Workplace Savings NZ

submission to the

Ministry of Economic Development

on the

SCOPING PAPER:

Draft Disclosure Regulations for Retail KiwiSaver Schemes

August 2010

Background

In July 2009 the Investment Savings & Insurance Association (ISI) published their consultation document titled "ISI Standard for Disclosure of Fees and Charges". Workplace Savings did offer input to this proposal.

Then in March 2010, the Securities Commission's Guidance Note: KiwiSaver Distribution and Disclosure raised the following issues (point 3.11 on page 4):-

"The Commission notes that the law does not currently prescribe or favor any particular method of calculating investment performance. However, the Commission believes that consistency and comparability in this area is highly desirable. ***The Commission would encourage industry participants and their industry bodies to work together to develop a standard method for measurement of investment performance that is consistent with the requirements of the securities legislation***. If such a consensus can be achieved, the Commission will consider issuing further guidance as to the acceptability of such a methodology as sufficient compliance for its enforcement purposes. In the absence of a consensus the Commission may need to consider the need to recommend legislative intervention in this area."

Workplace Savings NZ immediately responded stating that we also thought that it should be possible for the industry to adopt consumer oriented disclosure standards for products fees and investment performance in a transparent and useful manner, which in turn should lead to concise product comparability for investors.

At that time, we went to say that we think the issue of disclosure standards is much broader than just disclosure of Investment Performance, and suggested exploration of the following aspects of disclosure:-

a) Internationally recognised disclosure standards for
   - Product Fee (direct & indirect member & other administration fees) reporting;
   - Investing Fee (direct & indirect) reporting; and
   - Investment Performance reporting.
b) International best practice for implementation of industry wide disclosure standards; and
c) International best practice for dissemination of the information, using methodologies/technologies that build trust and acceptance by the investing public.

We also suggested that there may be a role for the regulator to play in relation to transparency and comparability, and drew attention to a recent article in the Australian Financial Review, which in summary suggested:-

"The Australian Prudential Regulation Authority may have new powers to monitor the performance of super schemes under a government inquiry into the $1.2 trillion superannuation sector. There are concerns by Jeremy Cooper, who is conducting a 12-month review of the sector, that key measures such as fund performance and investment management, marketing and administrative fees need to be examined by an independent body. While APRA's mandate covers the financial stability of Australia's retirement sector and the banking and life insurance sectors, Mr. Cooper may look at recommending that APRA's powers be broadened to take in fund performance, which would need legislation. Key targets of the review are fees and performance, with around $14 billion in fees collected from member accounts. The Rudd government has stated it would like to see the average fee on super accounts fall to less than one percent from its present 1.2 percent."

Workplace Savings NZ subsequently met with Bryan Chapple (Manager, Investment Law) and Rachel Dillon (Senior Analyst, Investment Law) from the Ministry of Economic Development to discuss these topics.

Submission

1. Do you agree that these are the key areas influencing disclosure of fees and costs?
We think that that you have accurately summarized the key areas of influence.
2. What do you consider to be the likely costs and/or benefits of requiring a TER calculation?
Workplace Savings NZ believes that the comparability of fees charged by workplace savings schemes and KiwiSaver schemes is paramount in assisting retail investors make informed choices. We also strongly believe that what an investors needs to know about fees is how much, <u>in dollar terms</u>, the product will cost (projected using a per annum calculation) for a given level of savings. Workplace Savings NZ does not believe that producing a Management Expense Ratio (MER) or a Total Expense Ratio (TER) adequately answers the "cost comparison" question adequately for retail investors. We are aware that some years ago an attempt was made to establish a standard way of expressing the total cost of investing in a particular managed fund. The Management Expense Ratio (MER) was designed to show, as a percent of funds invested, how much the investor would pay in any particular year. The ISI took over the "MER standard" (originally applied only to unit trusts) and mandated that their members use the standard. We understand that the MER standard was withdrawn a couple of years ago as it had gradually fallen into disuse. Apparently the standard was commonly not disclosed in the required format, it suffered from being complicated, the calculation basis was too loosely defined (resulting in inconsistent calculations), and usage of the standard was not policed by the issuing body (i.e. the ISI). The Retirement Commission says on their website: Comparing Fee Structures[1] Providers often use a Management Expense Ratio (MER) to produce a single figure of expenses so that you or your adviser can compare products quickly and easily. Members of the Investment Savings and Insurance Association (ISI) are obliged to give MERs for most of their products. Non-members (such as banks) do not have to. Sometimes a measure called the Ongoing Management Charge (OMC) is used for a similar purpose. The MER is usually quoted as a percentage of the product's assets. However, MERs are not always successful in providing a complete comparison between products. That's because: • Entry fees, servicing fees, switching fees or exit fees are not 'regular charges' so they are often excluded from MER calculations. Performance-based fees do not have to be included either. • MERs are not intended to show the actual costs for an individual investor but for all investors in that product. • There are no independent standards that providers must comply with when they calculate their own MERs.

