

Governance of Public Pension Funds: New Zealand Superannuation Fund

By Brian McCulloch and Jane Frances

pe'whān n. 1. periodic payment
made esp. by government or employer
on retirement or to person above specified age

PENSION

re-foh'm vt. & i. 1. make distribution procedure
(e.g.) better by removal or abandonment
of imperfections, faults or errors

REFORM

prīm vt. 1. denigrate; look to
equip person with information

PRIMER



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Introduction and Summary

Over the next fifty years or so, a permanently higher proportion of the population will become eligible to receive payments of New Zealand Superannuation. The New Zealand Superannuation Fund has been established to smooth the impact this will have on the rest of the Crown's finances.¹

The effect of the policy is to build up a portfolio of Crown-owned financial assets over the next few decades while the annual cost of New Zealand Superannuation remains relatively low. Those assets, along with compound investment returns, then will be drawn on progressively to supplement the annual Budget as the Crown's finances adjust to a much higher level of ongoing expense for New Zealand Superannuation. It is a smoothing mechanism for what remains fundamentally as a "pay as you go" universal benefit.

An essential element of the success of this policy is efficient management of the financial assets that constitute the Fund. The large projected size of the Fund means that even relatively small efficiency losses could have a significant negative effect on national welfare. Moreover, the general experience internationally has been that politically controlled public funds typically exhibit poor financial performance. A crucial element of the policy underlying the Fund was therefore the design of governance arrangements so that the Fund is managed as efficiently as possible. The objective was to establish a clearly defined portfolio of Crown financial resources, managed by an independent governing body with explicit commercial objectives and clear accountability.

After briefly reviewing the context behind the policy and the policy objective, this paper examines the resulting key design elements of the governance framework for the New Zealand Superannuation Fund that attend to each element of that objective: clearly defining the Fund, placing an appropriate level of independence around the governing body, providing explicit legislated commercial investment objectives, and establishing a robust accountability framework. Finally, the paper briefly reviews the experience of implementation to date, and also summarises the arrangements surrounding the governance of other portfolios of financial assets owned by the Crown in New Zealand.

¹

Note on terminology: The "Crown" and the "Government": New Zealand has a constitutional monarchy. The resources and obligations of the central government sector (or state sector) are therefore generally referred to as being ultimately owned and owed by the "Crown". The Executive, being the Prime Minister and Ministers currently in power, is referred to as the "Government". The Government is accountable to the "Legislature", which in New Zealand is a single House of Parliament, comprising the elected members of the Government party (or parties, in the case of a Coalition Government), along with the elected members of the Opposition parties.

Context

New Zealand Superannuation Policy

New Zealand Superannuation is a universal benefit paid to all individuals over the age of 65 who meet New Zealand residency criteria. The level of the pension ensures that a married person receives, after deduction of income tax, no less than 32.5% of the national average ordinary time weekly earnings and it is indexed annually.² There are neither means tests nor income history requirements.

Indexation of the rate of New Zealand Superannuation is based on inflation in the Consumer Price Index, but subject to the pension level not falling below the specified minimum relativity with average earnings. Currently, the pension level is above this minimum relativity, but within a few years the faster rise in real wage rates and earnings will mean that the minimum will be triggered and the pension will effectively become indexed to wage growth. This is illustrated in Figure 1.

