From: Natalie Muir
Sent: Tuesday, 12 July 2022 1:33 pm
To:[redacted]
Cc: Andrew Park <Andrew.Park@fma.govt.nz>
Subject: OIA re Value for Money CRM:006901221

Kia ora [redacted]

We hold one document within scope of your request below. Please find it attached by way of release under the OIA - *Value for Money - Discussion Document* ('**presentation**').

Purpose of document
Read alongside the *Value for Money Industry Report* ('**report**') published in May 2022 and available here Value-for-Money-Industry-Report.pdf (fma.govt.nz), you can see how the presentation echoes the key issues in the report. The report sought an industry discussion on use of market indices and trail commission (see paras 1.18-1.20 and 1.26 to 1.29) and the presentation builds on that, effectively presenting the FMA's 'side' of those discussions. The intention of doing so was:

- to be transparent with fund managers and their supervisors ahead of any discussion, about the FMA's thinking on the topics raised in the report including potential solutions for the trail commission aspects;
- in doing so, to facilitate the timely organisation of the industry discussion on the topics; and
- setting all comments in the context of the Value for Money guidance published in April 2021.

Current status
As you know, the Financial Services Council, Big Group and Trustees Corporations Association have copies of the document and the FMA is happy the timing and format of industry discussions on the issues raised in the report and presentation are determined by industry. This courtesy, as the FMA has communicated frequently to fund managers and supervisors, reflects the FMA being conscious of these discussions being just one of the various information and other requests for fund managers' time.

If you have any questions for the FMA about this project please contact Andrew Park in the first instance. If you have any questions about our release of the document under the OIA please contact myself in the first instance.
Many thanks
Natalie Muir
Principal Adviser, Governance

From: [redacted]
Sent: Wednesday, 6 July 2022 3:11 pm
To: Natalie Muir <Natalie.Muir@fma.govt.nz>
Cc: Andrew Park <Andrew.Park@fma.govt.nz>
Subject: Re: OIA re Value for Money CRM:006901215

Thanks Natalie. Much appreciated.
I used a template I found online but maybe this is no longer active.

Our understanding is that the FMA has prepared a further document (in addition to its Value for Money release) and this is circulating around the industry. Naturally, we're interested to know what's in it. Our understanding is that while the FMA may not have modified its position, the tone of this document is different from the VFM release.

Kind Regards
[redacted]

On 6/07/2022, at 2:24 PM, Natalie Muir <Natalie.Muir@fma.govt.nz> wrote:

Kia ora [redacted]

I acknowledge your OIA request below.

I see you note you put in an OIA request to another address aside from this email to Andrew. We have checked, but did not appear to receive a different email from you. What email address did you send it to?

In any event, we have your request below, and we're progressing work on it, and will respond as soon as possible.

Many thanks
Natalie Muir
Principal Adviser, Governance

<image512822.JPG>

Natalie Muir Principal Adviser, Governance
T +64 4 4714616 M +64 21 948 023
E Natalie.Muir@fma.govt.nz
Level 2, 1 Grey Street, Wellington, 6011
PO Box
1179,
Wellington www.fma.govt.nz<imagee99149.PNG> <image6a11bf.PNG> <image9b7d9a.PNG> <imagef41456.PNG>
6140, New
Zealand
<imaged5ec91.JPG>

<imageb58825.GIF>

From: Jen[redacted]
Sent: Friday, 1 July 2022 10:47 am
To: Andrew Park <Andrew.Park@fma.govt.nz>
Cc: Campbell Gibson <Campbell.Gibson@fma.govt.nz>
Subject: Re: Response to Value for Money question

Thanks Andrew.

Could I please make a request pursuant to the Official Information Act 1982 for any discussion documents and/or the material within these documents relating to the current industry engagements with mangers, their supervisors and industry groups?

I put in a formal OIA request yesterday but this might no yet have come past you.

Kind Regards
[redacted]
On 1/07/2022, at 10:40 AM, Andrew Park <Andrew.Park@fma.govt.nz> wrote:

[redacted] good to talk, please find a statement below.

"The FMA has not modified its position on Value for Money set out in the guidance published in April 2021 and reinforced in the report from the pilot published in [May 2022]. When we released the Pilot report we stated our next steps included further discussions with the industry. The FMA has continued to engage with MIS managers, their supervisors and industry groups on the timing, agenda and format of the discussions described in the report."