[1] Sourced from www.sorted.co.nz

- MERs are based on past years, so may be different to MERs in the future.

Interestingly the Sorted website does have a KiwiSaver Fees Calculator[2] which calculates and compares KiwiSaver Fees in dollar terms. We would comment that the only drawback we see in this calculator is that the fees calculated is presented as a lump sum over the savings lifetime (i.e. from the age of joining KiwiSaver until age of 65) rather than making a per annum calculation, as we have suggested above is our preference.

3. Which approach (either requiring a 'synthetic' TER or one investment management fee), in your view, is more suited to NZ and why?

Workplace Savings NZ agrees with the ISI, that as much is practically achievable, the full cost of investing should be disclosed.

Where a product manager chooses to invest in segregated (i.e. a single relationship) mandates the fee position is commonly quite straight forward and easy to disclose. However, where a product manager chooses to invest in "Manager of Managers" structures (i.e. a one to many relationship model) the fees charged in each part of the investment process, and by the connected parties, becomes less transparent.

The above explanation is simplistic, and Workplace Savings would welcome the opportunity to discuss the issue in-depth with the Ministry.

4. What issues have you identified or come across in the use of terminology in the managed funds industry?

Workplace Savings NZ believes that historically the major impediments in achieving consistent disclosure have arisen as a result of:-

1. the lack of industry agreement on the definition of industry terminology and the calculation basis to be used; and/or
2. insufficient disaggregation, where the existing industry terminology has been too broad (and which has contributed to major inconsistency in use);
3. the vagaries of how the disclosure should be made in a meaningful way; and
4. the lack of enforcement of the standards introduced (we strongly believes in the principle that people (and businesses) do what is inspected and not always what is expected).

To illustrate our point we have produced two lists of common terminology - see Appendix A. First on this list is an extract of terminology from our own website, secondly a list from the Retirement Commissions website.

5. Do you consider the specification of categories worthy of consideration and, if so, what in your view, should those categories comprise of?

We would contend that the categories should be:-

1. Plan Membership Fees; and
2. Investing Fees.

That said, expanding the list of categories as espoused at paragraphs 16 & 17 of your Scoping Paper would also be acceptable to us.