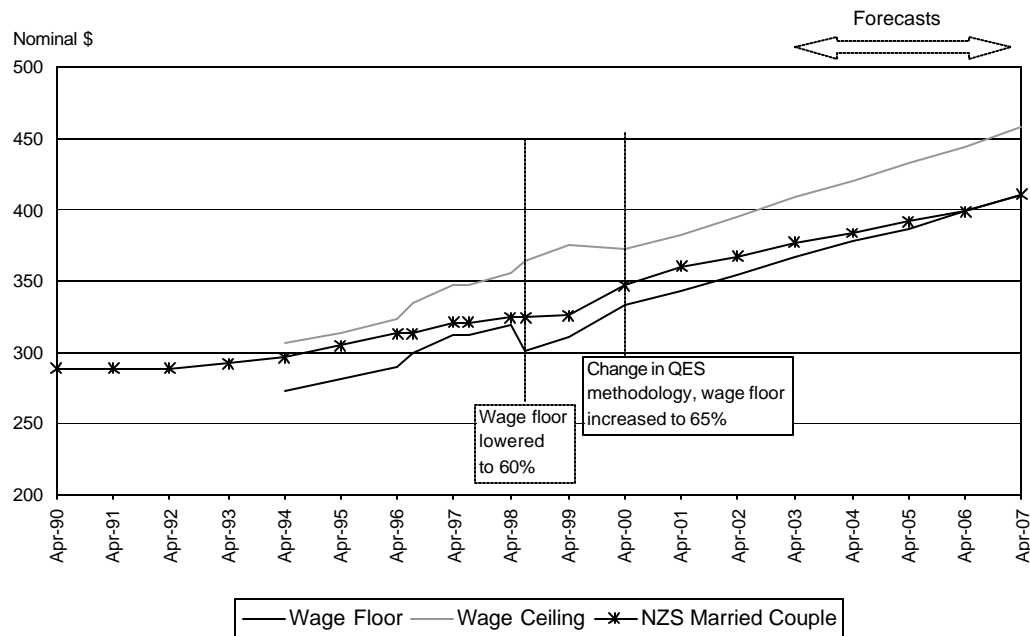


Figure 1: Bounds for Indexation of the NZS Rate

² This minimum pension level is formally expressed in terms of a married couple, both eligible, receiving no less than 65% of national average ordinary time weekly earnings between them. However, this can create confusion when attempting to compare notional individual earnings replacement rates across different countries. The rate for an unmarried individual living with others (living alone) is set 20 percent (30 percent) higher than the amount for a married person. For detail of the eligibility for, and amounts of, the New Zealand Superannuation benefit, see http://www.workandincome.govt.nz/get_financial_assistance/benefits/main_benefits/nz_superannuation.html

The New Zealand Government has provided public pensions for over 100 years (Preston 2001). They have taken several forms over that time, including means-tested schemes, social security taxes, and a compulsory contributory scheme. The forerunner of the current New Zealand Superannuation was introduced in 1977. It was a universal pension paid at age 60 and set at 80% of the average wage for a couple and 60% for an unmarried person. Between 1992 and 2001, the age of eligibility was progressively increased to age 65, and indexation was linked to price inflation instead of wage growth so the rate has progressively fallen towards the floor of 65% of average wages as the rate for a married couple (which equates to 32.5% per married person).

The policy for New Zealand Superannuation entitlements is unchanged by the establishment of the New Zealand Superannuation Fund. The New Zealand Superannuation Act 2001, which established the Fund, re-enacted the existing entitlement provisions with only minor drafting clarifications.³

Population Ageing

Populations around the world are ageing and the New Zealand population is no exception. While New Zealand is expected to experience slower overall population growth over the coming decades, there will be growth in the number of older people and a significant change in the age structure of the population.

Figure 2 highlights the changing makeup of the New Zealand population.⁴ The proportion of the population over 65 increased from 9% in 1951 to 12% in 2001 and is projected to increase to 26% in 2051 and 28% by 2100. In comparison, the working age population is projected to fall from 65% of the population now to 58% by 2051 and 56% by 2100. The youth population is projected to fall from 23% to 16% in 2051 and then remain at that level. This change in population structure is driven by lower expected fertility rates and higher life expectancy. The transition over the next fifty years to an “older” population therefore represents a permanent change. The post-War “baby boom” accelerates the profile slightly but it is not a major factor. Expected migration also has only a minor effect. The effects of declining fertility, increasing longevity and migration are examined further in the following sections.

³ The only substantive change was to restore the minimum earnings relativity for a married couple's combined entitlement to 65%. The previous Government had reduced it to 60%. Figure 1 illustrates this drop in the wage floor in 1998.

⁴ Unless otherwise noted, all demographic statistics and forecasts stated in this paper are from Statistics New Zealand with fixed scenarios of fertility, life expectancy and migration. See <http://www.statistics.govt.nz/>. Stochastic projections of New Zealand social expenditure are also available (Creedy and Scobie 2002).

