NZSUPERFUND
Te Kaitiaki Tahua Penihana Kaumātua o Aotearoa

11 April 2018

Clerk of the Committee
Governance and Administration Select Committee
Parliament Buildings
WELLINGTON

Dear Sir / Madam

STATE SECTOR AND CROWN ENTITIES REFORM BILL (No. 20-1)

The following submission on the State Sector and Crown Entities Reform Bill (No. 20-1) ("**the Bill**") has been prepared by the Guardians of New Zealand Superannuation ("**the Guardians**"). The Guardians manages and administers the New Zealand Superannuation Fund ("**the Fund**").

EXECUTIVE SUMMARY

We support and endorse the policy of integrity and accountability which underpins the Bill.

There is a broad spectrum of Crown organisations with diverse risks, challenges and complexities and their demand for knowledge and specific skills varies within the public sector. A "one size fits all" approach to governance of those organisations, including the remuneration of Crown entity chief executives, which does not take account of the various needs of differing organisations or sectors in terms of technical skill, leadership, accountability and executive management, and risks causing the organisation to fail to meet its objectives.

We submit that the Bill should not apply to the Guardians for the following reasons:

1. The proposed amendment is inconsistent with the governing legislation for the Guardians.

2. It is also inconsistent with best practice principles of investment governance.

3. The proposed change creates greater risk for the Government by potentially politicising a critical governance decision and reducing accountability for the Board of the Guardians.

4. The proposal regarding five year term for the Chief Executive employment agreement is entirely inconsistent with the long term purpose of the Fund.

We consider that the Guardians should be treated like State Owned Enterprises, which, like the Guardians, operate at arms-length from the Crown and have a commercial focus.

In the event that the Government does wish the Bill to apply to the Guardians, we propose some amendments to mitigate the risks of undermining the operational independence and accountability of the Board of the Guardians. These amendments include principles to guide

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the exercise of the proposed discretion under section 117 of the Crown Entities Act ("**CEA**"). The principles proposed are best practice for decisions of this type and would be applied by any rigorous decision maker. The inclusion of these principles in the Bill makes their application explicit and transparent, consistent with the policy of integrity and accountability underpinning the Bill.

Additionally, the Committee should consider whether the Bill amounts to an implied repeal of provisions of the New Zealand Superannuation and Retirement Income Act (**"NZSRI Act")**, either from a policy perspective or a legal perspective. Amendments to the relevant part of the NZSRI Act require consultation with the political parties that are in agreement with the relevant part of the Act as well as with the Guardians. This unique feature of the NZSRI Act reflects the intergenerational and multi-partisan approach taken in relation to the establishment of the Guardians and the Fund.

APPEARANCE BEFORE THE SELECT COMMITTEE

We request an audience with the Select Committee to present our submission.

SUBMISSION

The remainder of this submission is set out as follows:

1. Background on the Guardians and Fund
2. How the Guardians invests and its unique legislative framework
3. Approach to Setting Chief Executive Remuneration
4. Specific Proposals on the Bill

1. Background on the Guardians and Fund

The Fund is a Government savings vehicle established to partly pre-fund the future cost of New Zealand superannuation payments and therefore reduce the burden of the cost of superannuation on future generations of New Zealanders.

Since the inception of the Fund in September 2003, the Government has contributed NZ$15.02 billion to it. As at 28 February 2018, the Fund has returned 10% p.a. (after costs, before NZ tax). After paying tax in New Zealand during this period (of $6.25 billion), the Fund is now NZ$38 billion in size.

The Fund's long-term performance expectation is that it will beat the New Zealand Treasury Bill return by at least 2.7% p.a. over rolling 20 year periods. Since inception, the Fund has exceeded the Treasury Bill return by 6.3% p.a. (estimated dollars earned over and above Treasury Bills: $22 billion).

The Guardians is recognised internationally for its investment success, governance, transparency, innovation and leadership in responsible investment. For further information on the Guardians and Fund see our website at www.nzsuperfund.co.nz.

2. How the Guardians invests

The Fund's world class legislative framework has allowed the Guardians to invest in a genuinely long-term, contrarian and active manner that is not available to all investors, and which has added considerable value to the Fund for New Zealanders.

Our investment approach is based on a Reference Portfolio, a notional portfolio of passive, low-cost, listed investments suited to the Fund's long-term investment horizon and risk profile.

Our aim, as an active investor, is for the Fund's Actual Portfolio to perform better than the Reference Portfolio, using active investment strategies based on the Fund's endowments as a long-term, operationally-independent, sovereign investor with known cash-flows.