---

[2] Sourced from www.sorted.co.nz

Workplace Savings NZ has submitted on the Securities Law Review: Discussion Paper in relation to Product Disclosure Statement prescribed information , stating that:- A.1.1. We believe that the content of Part A, together with much of the wording used, could usefully be prescribed (descriptive & not marketing) for each product type. The meaning of a particular term or phrase should be the same irrespective of which provider is using it. Readers should be referred to a common glossary if more details are required. The glossary would be maintained on the Securities Register site or, perhaps, by the Retirement Commission (or the Financial Markets Authority). A.1.2. In addition, calculation methods behind information presented in respect of, for example, fees and/or investment returns need, in our view, should be standardised. <u>This will be essential if comparability is a major objective</u>. A.1.3. If content is to be covered by regulation, the ability to update and/or revise prescriptive wording as and when appropriate must be recognised. The regulator must be able, and willing, to review wordings promptly if the need arises, with requests from providers being sufficient to trigger a review (not necessarily a change). We think these principles also hold true with respect to disclosure of fees and returns. We contend that one answer here is for the MED to prescribe that:- a) the industry to agree an encompassing and sufficiently disaggregated list of terminology; b) to ensure that there is an explicit definition for each item on this list; c) to ensure that the basis of calculation is unambiguous and inclusive of all possibilities; d) to have a non-Industry body take ownership of the industry-agreed list of terminology and relevant definitions; e) to have the regulator prescribe that all disclosure uses only terms and definitions from the agreed list; and f) to have the regulator police use of the terminology and definitions. We suggest that the terminology and definition list would need to become a living document, and that over time "the independent Owner" could permit new terms to be added or redundant terms deleted, or as needs dictated definitions modified as financial literacy improvements were achieved.
6. What do you consider to be the arguments for and against the disclosure of transaction costs?
Please refer to the comments above.
7. What do you consider the necessary information to be disclosed in relation to performance fees?
Workplace Savings NZ suggests, as a generalization, that performance fees do not make-up a significant component of fees for the majority of the investments undertaken by workplace savings schemes and/or KiwiSaver schemes. That said, we believe that if a performance fee is applicable to an asset class, it would be sufficient disclosure for the retail investor that the minimum fee is disclosed for the purpose of performing the projected per annum cost calculation. In addition a descriptive reference should be made to the existence of the performance fee that explains in what circumstances that fee would become payable.
8. What, in your view, is the best method for disclosure of trail and soft commissions to investors and why?

Workplace Savings NZ believes that a trail commission, if paid, should be disclosed as that will be an integral part of the full product fee paid for by the investor. In the first instance, in our view, trail commissions should be transparent to the investors and should be fully disclosed in terms of our discussion at Q2 of this submission. We contend that, in reality, disclosure of soft commissions in a generic fees disclosure model may be "a bridge too far". At this point in time the investor should be encouraged to rely on their adviser's compliance with the Code of Conduct for Financial Advisers. We see little or no benefit for the retail investor from the introduction of a more prescriptive approach.
9. Do you have a view as to whether returns should be presented gross or net of fees or both?
We suggest that this is a vexed issue and the answer will be dependant upon the purpose of disclosure. In the first instance, if the investor's principal interest is about investment manager performance then at an asset class level, it will be useful for an investor to see <u>gross returns</u> as this will assist their understanding about how the particular investment manager (or managers) have performed relative to the chosen asset class performance benchmark (e.g. an index such as the NZX50 for NZ Equities). However, if the investor is only looking at, or is only interested in the "portfolio" return and the portfolio is a basket of diversified investments, and then the first point may not be relevant to the investors information needs. If however, the investor's principal interest is about how their investment has performed relative to similarly constructed investments, then it will be useful for an investor to see <u>net of fee returns</u> as this information will inform them in comparative terms about how their investment has performed. Once again, we would like to point out the above answer is overly simplistic, and that Workplace Savings would welcome the opportunity to discuss the issue in-depth with the Ministry.
10. Do you consider that returns should be disclosed net of tax? Why or why not?
Please refer to our answer above at Q9. Workplace Savings believes, that at the personal level, the investor should be interested in disclosure of returns after fees and after tax as this is the bottom line individualized measurement of wealth accumulation over time. Currently however, for Collective Investment Scheme's, given the differing tax treatments applicable to the different investment structures and the system used by some providers, generic after tax returns are impossible to produce and therefore can not realistically be expected to be used comparatively. Prior to the introduction of PIE in New Zealand however the disclosure standard was net of tax and net of all fees. Illustratively the calculation was:-

Gross of fees Investment Return	5.00%
Less Tax Impact	(1.50%)
Less Investing Fees	(0.50%)
Less Plan Membership Fees	(0.25%)
Net of Tax, Net of Fees Return	2.75%

It has been suggested to Workplace Savings NZ that gross reporting re-emerged in NZ post PIE because some providers are using dated administration platforms and this combined with the resources available and the time constraints to implement PIE meant that net reporting was going to be a challenge.

The question then becomes, if the Ministry believes it can be done, should net of tax and net of fees reporting for KiwiSaver be prescribed?

11. What, in your view, are the key issues around the calculation of total returns for a fund? Is there a need to prescribe methodologies and, if so, why? If not, why not?

We have interpreted you question as asking our views in relation to the methodologies and timing of investment valuations.