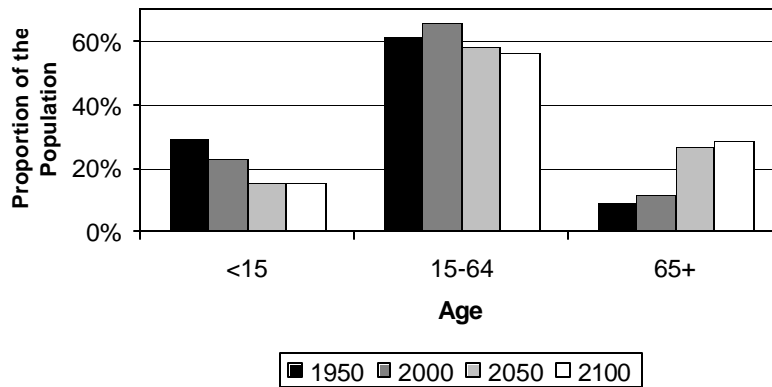


Figure 2: New Zealand Population Age Structure

Declining Fertility

Figure 3 illustrates how the New Zealand fertility rate has moved over time.⁵ Over the last twenty years, the fertility rate has been below the replacement rate for the population, which is 2.1 births per woman. Forecasts assume that the rate will continue to fall to about 1.9 births per woman by 2010 and remain at that level. Women in New Zealand are now having fewer children and having them later in life.

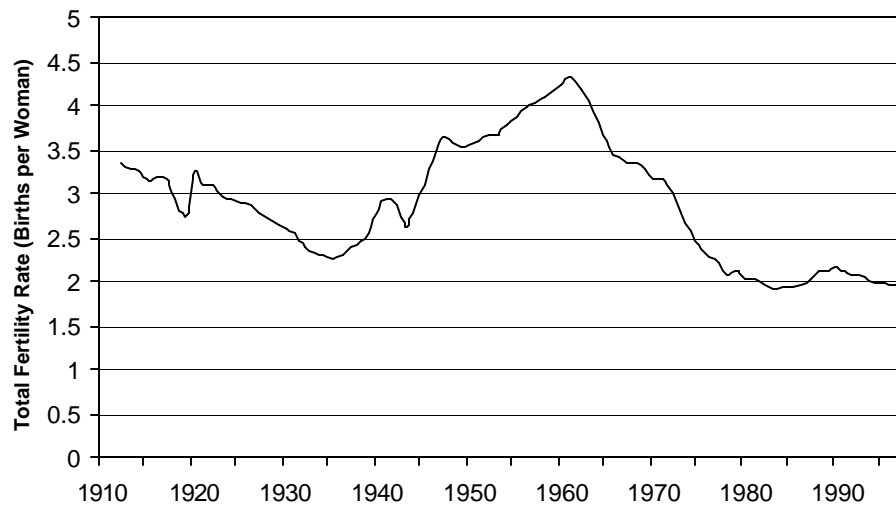


Figure 3: Total Fertility Rate

⁵ The total fertility rate in a particular year is the average number of births a woman would have during her reproductive life if she were exposed to the fertility rate characteristic of the various childbearing age groups in that year.

Increasing Longevity

Life expectancy has increased steadily and is expected to continue increasing. A woman (man) born in 1956 is expected to live to 73 (68.2) years of age, while one born a 1996 is expected to live to 79.6 (74.3). By 2050, life expectancy for both men and women is expected to exceed 80 years of age. Increasing life expectancy has generally led to increasing periods of eligibility for New Zealand Superannuation, although this has been affected by different ages of eligibility being operated at different times. This is illustrated in Figure 4, which shows actual historical data to 1996, and then forecast data from 2000. Until 1977, two benefits were in place: the Age Benefit, which was means tested and available from age 60, and Universal Superannuation, which was available to all from age 65. The payments made from 1977 to 1991 were available from age 60. The age of eligibility was then moved up to 65 over the period 1992 to 2001. The forecasts beyond 2000 are on the assumption that the eligibility age stays at age 65.