Hope this helps,
Cheers
Andrew

<image8d354b.JPG>

Andrew Park Manager, External Communications (Media & Stakeholders)
T +64 9 967 1215 M +64 21 220 6770
E Andrew.Park@fma.govt.nz
Level 5, Ernst & Young Building
2 Takutai Square, Britomart, Auckland, 1010
PO Box
106 672,
Auckland 1143, New Zealand www.fma.govt.nz<imaged583e7.PNG> <imagec71d7f.PNG> <image89efb4.PNG> <image422d9b.PNG>

<imageacb1d2.JPG>

<imagee3570e.GIF>

[DATE OF MEETING] 2022

Value for money

- Annual Review and assessment tool
- Market Index
- Trail Commission and Advice

FINANCIAL MARKETS AUTHORITY
TE MANA TĀTAI HOKOHOKO

Value for Money Purpose
Annual Review and assessment tool

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TĀTAI HOKOHOKO

Value for money – purpose

Designed as assistance for MIS Managers and their Supervisors to meet existing requirements in respect of fees and value for money

KiwiSaver

- Includes statutory obligation not to charge unreasonable fees

All MIS Managers

- FMA's expectations for good conduct
- Statutory duty to act in members' best interests – duty applies when a MIS manager exercises a power or performs a duty

Value for money is a core aspect of acting in members' best interests

- Simple test: how comfortable is the conversation – with investors, with Supervisors and the FMA, publicly – that demonstrating reasonable fees and value for money is **not** in members' best interests?

Value for money – Annual review and tool

Guidance, annual review, self-assessment tool

- Feedback on Value for Money guidance: MIS managers and supervisors **wanted more specific information about how to deliver**
- Self-assessment tool was developed by Supervisors and FMA to provide a consistent process for MIS managers, working with Supervisors, to demonstrate reasonable fees and value for money
- Tool was piloted to test ease of inputs, utility of outputs and was improved to make it easier to use:
  - ➢ now straightforward for funds with satisfactory performance after fees relative to market index
  - ➢ will take longer for funds not able to do so and/or with features such as performance fees
  - ➢ FMA accepts first use will take time, but ensuing updates will be simpler
- **Value for money is fundamental, it <u>should</u> take time to assess and evidence**
- MIS managers should use the process or, if they wish to use another approach:
  - ➢ explain and demonstrate to Supervisors, FMA and members how that approach achieves the same goal
  - ➢ expect scrutiny of the methodology (which will also take time – especially the first time)

Market index
- General scepticism
- Performance fees

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TĀTAI HOKOHOKO

Market index

General scepticism

- MIS managers said investors care more about performance relative to peers or ‘just getting a good return’
- Peer performance is partially instructive at best about the value proposition of any MIS manager (are they *really* peers on a risk-adjusted basis? What period? How much luck is involved? – all questions familiar to any managers rated poorly relative to peers)
- For the risk taken and cost paid, is it **really** a ‘good return’?
  - ➢ Is that how MIS managers evaluate the performance of underlying managers? Their own PMs?
  - ➢ BTW: ‘Peer risk’ is a far more influential driver of passive investing styles – ‘herding’ – than is a regulatory focus on value for money
- Most fundamentally, the investment management industry is based on individuals being unable/unwilling to manage their own money, including being price conscious and understanding value propositions. MIS managers should care about demonstrably robust, risk-adjusted net returns <u>on their investors’ behalf</u>
- Without an appropriate market index, how can the MIS manager know **themselves** what they are doing is adding value?

Performance fees

Hurdle rate of return and benchmark

KiwiSaver

Hurdle Rate of Return should reflect:

- The long-term objectives and inherent risk characteristics for the fund concerned (in general the higher the risk, the higher the required hurdle).
- An appropriate return benchmark, generally the expected return from the standard fund asset mix under normal expected market conditions before allowance for 'added value' from active management.
- … for a true 'absolute return' investment fund, a cash-based benchmark (e.g., 90-day bank bill rate (BKBM)) may, in certain circumstances, be an appropriate benchmark. In these circumstances we would expect the fund's track record over time to reflect the 'absolute investment style'.
- If appropriate, an allowance in the minimum Hurdle Rate of Return where there are active management fees already implicit in any base fee