In that context we believe that there should be prescribed methodologies for asset valuations. Workplace Savings NZ understands that the internationally recognised best practice standards in this regard are contained in the Global Investment Performance Standards (GIPS) promoted in New Zealand by the Chartered Financial Analyst Institute.

On the issue of the timing of asset valuations, we believe that product managers should be required to disclose in the Securities Register their process and procedures in this regard.

In the broader context of the Securities Law Review, it is useful in our view, to note that workplace savings schemes and KiwiSaver schemes do as a matter of best practice produce documents called a Statement of Investment Policies and Objectives (SIPO). We also note that the NZ Super Fund produce a more detailed document called a Statement of Investment Policies, Standards & Procedures. Historically these documents have been produced as governance tools, however the reality is that they are often laden with useful information for the more educated investor, and may assist to inform disclosure on this topic.

12. What do you consider the pros and cons of a GIPS-based performance reporting regime in application to retail KiwiSaver schemes?

Workplace Savings NZ does not have a position for or against the adoption of GIPS in this jurisdiction.

However, we do consider that it would be useful for informed debate to occur between retail KiwiSaver providers; the investment management industry and the Ministry on what represents international best practice in this area, alongside what regulators consider NZ must do to ensure we comply with our international obligations.

13. Do you consider that disclosure of past performance provides value to the retail investor? If so, why? If not, why not?

Most investment advisers and Product Disclosure Statement will tell a retail investor that past performance is not an indicator of future performance (or investment outcomes). Equally, say for retirement savings, they may suggest that the retail investor shouldn't fixate on short term returns but look to the longer term in line with their savings objectives. Mixed messages – we know! That said, we believe that past performance has a role to play in the education of retail investors. That education role is about helping the retail investor to understand something about the consistency, or lack thereof, of the investment's relative performance. In other words, just where on the league table does their product provider sit, relative to the particular investment portfolio being compared? And how might the providers/investment manager's track-record in the areas of investment process, investment personnel and investment philosophies affect returns over time? In this context, comparable information - usually gross returns net of fees over a three or five (3 or 5) year rolling average, is what we might say has been the domestic industry's historic standard. However, we are aware that in other jurisdictions, longer time horizons have been/are used. Workplace Savings recognises that retail investors will also want to know short term performance outcomes, but consider that there should be a clear focus on the longer term. The Ministry might learn more in this area by talking with APRA, Morning Star or Funds Source.
14. Do you consider that benchmarks for performance should be disclosed? If so, what type of benchmark would provide the most useful comparison?
Are we moving here to a distinction between what information should be mandated for a "retail" investor versus what say a more 'habitual" investors might have an interest in knowing and understanding. As we have pointed out at Q9, Workplace Savings NZ believes that there is a limited role for disclosure of benchmarks. Equally we have pointed out in Q11 that for the most inquisitive investor this information is disclosed and available in a scheme's SIPO (which most providers would, we expect, make available upon request). But, we would also point out that not all situations can be covered by disclosure of a benchmark. What about when an investment manager is appointed who operates on "benchmark unaware" basis (i.e. is a stock picker)? And what would happen when there are multiple indexes for a type of market, and where there is not one clear-cut standard benchmark adopted by investment managers? We feel that this type of disclosure, if deemed applicable, may best be suited to investment commentaries in say a scheme's annual report.
15. To what extent should disclosure of portfolio holdings be mandated?
Workplace Savings NZ does not see significant benefit for the retail investors arising from a continuous disclosure regulation for portfolio holdings. We do believe that such information should be available to retail investors upon request. That said, if the Ministry was to mandate this proposition, we would expect to see protection of providers from client misuse.
16. What do you consider to be the pros and cons of prescribing categories for the classification of portfolio holdings?