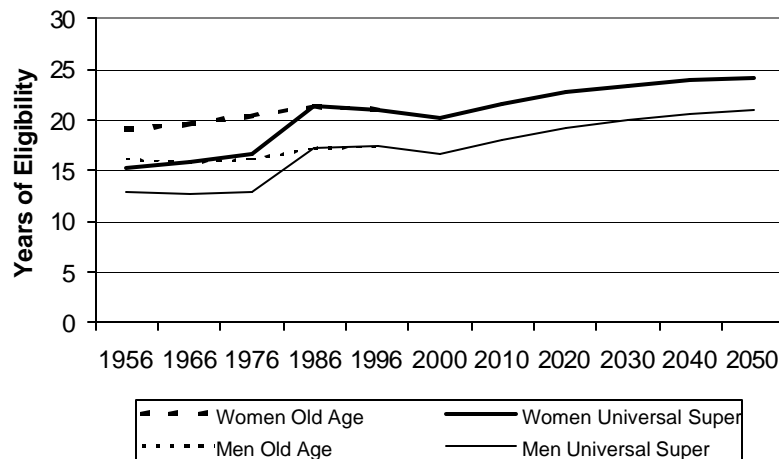


Figure 4: Years of Eligibility for New Zealand Superannuation

Migration

Migration trends will affect the population structure of New Zealand, but not to the same extent as fertility or life expectancy. In New Zealand, over the 50 years to 1998, positive net migration averaged 6,000 per annum. In comparison, natural increase (births less deaths) increased New Zealand's population by an average 33,000 per annum over the same period. Even if migration was to become a significant factor in the overall growth rate of the population, it is not clear what effect it would have on the age structure. Current immigration policy tends to favour younger working-age applicants.

Implications for Crown Finances

Direct Cost of New Zealand Superannuation

New Zealand Superannuation is a universal payment. The cost of New Zealand Superannuation is therefore directly related to the number of people of eligible age. Since the rates of New Zealand Superannuation are linked to wage levels (and since wage

growth is strongly related to GDP growth), the cost to the Crown of New Zealand Superannuation as a proportion of New Zealand Gross Domestic Product under current policy can be reliably measured for several decades into the future.

Figure 5 illustrates the projected path of the net cost of New Zealand Superannuation to the end of the century.⁶ Several features are apparent. First, over the next few decades, there will be a significant increase in the cost of New Zealand Superannuation, rising from about 4% of GDP to about 9%. Second, the higher cost is a permanent shift that is driven by the fundamental demographic changes discussed above. Third, the baby boom generation has the effect of exacerbating the upward trend, indicated by the hump in the slope between 2030 and 2040 when the bulk of them are over 65. Another ripple around 2070 reflects their children becoming eligible for New Zealand Superannuation. Fourth, the decline in cost that has been experienced over the past decade is about to be reversed. The decline resulted not from demographic changes, but from a combination of policy changes – a rapid transition in eligibility age from 60 to 65, and a decline in the rates of New Zealand Superannuation as a percentage of average wages.

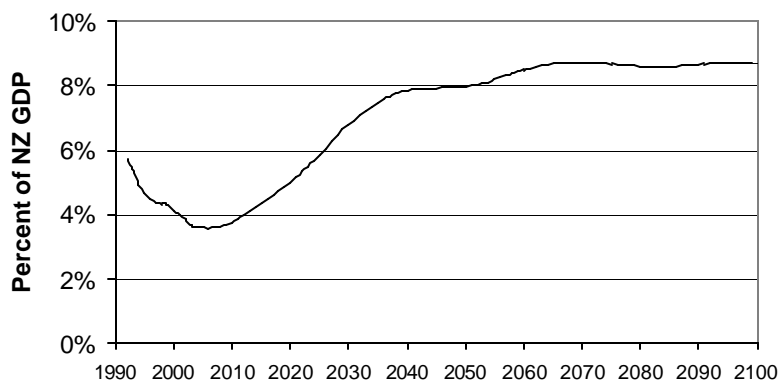


Figure 5: New Zealand Superannuation as a Percent of GDP

Other Costs with an Ageing Population

New Zealand Superannuation is not the only cost to the Crown that will vary according to the age structure of the population. In particular, the Crown is likely to face significant increases in the cost of public healthcare as the population ages. This will serve to compound the pressures on Crown finances over the next few decades. Stephenson and Scobie (2002) survey the broader economic implications of population ageing in New Zealand.

While the older population will increase over the next few decades, the youth population is projected to decline (see Figure 2). The World Bank (1994) considered whether the cost to government associated with the increasing proportion of old people could be met

⁶ New Zealand Superannuation is taxed as income to the recipients. This tax is deducted on payment and returned to the Crown. The “net cost” is the after-tax cost. This is generally treated as the relevant cost to the Crown of New Zealand Superannuation.

through the diversion of resources away from the shrinking youth population. They did not believe it would be possible to do so because the cost to the government associated with children is less than that of older people, the social resources needed by children (eg schools) are different from those needed by older people (eg pensions, hospitals and custodial care) during the transition, and societies with few children have made a quantity-quality trade-off and are more likely to invest more heavily in each child rather than reallocate all these resources to the elderly.