These strategies are expected to deliver better risk-adjusted returns, and/or offer diversification benefits for the Fund, compared to passive investments. Since the inception of the Fund, these active investments have generated $7 billion more for taxpayers than a purely passive approach would have done. Active investments are, however, more complex and costly to implement, and identifying and implementing them has required the building of a team with significant in-house expertise. In order to undertake this type of investment activity, the Board must be confident in its ability to attract and retain the skills and expertise necessary.

Legislative Framework

In 2001 the Government established the Fund with a legislative framework to allow it to fulfil its intergenerational purpose without political interference. This framework has been globally recognised as a world class example of investment governance.

The framework enables the Guardians to make investment decisions on a timely, commercial basis. It makes the Board fully accountable for performance and allows the Board to use the Fund's long term time horizon and clear mandate with reduced risk of political interference to enhance returns. As the Fund grows in size, this framework becomes increasingly important.

Operating Independence

The Guardians operates with "double arm's length" independence from the Government. The first limb of this independence is set out in section 56 of the NZSRI Act whereby the Minister of Finance must establish a committee to propose nominations for Board members of the Guardians. The Minister is only able to appoint Board members from the pool of nominees proposed by the nomination committee. Section 55 of the NZSRI Act requires that the nominees must have "substantial experience, training, and expertise in the management of financial investments".

The second limb of independence is set out under section 49(4) of the NZSRI Act and provides the Guardians a large amount of independence:

> There are no restrictions on the Guardians' power to invest the Fund, other than as provided by sections 58, 59, and 64.

"Invest" is defined broadly in section 5(1) of the NZSRI Act**:**

> **invest** means to carry on any activity, do any act, or enter into any transaction that the Guardians consider to be for the purpose, directly or indirectly, of—
>
> (a) enhancing or protecting the value of the Fund:
>
> (b) managing, or enabling the management of, the Fund

All costs and expenses, including the Chief Executive's remuneration, are met by the Fund. Returns are calculated net of all costs. Only Board fees and related costs and the costs of the audit of the Fund and Guardians by the Auditor-General (or nominee) are paid for out of Parliamentary appropriations.

Current Limits on Independence

The NZSRI Act (section 49(4)) provides that there are no restrictions on the Guardians' power to invest the Fund, other than as provided by sections 58, 59 and 64.

Section 58 of the NZSRI Act establishes the Fund's mandate – requiring us to manage the Fund in a manner consistent with best-practice portfolio management. Section 59 restricts the Guardians from taking controlling interests in operating entities, and section 64 outlines the Minister of Finance's limited ability to give directions to the Guardians. Section 64 limits directions as to the Government's expectations of the Fund's risk and return.

The Minister is prevented under section 64(2) from giving directions that are inconsistent with the Guardians' duty to invest the Fund under section 58 of the NZSRI Act.

None of these restrictions contemplate a constraint such as that under the proposed amendment to section 117 of the CEA.

3. Setting Chief Executive Remuneration

The Guardians' legislation requires us to manage the Fund in line with global best practice. The employment market for professionals in the investment sector is highly competitive. We aim to build and maintain a team of talented people who can deliver value in terms of Fund performance.

The Board carefully formulates the components of the Chief Executive's remuneration to reflect that the Guardians is a Crown entity, to maximise alignment with the Guardians' strategic objectives (as set out in the Statement of Intent) and to fulfil the mandate of the Fund. The major components of the Chief Executive's remuneration are base salary and participation in a discretionary incentive scheme alongside members of the Guardians' Leadership and Investment teams.

The Chief Executive's base salary is based on:

- job size (determined by independent experts);
- competence; and
- current, independent, remuneration market data.

The discretionary incentive scheme is designed to incentivise and create a collective culture of good performance across the Guardians. Incentive payments are provided at the discretion of the Board. There are two parts to this scheme.

- First, an individual performance component (maximum 20% of actual base remuneration) linked to behaviour consistent with the Guardians' desired workplace culture. This component of the scheme reinforces a positive, constructive workplace culture. For financial services organisations, the importance of culture and behaviour is critical from a risk management point of view.
- Second, a whole-of-Fund investment performance component (maximum 40% of actual average base remuneration) based on the Fund outperforming its Treasury Bill and Reference Portfolio benchmarks. It is based on Fund performance over rolling four year periods to align as best possible with our long-term investment horizon.

In determining the overall remuneration, the Board then factors in the recommendations and guidance provided by the State Services Commission as part of the consultation process under the CEA (as it currently stands).

Transparency and Accountability

We are very mindful of being part of the public sector and understand the importance of public sector accountability. Accountability for the Guardians' Chief Executive's remuneration is achieved through the consultation process and full disclosure of all elements of the remuneration package, including considerable detail on how the performance related components are determined and are aligned with the organisation's strategic objectives.