Non-KiwiSaver managed funds

Hurdle Rate of Return:

- all managed funds are required to report… performance … against the returns of an appropriate market index
- Although not a legal requirement, it is reasonable to link the hurdle rate for any performance-based fee to the returns of the comparative index
- Some funds currently base their performance fee on a hurdle rate of return linked to a market index that does not reflect the asset class and risks of the underlying investments
- The impact of this is a fund may still be paid a performance-based fee although it has underperformed against the fund's comparative index

Performance fees – Value for money guidance

…it is not in members' best interests to pay a fee for outperformance of a cash-based benchmark for an equity-based fund, as the risk of the benchmark and the fund are materially different and the benchmark will, over time, be simple to beat (and so does not represent value added by the manager)

Also:

how [are] *claims a fund has an absolute return strategy – to justify use of a cash benchmark – … substantiated by the fund's structure and outcomes. Especially, can the MIS Manager show fund volatility reflects that of the cash benchmark; and is the risk control typically a key purpose of an absolute return strategy, evident in mitigating the scale and frequency of fund drawdowns*

Performance fees – what happens

A sample of performance fee benchmarks…

- 15% over OCR + 5%, no cap
- 10% over 90-Day Bank Bill
- 15% over market index
- 15% over 10% performance
- 15% over OCR + 12%
- 10% over OCR + 5%, no cap
- 15% over OCR + 5% capped

Some long-only, some labelled absolute return

… and of outcome (just one, but illustrative)

- Benchmark = OCR + a margin, capped
- Sample period = 10 years ending 2021
- Performance fee paid **eight** times
- Had hurdle been based just on outperforming fund market index, fee paid **four** times (two of which paid when OCR-based benchmark did not pay out, once for ‘good defense’)
- Had hurdle been based on market index + 2 hurdle, fee paid **three** times

Trail Commission, Advice

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TĀTAI HOKOHOKO

Trail Commission - the discussion

Market Conduct and Best Interest of the Customer

This is an industry discussion on an industry conduct issue (MIS managers, Advisers, Banking and Insurance)

- Commissions appear to benefit intermediaries and MIS manager and not the investor/customer
- Inherent conflict of interest: risk fund choice is determined by which MIS manager pays highest – or any – commissions
- Risk commissions **distort** competition in the intermediary market and between MIS managers
  - Customers do not choose the intermediary on the MIS manager-related service/cost offering
  - Cost to customer/investor of trail paid to intermediary is typically not avoidable or transparent
  - Risk MIS Managers compete with commission payments to be more appealing to intermediaries, rather than compete with value for money to be appealing to investors. Note: Industry submissions on value for money guidance made same point
    - ….”better outcome for the market to compete by providing the best value proposition to customers, rather than competing on the basis of providing the best value proposition to advisors.”
  - Cost of acquisition paid by investors acquired directly, subsidises intermediated members without clear, effective disclosure

Key issue is not price but value

- Does the member receive value during the acquisition process to justify the commission charged?
- Is it **at least clear** to members when their fees include cost of trail and what, if any, service or value they receive in return?

Three specific problems

1. Acquisition cost is socialised…

A MIS Manager acquiring members through a third party socialises the acquisition cost – trail commission paid to the third party – across all members, regardless of how members joined the MIS Manager’s fund(s).

This is achieved through the acquisition cost being embedded in the fees paid by all members.

The acquisition cost is ongoing, typically annual and is a % of each member’s balance (in some structures there is also an upfront $ cost, again paid from fees).

This distorts competition and means members coming direct subsidise the cost to the MIS Manager of members coming through third parties

2. …but cost transparency is not socialised

Depending on the MIS manager and third party, the members acquired through the third party may or may not be aware of:

– what the third party is paid;
– that the cost is met from fees paid by all members of the fund the member is joining (including the member)
– the amount of the cost
– what, if anything, the member has received or will receive in return for the cost

Members who have joined a fund **direct** are typically unaware of any of this. There is no FAP disclosure and the MIS manager does not itself disclose the existence, reason for, recipient or sum of the cost.

Members do not have a clear view – or any view – of who gets the value of them paying the cost and in most cases no ability to opt out.

