reasonable period of time. In addition, there is a risk that any regime will be designed to be in the interests of industry, rather than putting investors' interests in first place.

Option 4: Require all retail KiwiSaver funds to publish information quarterly with the minimum requirements specified in regulations.

This option proposes that minimum standards be set, by way of regulation, requiring all retail KiwiSaver funds to publish quarterly information. It is envisaged that this will take a similar form to that currently provided by the six default funds (see Appendix 1).

The requirement to publish the information could be satisfied by placing the information on a website. Where the value of this option lies is in it being a means of delivering key and necessary information to all relevant parties. Prospective investors, should they chose to, will be able to review key metrics compared to other funds to make choices based on those metrics. Current investors will be able to more effectively monitor their fund and make judgements about whether performance, fees etc. are acceptable. Market commentators are able to compile these metrics into league tables and deliver more robust and accurate fund assessments. Regulators will have access to the key metrics they need to be able to practice adequate oversight and monitoring of KiwiSaver schemes. They will also have access to sufficient information to make better informed judgements as to when intervention is required on their behalf.

Requiring information to be published will make it available to members, public, regulators and market commentators.

Costs

As noted previously, any requirement stipulating the provision of more detailed and more regular information will likely incur additional costs for scheme providers. These costs will be largely system-related and dependent on whether scheme providers have the capability to easily produce the level of reporting required. In initial consultations with industry stakeholders, the consensus is that such capability should be a minimum requirement of any fund manager and a matter of sound business practice.

This option will require an amendment to an existing regulation-making power in the Securities Act which will be used to provide for KiwiSaver scheme providers to periodically publish, provide to investors and provide to the regulator, specified information on fees, returns, asset allocation and conflicts of interest in a prescribed manner.

Benefits

There are benefits to enabling investors to be fully informed and knowledgeable about what their fund invests in and why. When a robust and credible market develops for the reporting and ranking of fund performance, investors will have a greater incentive and ability to become financially literate and to actively educate themselves in the details of fund management, the relevance of investment strategies and the role of investment management teams in delivering superior performance. Overall, increased information is likely to lead to more effective competition and better aggregate fund performance. An increase of just 10 basis points across all KiwiSaver funds (currently $4.9 billion) would deliver an additional $49 million into members' retirement savings accounts.

The quarterly publishing of information will also provide the relevant regulatory authorities with the means to observe and review the undertakings and actions of scheme providers in a manner that is both timely and effective. Such a requirement is currently in place for the six appointed default funds and is considered sufficient by the GA to enable him to maintain adequate oversight of those six default funds.

Risks

Smaller schemes may decide the costs are too onerous and exit the market. There has been an expectation in the market for some time that it is overdue for consolidation and attrition.

Option 5: Extend the KiwiSaver default fund requirements to all KiwiSaver schemes.

This option would extend the full default fund requirements to all KiwiSaver schemes. This option has been endorsed by some industry stakeholders in early consultations. In discussions with the GA, he has expressed the view that the key difference in his ability to monitor and enforce with regard to the six default funds versus the remainder is largely attributable to the quarterly reporting he receives from the trustees of the six default funds. These reports are then reviewed by an independent panel and it is the frequency and key metrics provided by these reports that enable the panel to make informed judgements about fund operations and standards.

The same information provided to the regulator will also be useful to investors. It therefore follows that the most expedient and cost-effective way to garner the same outcome (i.e., quarterly reporting of key metrics) is to improve the flow and disclosure of information to the public, regulators and market commentators. This can be achieved by requiring the quarterly publishing of key metrics.

Some of the issues identified with extending all the default fund requirements to all KiwiSaver funds are:

- The process for selecting and appointing the six default funds involved intensive due diligence of the scheme providers and that they meet certain requirements regarding capital adequacy ratios, robust systems, appointment of trustee corporations; and
- The six default funds are appointed by way of a deed of appointment which sits outside of the KiwiSaver Act. Therefore, the additional requirements imposed on the funds are outside of existing legislation. The deed of appointment for each is currently scheduled for re-tender in 2014.

Costs

There are substantial costs of undergoing and meeting a full due diligence process as required through the Deed of Appointment pertaining to the default funds.

Benefits

All schemes would be required to undergo a full due diligence process and would need to ensure their processes and operations were of an exemplar standard. This would serve to systematically raise the level of service and standards across the sector.

Risks

It is likely that the imposition of due diligence costs etc would lead to a number of scheme providers exiting the market, in particular the smaller, boutique fund managers. This would likely lead to a reduction in competition and innovation in the sector.

There has been an expectation in the market for some time that it is overdue for consolidation and attrition.

No alternative options were suggested by stakeholders in consultation.

CONSULTATION

The following departments and agencies have been consulted on the contents and proposals contained in the Cabinet paper and RIS: Treasury, Inland Revenue, State Services Commission, Department of Prime Minister and Cabinet and the Government Actuary.

In addition, informal discussions have been held with industry stakeholders such as and including: corporate trustees, fund managers, market commentators, industry representative bodies, the Securities Commission, the Registrar of Companies.