We think that most KiwiSaver providers already self classify, and disclose, the categories of assets held in their investment products investments portfolios. We see little or no benefit for the retail investor from the introduction of a more prescriptive approach.
17. Do you consider requiring disclosure of credit ratings for debt securities worthy of further consideration?
Workplace Savings NZ believes that the majority of workplace superannuation schemes and KiwiSaver schemes will already disclose in their products SIPO the credit rating benchmark for debt securities that an investment manager is permitted to deal in. We see little or no benefit for the retail investor from the introduction of a more prescriptive approach.
18. What, in your view, are the pros and cons of disclosure regarding portfolio composition and turnover rate?
We are not entirely sure what question is being asked here? Is your concern with securities churning within a mandate and the implications on fees arising from brokerage, or are you more generally asking about issues related to portfolio tilting (either through Strategic Asset Allocation, Dynamic Asset Allocation, of some other mechanism) and the implications for the investor? We think that this issue is not material to a retail investors, and is more likely something which the manager would have oversight/control and responsibility for. We therefore see little or no benefit for the retail investor from the introduction of a more prescriptive approach in this area.
19. Have all potential areas where conflicts of interest been correctly identified? Do you consider that such possible conflicts of interest should be fully disclosed? What, in your view, are the pros and cons?
We think that your Scoping Paper has adequately canvassed potential areas where conflicts of interest might arise. We see little or no benefit for the retail investor from the introduction of more prescriptive disclosure in these areas. Workplace Savings would welcome the opportunity to discuss the issue in-depth with the Ministry.

Appendix "A"

Making Sense of Fees[3]

Plan Membership Fees:

- **Administration Fee:** Pays for your membership in the plan. It may be a dollar amount each year (regardless of the amount invested), a percentage of the assets invested or a mixture of both.
  Also known as: Membership fee, account charge, application fee, policy fee, monitoring fee.

- **Entry Fee:** Pays for the expenses of setting up records. It could also be income for the provider and/or a fee for the introducer. The entry fee is usually deducted from your investment before it is invested, or deducted from your first investment return.
  Also known as: Placement fee, arrangement fee, application fee, set-up fee, establishment fee, initial charge, service fee, buy / sell spread fee.

- **Exit Fee:** Pays for converting your investment into cash and sending your money to you. Sometimes the exit fee is a penalty for not staying in a product for long enough. Make sure you know what fees you will have to pay if you leave.
  Also known as: Redemption fee, withdrawal fee, benefit payment fee.

- **Out of Fund Costs:** Pays for the cost of preparing and auditing the annual accounts, stationery, printing and meetings as well as legal fees, registry fees and custodian fees. The provider may pay these straight out of the fund so that all investors pay their share and the investment returns are reduced by the expenses. In other cases, the provider may pay them from other fees they receive so the investment return is not directly affected.
  Also known as: Disbursements, expenses, professional fees (for legal or accounting costs), recovered expenses, recoverable expenses.

- **Trustee Fees:** Pays for the people (or company), which are usually independent of the provider, that oversees the provider's activities on behalf of the investors in the product or trust. Under trust law, the trustee has specific responsibilities and is there primarily to look after investors' interests.
  Also known as: Trustee service fee.

- **Servicing Fees:** Pays for ongoing commission to the adviser who sold the plan to you. They may continue to get this commission even if you have nothing further to do with them. The contribution is usually a regular deduction from your plan's investments - you may not see the deduction but it will probably reduce your return.
  Also known as: Trailing commission, contribution fee.

---

[3] Sourced from www.workplacesavings.org.nz

- **Consulting Fee:** Pays for the cost of advice from an adviser - whether it's working out what kind of plan to offer employees; which provider to use and perhaps helping with the plan's implementation. The consultant could also have an ongoing role to deal with members' queries.
  Also known as: Advisory fee.

Investing Fees:

- **Investment Fees:** Pays for the investment manager that is responsible for the day-to-day decisions about where the plan's money is invested. The investment manager could be the product provider (such as a bank) or someone else altogether. The fee pays for the investment manager's costs in considering possible investment, weighing up whether to replace or add to existing investments, and keeping an eye on good deals for their investment products. Investment fees are charged on a regular basis and deducted from your return.
  Also known as: Fund management fee, investment management fee, recurring management fee, on-going management charge.