3. Intermediation ≠ advice

The help members acquired through third parties receive from the third party varies widely, including:

– Upfront and ongoing advice (meaning, help to make good investment decisions)
– Upfront advice on fund choice and contribution size (but no ongoing advice)
– What amounts to basic customer service: assistance with basic queries etc.
– Nothing at all

Members acquired directly by a MIS Manager typically get nothing from the third parties the MIS Manager uses, despite contributing to the cost of the third parties

Value for money guidance

What it says

- Important New Zealanders get the help they need to make good investment decisions
- **Prefer** fees for advice are charged to the member, not the scheme and are avoidable (and expect industry to move toward this approach)
- **But** acknowledge KiwiSaver market still maturing – low balances mean even a modest, optional fee may dissuade KiwiSaver members from using or seeking advice
- Accordingly, no prescription for how fees for advice are charged (guidance overall does not prescribe size or structure of fees in general)

But

- advice if offered should be received (engaged with and used)
- advice should be ongoing, not just at on-boarding (at least annually and at key life events)
- fee should be reasonable
- fee should be appropriately disclosed to member – how much, who receives it, what members get for paying it

Guidance focus is on value, not fees

Current practice

Current practice is not consistent. Some MIS managers seem unusually reliant on regulations as:

1. **assurance third parties are disclosing commissions paid by the MIS manager to the third party AND**
2. **justification for not themselves disclosing the payments (because it is not explicitly required)**

However, some MIS managers do disclose what is paid, who receives it and give the member the ability to opt out

Disclosure examples

“I understand… the financial adviser or distributor through which my investment was made (if applicable) may be remunerated by the Manager for distributing the scheme.”

“If you have received financial advice from a financial adviser we have entered into an agreement with… the… fees remunerate the person who provided that help. The benefits… [include]..splitting out this fee from other fund charges [so you can see]… how much you are paying for financial advice and servicing… you may ask us to stop deducting fees… at any point.”

“If you join the Scheme, we.. pay commission to third party advisers… for introducing you to us and for any advice provided to you… we pay these costs from the revenue we receive from the fees you pay to us.”

“…certain financial adviser fees… can be charged on an individual basis if your… adviser has a fee facilitation agreement in place with us and you have authorised the fee(s) to be deducted from your account… the ongoing… fee will not be charged if you tell us to stop… for example because you no longer receive advice from your… provider.”

Options

1. Advice underpinning

Requires MIS Manager or third party to have a FAP licence:

- How does the onboarding decision (fund choice, contributions) occur otherwise?
- On what basis does the MIS Manager try to retain members transferring out otherwise?

2. Basic advice offer

Helps members make good investment decisions (and can be evidenced accordingly)

At on-boarding and at least annually, at key ages and stages and in acute situational vulnerability (e.g., during volatility)

Offered digitally / in-person

Augmented as agreed by the MIS manager / third party and as adds value to members

3. Available to all members

Provided to all members coming in through third parties (and can be evidenced accordingly)

Is available to all members, regardless of how they were acquired, and is regularly and prominently communicated to all members accordingly

Alternative (some providers use already)

All members are aware of the socialized cost of acquisition via third parties and can choose not to pay it by advising the MIS manager, who stops deducting it from the member's balance.

Alternative (Australian approach)

All members are aware they contribute to the cost of trail and can *choose who receives it* (i.e., someone who provides value to the member)

4. Transparency

As agreed by MIS manager and third parties. Disclosed at 'both ends' of the acquisition process:

- By third party
- By MIS manager (including in PDS)
- How much, who gets it, the value proposition to the member
- Service delivered = service offered

Objections

1. Other acquisition costs are not itemised (e.g. Marketing)

Financially very different: Trail commission is a payment for an *actual acquisition.* Marketing is an output, Trail is an outcome. The ongoing quantum of the payment is linked to an individual member as a % of that member’s balance.

Trail has inherent conflict: Trail is intermediated, marketing is not.

2. Not prescribed by regulations / contrary to ‘single fee’ requirement in regulations

Not a good conduct argument especially given the intermediated nature of trail described at point 1. This is clearly accepted by some MIS managers who do disclose the ongoing cost of trail (and make it avoidable).

Non-disclosure potentially also a fair dealing breach for those members who have joined directly, but are paying the socialised cost of trail