We are committed to continuing to share the basis of the Board's conclusions on Chief Executive remuneration (other than private details such as personal performance) with Treasury, the Minister and the Commission. To date, the Commission has not provided the Board with detailed information regarding the data it takes into account in coming to its dissenting recommendation to the Board or the then Minister of Finance. The Commission has not provided specific data to the Guardians on key points such as the sizing of the role, market benchmarks or good practice in relation to the use of incentive schemes for investment organisations, to explain why it disagrees with us. Instead, the Commission provides a "public sector" remuneration range, the source and content of which is unspecified, and without reference to the pools from which we source our expert talent, nor to the specific market in which the Guardians operates.

We are also mindful of the costs and risk of underperformance of the Fund should we not recruit or retain a Chief Executive with the right attitude, skills and experience. Ultimately the Board is accountable for and will be measured on whether or not the Guardians meets its long-term outcomes, as set out in the Statement of Intent. Removing from the Guardians Board the fundamental Board responsibility of appointing and remunerating the Chief Executive undermines that accountability.

4. Specific Proposals on the Bill

1. *The proposed amendment to section 117 of the CEA undermines the independence of the Guardians' power to invest.*

Attracting and retaining high-quality employees (including the Chief Executive) falls within the broad definition of "invest" in section 5(1) of the NZSRI Act. The responsibility of the Board to invest the Fund needs to be understood within the context of legislation designed to achieve a sophisticated approach to investment, consistent with the requirement to invest the Fund in a prudent and commercial manner with best practice portfolio management.

In order to avoid the risk that the independence of the Guardians' power to invest will be undermined, as noted above we submit that the Guardians be excluded from the scope of clause 4 of the Bill. This submission is included in **Appendix One**.

2. *These risks can be partially mitigated through requiring best practice and transparency in the exercise of the proposed discretion.*

If the Government wants to include the Guardians in the application of the Bill, then in order to help mitigate the reduction of the Board's powers and accountability, as contemplated in the current version of the Bill, the Bill should be amended to require the Commissioner to take into account, and report on, factors that are key to the management and administration of the Fund. As a general principle of good Government, it is important that decisions such as this can be demonstrated, publicly, to have been made on an evidence-based basis.

The articulation and publication of how each of those factors was taken into account by the Commissioner (in a situation where s/he declines to provide written consent) would also allow the responsible Minister to assess the decision-making process and outcomes, and to ensure transparency.

We therefore submit that, in considering whether to give consent to the Board's proposal for the terms and conditions of the Chief Executive's employment, the Commissioner must be required to consider:

- the context and market in which the statutory entity operates, including the sectors from which talent is sourced for the role;
- job sizing by an independent third party and a comparison with other roles of the same job size and/or reference level;
- detailed information on applicable market benchmarks;
- the extent to which the Board of the organisation remains accountable for the outcomes of the statutory entity, as set out in the Statement of Intent;
- the alignment between the terms and conditions of employment agreed between the Board and the Chief Executive with the timeframe and strategic objectives of the statutory entity;
- the functions of the statutory entity;

- the performance of the statutory entity;
- whether or not the remuneration requires the entity to receive additional Government appropriations;
- the relativity of Chief Executive remuneration to employee remuneration at the statutory entity; and
- the relativity of Chief Executive annual remuneration increases to annual staff remuneration increases at the statutory entity.

We submit that where the Commissioner does not consent to the Board's proposed employment agreement with the Chief Executive, the Commissioner shall be required to articulate the basis for declining consent by reference to each of the above factors and provide support by way of a detailed report, including the relevant market data from an independent, third party reviewer.

We submit that, in any event, an overarching provision be included in section 117 of the CEA (clause 4 of the Bill) that consent must not be withheld by the Commissioner if the reasons for doing so are outweighed by the entity's need to employ and retain an appropriately qualified and experienced Chief Executive, as attested by the Chair.

3. The proposed five year term limit is inconsistent with the Fund's long term purpose

The proposed new section 117(1) of the CEA (clause 4 of the Bill) requires a fixed-term for Chief Executive appointments of not more than five years, with the power to reappoint. We consider that fixed-term employment packages are uncompetitive in the markets from which we recruit and note that while a fixed-term might be appropriate for political appointments, it is entirely inconsistent with the double arms-length independence and long-term nature of the Fund. The Guardians' remuneration structures have been carefully designed by the Board to meet the Fund's objectives in line with its long-term nature, future focus and associated risk appetite. Currently the Chief Executive must be employed for four years before s/he is eligible for the Guardians' full incentive scheme, thereby reinforcing the long-term nature of the Guardians' mandate and the need to manage risk through time, not just in the short term. Limiting to five years the leadership of the Guardians which, by its nature, is required to plan and execute strategies over the long term, puts the personal incentives of the Chief Executive at odds with the very purpose of the organisation s/he is tasked with leading.