Policy Objective

Smoothing Crown Finances

Government policy is to preserve New Zealand Superannuation as a universal age-related benefit, retaining substantially the current provisions indefinitely. With tax revenue expected to stay in the region of 30% to 35% of GDP, a doubling in the cost of New Zealand Superannuation from under 4% of GDP to over 8% (along with increases in other age-related costs) implies a significant change in the structure of the Crown's finances over the next few decades. The policy objective is to put in place arrangements to assist the Crown's finances to make this change. It involves drawing resources off the Budget for the next two to three decades, and then progressively drawing on those resources over the following decades as the annual cost continues to increase. Eventually, the resources are fully drawn on, and the Budget will have adjusted to a new structure that incorporates the permanently higher ongoing cost of New Zealand Superannuation.

This policy could be considered to be a form of tax smoothing. Davis and Fabling (2002) estimate that there is potential for significant welfare gains from a fiscal policy based on tax smoothing to manage the fiscal implications of population ageing. However, they note that this is dependent on having in place strong institutions to enable the gains to be captured. In particular, there need to be strong governance arrangements around the large pool of Crown financial assets implied by the tax smoothing fiscal strategy.

The smoothing objective adopted for the Fund was to set the rate of total contribution from the Budget to New Zealand Superannuation (that is, current year expense on New Zealand Superannuation Entitlements plus the capital contribution to the Fund) so that if that same rate (as a percentage of GDP) was to be provided over the next forty years, it would be just enough, along with the accumulating Fund and its investment returns, to meet the expected cost of New Zealand Superannuation entitlements over that forty year period.⁷ Each year, the level of required contribution is recalculated based on the latest forecasts and a rolling forty-year time horizon.

The effect of this rolling time horizon calculation of the contributions to the Fund is illustrated in Figure 6. It requires an annual amount of 1% to 2% of GDP (being the positive gap between the two lines until the mid-2020s) to be set aside from the Budget initially. This declines to zero by the mid-2020s, after which those resources and compounding investment returns are progressively drawn on to smooth the continuing increase in the annual cost of New Zealand Superannuation entitlements.⁸

⁷ The forty-year horizon was an arbitrary choice. The effects of alternative horizons are illustrated in Figure 4 of McCulloch and Frances (2001a).

⁸ The Government decided to adopt a transitional approach for the first three years to allow the Crown's finances to adjust to making capital contributions. Amounts of \$600 million, \$1200 million and \$1800 million were provided for in 2001/02, 2002/03, and 2003/04. This explains the hook at the start of the contribution line in Figure 6.

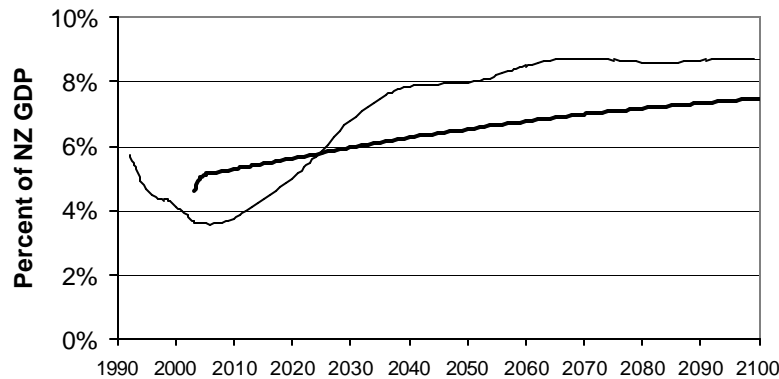


Figure 6: Smoothing the Cost of New Zealand Superannuation

Without the smoothing, the annual cost of New Zealand Superannuation more than doubles from 3.6% of GDP in 2003 to 8% by 2050. With this smoothing, the effective charge against the annual Budget (that is, the annual cost of payments to recipients, plus (minus) the capital amounts set aside (drawn on)) starts at 4.6% in 2003 and reaches only 6.5% by 2050. This represents an increase of less than one-half.