CONCLUSIONS AND RECOMMENDATIONS

The preferred option for ensuring optimal governance arrangements for KiwiSaver funds is Option 4: Amend the current structure of retail KiwiSaver schemes to align with that of unit trusts and include all retail KiwiSaver schemes within the scope of the Securities Trustees and Statutory Supervisors Bill.

The preferred option for setting the optimal level of reporting requirements for KiwiSaver funds is Option 5: Require all retail KiwiSaver funds to publish information quarterly with the minimum requirements specified in statute.

Taken together, we consider that these options best achieve the objectives set out above. Governance arrangements will become clearer and more consistent with that for unit trusts, and allow for the effective supervision of trustees. The ability to prescribe information disclosure in regulations will allow for information to be available to the market, investors and regulators, allowing for both the effective operation of the market, and for regulators to take action against wrong-doing. The changes will also move the regulatory regime towards international best practice.

We consider that there is no evidence that industry will be effective in making these changes without regulatory intervention. We also consider that maintaining the status quo maintains a regime that does not allow a fully competitive market to develop, and where there is a greater risk that any wrong-doing by fund managers and trustees is less likely to be detected.

IMPLEMENTATION

If Cabinet agrees to the preferred options then a process of consultation will be undertaken with industry representatives to determine what key reporting requirements will be scheduled for legislation. A substantial body of work has already been completed in this area through the RFPP 2006 and Taskforce 2009 which will serve to minimise the risks of a truncated process.

It is intended that the risks associated with fast-tracking KiwiSaver changes ahead of the full review of securities law will be mitigated through this consultation process. In addition, formation of the specific requirements to be outlined in the regulations will be informed by the broader work on managed funds.

Legislation will be required to implement the recommendations in this paper. [Withheld under sections 9(2)(f)(iv) and 9(2)(g)(i) of the Official Information Act 1982].

[Withheld under sections 9(2)(f)(iv) and 9(2)(g)(i) of the Official Information Act 1982].

It will include changes to the Securities Act, including:

- Changes to definitions of issuer, to provide for the providers of retail KiwiSaver schemes to be the issuer rather than the trustee; and

- Changes to regulation-making powers to provide for public disclosure of information (which will be used to require public disclosure of KiwiSaver scheme performance);

It will also include:

Changes to the Securities Trustees and Statutory Supervisors Act (assuming it is passed first), to provide for the licensing of superannuation trustees of retail KiwiSaver schemes; and

Changes to the KiwiSaver Act to implement new governance requirements for retail KiwiSaver schemes and transfer functions from the Government Actuary to the new regulator.

For the regulator (the proposed Financial Markets Authority), the proposed changes will mean a clearer distinction between the duties of managers and those of trustees – allowing the regulator to hold each accountable in an appropriate manner. The additional information will also allow the regulator to more promptly act on either issues that it identifies with particular funds, or the sector as a whole, than is the case currently. A more proactive approach may see more resources being devoted by the regulator in this area. It anticipated that the regulator will take a risk-based approach to the areas where monitoring is required, but there may be a need for some increase in resource. On the other hand, it is also arguable that the synergies from combining the two main regulators in this area will in any event allow for more effective monitoring without additional resource. It is proposed that this will be identified in the establishment phase for the new regulator.

For investors, the new governance regime should also make clearer the respective duties of managers and trustees. In addition, for those that do use information collated and published regarding the ranking of fund performance and fees, they would have more reliable information available to them. For those that do not currently make use of this information, there need be no change.

The new regime may also reduce the risk of moral hazard, whereby investors consider that in the absence of reliable information in the public domain, the government is somehow taking responsibility for scheme performance. The survey data quoted earlier in this Statement suggests that it is unlikely that moral hazard could increase further given the overwhelming majority of those surveyed who consider that KiwiSaver is government-guaranteed. However, there is no evidence base on which to determine conclusively ex-ante the direction and extent of any change in moral hazard.

MONITORING, EVALUATION AND REVIEW

The proposed changes to the regulation of KiwiSaver will be overseen by the proposed new single regulatory authority.

At present there is insufficient information to fully evaluate the performance of KiwiSaver funds. The information proposed to be collected will improve our ability to monitor and evaluate the overall performance of KiwiSaver funds. We also expect to observe more informed market commentary on the role of fund manager decisions on the performance of schemes.

A full monitoring, evaluation and review plan is being developed as part of the full Securities Act review. This plan will include this area and will be integrated into the existing KiwiSaver evaluation work programme.

Appendix 1

SUMMARY INVESTMENT RETURNS FOR QUARTER: **30-Jun-09**

	Quarter ended 30 June 2009 -					
Asset Class	**Average Asset Weighting for the quarter**	**Actual Investment Return**	**Benchmark Average Asset Weighting for the quarter**	**Benchmark Return**	**Variance against Benchmark**	**Commentary (including hedging position)**
Income Assets						
New Zealand Bonds						
Global Bonds						
New Zealand Cash						
Growth Assets						
New Zealand Equities						
Global Equities (unhedged)						
Global Equities (hedged)						
New Zealand Property						
Global Property						
Alternatives						
Gross returns **before** fees						
Gross return **after** fees						
	$					
Total Funds Under Management						