4. The proposal requires a materiality condition

We submit that it is necessary to amend the proposed new section 117(1A(b)) of the CEA (clause 4 of the Bill) to ensure only amendments to material commercial terms and conditions are captured, rather than "any or all" terms and conditions. As currently worded this is impractical, as it would require us to gain consent from the Commissioner for even trivial amendments and updates to wording.

5. The proposal should require the Commission to meet reasonable commercial timeframes

We submit that the Bill should require the Commission to meet reasonable commercial timeframes when exercising their discretion under section 177 of the CEA (clause 4 of the Bill).

The Guardians is obliged and committed to being a good employer. An annual review of remuneration and performance is part of that commitment. It is important for the Board of the Guardians that all Guardians employees, including the Chief Executive, are treated fairly, consistently and properly. In addition to quantum, this means that remuneration decisions must be made in a timely manner. Additionally, where the Guardians is recruiting from a commercial environment, this can be made challenging, and our competitiveness as an employer reduced, if the timeframes for the recruitment process cannot be managed tightly.

Accordingly, it is important that the process and timeframes for consenting to the terms and conditions of the appointment, and for amendment, is certain and practical. On a number of occasions in the past it has taken many months to obtain a response from the Commission, a timeframe which is inconsistent with the Guardians' objectives and desire to be a good employer. We submit that the Bill requires that the Commission responds to an initial request by the Guardians for consent within a reasonable timeframe, for example 10 working days. Subsequent requests, if consent is withheld, should be responded to within 5 working days.

The above submissions are included in **Appendix Two**.

Yours sincerely,

Catherine Savage

Chair, Guardians of New Zealand Superannuation

Appendix One (section 117 of the CEA does not apply to Guardians)

Text inserted

4 Section 117 amended (Employment of chief executive)

Add the following clause to section 117:

(3) This section does not apply to the Guardians of New Zealand Superannuation, the Crown entity that manages and administers the New Zealand Superannuation Fund.

Appendix Two (section 117 of the CEA applies to Guardians)

Text inserted

4 Section 117 amended (Employment of chief executive)

Delete section 117(1) (which relates to the fixed term of employment) and replace section 117 with:

(1) The terms and conditions of employment of a chief executive of a statutory entity appointed by the statutory entity must be determined by agreement between the board and the chief executive.

(1A) However, the statutory entity must obtain the written consent of the State Services Commissioner before—

(a) finalising the terms and conditions; or

(b) amending any or all of the material commercial terms and conditions once they have been finalised.

(1AA) When exercising their discretion under subsection (1A), the State Services Commissioner must have regard to the following factors:

(a) the context and market in which the statutory entity operates including the sectors from which talent is sourced for the role;

(b) job sizing by an independent, third party and a comparison with other roles of the same job size and/or reference level;

(c) detailed information on applicable market benchmarks;

(d) the extent to which the statutory entity remains accountable for the outcomes of the statutory entity as set out in the Statement of Intent;

(e) the alignment between the terms and conditions of employment agreed between the statutory entity and the chief executive with the timeframe and strategic objectives of the statutory entity;

(f) the functions of the statutory entity;

(g) the performance of the statutory entity;

h) the frequency of remuneration reviews for the chief executive;

(i) whether or not the remuneration requires the statutory entity to receive additional Government appropriations;

(j) the relativity of chief executive remuneration to employee remuneration at the statutory entity; and

k) the relativity of chief executive remuneration increases to annual staff remuneration increases at the statutory entity.

(1AB) Despite anything in this section, when exercising the discretion under subsection (1A), the State Services Commissioner must provide written consent under subsection (1A) where the statutory entity's need to employ and retain an appropriately qualified and experienced chief executive outweighs the reasons for withholding consent, as attested by the Chair.

(1B) The State Services Commissioner must provide statutory entities with advice and guidance on the terms and conditions of employment of chief executives of entities.

(1C) If the State Services Commissioner declines to provide their consent under subsection (1A), they must provide the statutory entity with reasons and supporting evidence from an independent third party for that decision with reference to the factors in subsection (1AA).

(1D) When the statutory entity requests that the State Services Commissioner provides their written consent under subsection (1A), the State Services Commissioner must decide whether to provide their written consent:

(i) within 10 working days of an initial request being made to the State Services Commissioner; or

(ii) within 5 working days of any subsequent request being made after the State Services Commissioner declines to provide their written consent under subsection (1A).