Instead of establishing the Fund to hold and invest the capital contributions, the Government conceivably could have decided to continue reducing Crown debt by amounts equal to the capital contributions. However, this was not considered to be feasible because gross Crown debt is now down to relatively comfortable levels after a decade over which debt repayment was seen as a key fiscal priority.⁹ Establishment of the Fund was seen as a more credible means of obtaining the stronger Crown financial position required in the long-term to implement the smoothing policy described above.

The success of this policy depends crucially upon the Fund being managed efficiently. However, with only a few recent exceptions, the experience internationally is that the performance of public investment funds has been nowhere near efficient (Iglesias and Palacios 2000). The Fund is projected to grow significantly over the next few decades, to the order of 50% of GDP (McCulloch and Frances 2001a). As a result, even relatively small efficiency losses could have a significant negative effect on national welfare (Davis and Fabling 2002). Careful attention was therefore paid to placing governance arrangements around the Fund so that it is managed as efficiently as possible. These governance arrangements are discussed in detail in the subsequent sections of this paper.

New Zealand is not the only country to seek to implement governance arrangements to avoid the historical poor performance of public funds. In particular, the Canada Pension Plan Investment Board, the Irish National Pensions Reserve Fund and the Norwegian

⁹ Net public debt amounted to 50% of GDP in 1992. It is now in the region of 14% of GDP, including zero net foreign currency debt. This achievement is largely attributable to the implementation of the *Fiscal Responsibility Act 1994* (<http://www.treasury.govt.nz/legislation/fra/explanation/>). See Table 2 on page 39 for detail of the current and forecast financial position of the Crown.

Petroleum Fund provide examples of similar governance arrangements. This paper focuses on the arrangements implemented for the New Zealand Superannuation Fund and it does not present a detailed international comparison of governance arrangements.¹⁰

Other Issues

Retirement Income Policy

As described above, the policy for the New Zealand Superannuation Fund is essentially about fiscal management. Establishment of the Fund has not involved any significant changes to the parameters surrounding the payment of New Zealand Superannuation. The focus has instead been on how to finance the existing policy.

However, establishment of the Fund does not preclude changes to the entitlement parameters over time. For example, if the eligibility age were to be increased in the future, this would have the effect of reducing the forecasts of the annual cost of New Zealand Superannuation (that is, shifting downwards the line drawn in Figure 5 and also the corresponding line in Figure 6). As a result, the capital contribution calculation, which takes into account the forecast of the next forty years entitlement payments, would result in a lower ongoing required capital contribution. The policy objective of smoothing the impact on the rest of the Budget would continue to be pursued.

On a broader scale, being primarily a mechanism for long-term fiscal management, the Fund can by no means be considered a complete solution to issues of retirement income policy. It is simply a means to help the Crown meet the Government's commitment to retain a universal old age pension (that is, the first pillar in the World Bank (1994) multi-pillar framework). It does not preclude other policies from being introduced, such as compulsory saving or incentives for voluntary saving.¹¹ Such policies would be considered on their own merits, regardless of the existence of the Fund.

Contrast with an Archetypal Pension Fund in the Private Sector

Another implication of the fiscal management focus of the policy relates to how the Fund should be characterised. The New Zealand Superannuation Fund is not a pension fund in the normal sense of that term. It is an investment fund. The assets of the Fund are simply a well-defined subset of the property of the Crown. Recipients of New Zealand Superannuation, whether current or future, have no special claim over those assets. The Crown is the legal and beneficial owner of the Fund. This means that, while there may well be many issues of pension fund management that are relevant when thinking about the New Zealand Superannuation Fund, not all aspects of pension fund management will carry over automatically. In particular, both the scope of responsibilities and the fiduciary duties of members of the Fund's governing body are somewhat different than those of

¹⁰ See, for example, Palacios (Palacios 2002); McCulloch and Frances (2001b).

¹¹ Without parallel changes to the parameters for New Zealand Superannuation, these other policies would not directly reduce the future cost to the Crown of New Zealand Superannuation.

trustees of a typical pension fund. Further, the Fund has not been designed to ever fully finance the cost of New Zealand Superannuation. It is simply a smoothing mechanism for what remains fundamentally as a “pay as you go” unrequited benefit.