- **Monitoring Fees:** Pays for looking after your overall portfolio of investments, in addition to other fees associated with the plan. It can also cover such services as preparing quarterly reports and tax statements, providing advice on changes to your strategy, or providing a transaction report.
  Also known as: Asset management fee

- **Brokerage:** Pays for the transaction costs of a third party (such as a share-broker, real estate agent, bank or investment broker) for buying and selling investments on behalf of the plan's investment manager.
  Also known as: Dealing costs, transaction costs, buy/sell spread

- **Switching Fees:** Pays for moving your investments within the product you have chosen or between products. If you're selling and buying shares, the switching fee will be in addition to the brokerage fee.
  Also known as: Processing fee, handling charge

Notes:

1. **Brokerage:** The buying and selling of nearly all investments by a master trust (or by one of the underpinning products) will incur brokerage. Some products effectively charge that brokerage directly to incoming and outgoing investors through a difference in unit prices (sometimes called a "spread"). Other products charge the brokerage to the fund as a whole through reduced investment returns. In that way, all members bear the cost of buying and selling assets. Whether the brokerage is disclosed or undisclosed, the members of all products directly or indirectly bear the brokerage costs of buying and selling investment assets.
2. **Consulting fees:** A consultant can be employed on a number of different bases. The fees will usually be by agreement and often based on a cost per hour.

Fee types in Detail[4]

Fee Name	Description of what fee pays for:	Fee also known as:
When you start saving		
Entry fee	The expenses of setting up records. It could also be income for the provider and/or a fee for the introducer. The entry fee is usually deducted from your investment before it is invested, or deducted from your first investment return.	Placement fee, arrangement fee, application fee, set-up fee, establishment fee, initial charge, service fee.
Consulting fee	The cost of advice from an adviser - whether it's working out whether you need to save, what kind of investment strategy to adopt or which products might be appropriate.	Advisory fee.
As you invest new money		
Monitoring fee	Looking after your overall portfolio of investments, in addition to other fees associated with the product. It can also cover such services as preparing quarterly reports and tax statements, providing advice on changes to your strategy, or providing a transaction report.	Asset management fee.
Servicing fee	Ongoing commission to the adviser who sold the product to you. They may continue to get this commission even if you have nothing further to do with them. The contribution is usually a regular deduction from your investment - you may not see the deduction but it will probably reduce your return.	Trailing commission, contribution fee.
Switching fee	Moving your investments within the product you have chosen or between products. If you're selling and buying shares, the switching fee will be in addition to the brokerage fee.	Processing fee, handling charge.
Running the Product		

[4] Sourced from www.sorted.co.nz

Administration fee	Your membership in the fund. It may be a dollar amount each year (regardless of the amount invested), a percentage of the assets invested or a mixture of both.	Membership fee, account charge, application fee, policy fee, monitoring fee.
Associated costs	Costs that do not fit into the categories of fees normally encountered. For example, you may have complex products that require you to pay for specialist accountants to prepare your tax returns. Or a financial adviser might charge an implementation fee to cover the cost of putting a financial plan into effect.	
Brokerage	The transaction costs of a third party (such as a share-broker, real estate agent, bank, or investment broker) for buying and selling investments on behalf of the fund.	Dealing costs, transaction costs.
Investment fee	The investment manager is responsible for the day-to-day decisions about where the product's money is invested. The investment manager could be the product provider (such as a bank) or someone else altogether. The fee pays for the investment manager's costs in considering possible investment, weighing up whether to replace or add to existing investments, and keeping an eye on good deals for their investment products. Investment fees are charged on a regular basis and deducted from your return.	Fund management fee, investment management fee, recurring management fee, on-going management charge.
Out of fund costs	Costs of preparing and auditing the annual accounts, stationery, printing and meetings as well as legal fees, registry fees and custodian fees. The provider may pay these straight out of the fund so that all investors pay their share and the investment returns are reduced by the expenses. In other cases, the provider may pay them from other fees they receive so the investment return is not directly affected.	Disbursements, expenses, professional fees (for legal or accounting costs), recovered expenses, recoverable expenses.
Trustee fee	The people (or company), which are usually independent of the provider, that oversee the provider's activities on behalf of the investors in the product or trust. Under trust law, the trustee has specific responsibilities and is there primarily to look after investors' interests.	Trustee service fee.
When you withdraw savings		
Exit fee	Converting your investment into cash and sending your money to you. Sometimes the exit fee is a penalty for not staying in a product for long enough. Make sure you know what fees you will have to pay if you leave.	Redemption fee, withdrawal fee, benefit payment fee.