Since the Fund is not a superannuation scheme, it is not subject to the regulatory regime governing superannuation schemes in New Zealand.¹² However, as an investor, the Fund and the board are subject to the securities regulations in New Zealand and, presumably, in other jurisdictions in which the Fund invests. It has no exemption by virtue of being property of the Crown. Similarly, the financial statements of the Fund are required to follow the same financial reporting standards that apply to other reporting entities (public sector and private sector) in New Zealand.

¹² “Super annuation scheme” is the term used in New Zealand for pension funds. The Superannuation Schemes Act 1989 provides for registration of schemes, implied provisions of trust deeds, financial and actuarial reporting, members’ rights to information, and supervision by the Government Actuary. These are largely irrelevant to this Fund.

Features of Policy Design

In this part of the paper, references in square brackets are to relevant provisions in the New Zealand Superannuation Act 2001, unless otherwise noted. A copy of this legislation is available at <http://www.treasury.govt.nz/release/super/assent84.pdf>.¹³

The key features of the design of the governance arrangements for the New Zealand Superannuation Fund are summarised in the following statement:

A clearly defined portfolio of Crown financial resources, ... managed by an independent governing body ... with explicit commercial objectives ... and clear accountability.

The four elements of this statement form the basis of the explanation of the governance arrangements in this section.

Before going into that explanation, three points should be noted. First, these governance arrangements have been implemented as a complete and integrated package. They do not, by and large, represent a menu that can be picked and chosen from. This is because, as the World Bank points out, there are strong interdependencies among different parts of a fund's governance structure (Palacios 2002). For example, giving a board wide power for investment management could be compromised by partisan board appointments and, equally, a strong board of independent investment experts may be of little benefit if the investment strategy is predetermined politically. Second, once the "big picture" has been sketched out (as in the statement above) design of governance arrangements very quickly gets down to matters of relatively fine detail, any of which could turn out to be pivotal in the success of the overall policy. Third, these governance arrangements have been implemented in the context of the particular New Zealand environment. This includes a well-developed legal system, open capital markets, a strong public sector management system, and a small, relatively affluent economy. Different arrangements may be appropriate in a different context.

"A clearly defined portfolio of Crown financial resources ..."

The Fund will consist almost entirely of financial instruments that are, by their nature, highly fungible and that could be a temptation for governments, who face continual pressures to allocate more resources than they have at hand. An important element of the effectiveness of the policy is therefore being very clear about what assets comprise the **property of the Fund**, what **capital contributions** the Government is required to make to the Fund, and what **capital withdrawals** the Government can take from the

¹³ This is the version from when the legislation was originally enacted. There have since been some routine amendments to the benefits provisions, for example, to implement the annual update of benefit rates listed in Schedule One of the Act. However, the provisions relating to the Fund and its governance are unchanged. They can only be changed by Act of Parliament.

Fund. This is also important from the point of view of holding the board accountable for its administration of the Fund. The **credibility** of the policy and the Government's **commitment** to it also help define the portfolio in a forward-looking sense. Each of these bolded elements is expanded on in the sections that follow.

Property of the Fund

The New Zealand Superannuation Fund is not a separate legal entity.¹⁴ It remains a part of the Crown. In order to be clear about what assets comprise the Fund, the property of the Fund is defined in the legislation. It includes the capital contributions from the Crown, Fund investments, and the returns from investment [section 38]. As explained below, the governing board of the Fund, the "Guardians of New Zealand Superannuation", is a Crown entity that is separate from the Fund.

Capital Contributions

One way a future Government could seek to divert resources from the Fund is to limit the capital contributions that are intended to be made to the Fund over the next two decades or so. It was therefore important to be clear about what capital contributions are required to be made to the Fund. The policy objective is to smooth the cost of New Zealand Superannuation over time, based on a forty-year rolling horizon, as described above. The precise algorithm for calculating the level of capital contribution required from year to year to achieve this objective is stated in the legislation [section 43].¹⁵ Prior to the start of each financial year, the Treasury must calculate the amount of required capital contribution implied by this algorithm and publish it in the Budget Economic and Fiscal Update, along with a statement of assumptions [section 42].¹⁶

While it is important for the Government to commit as much as possible to meeting required capital contributions to the Fund, the Government is also required to adhere to the "principles of responsible fiscal management" set out in the Fiscal Responsibility Act 1994. These are [section 4(2), Fiscal Responsibility Act 1994]:

- (a) Reducing total Crown debt to prudent levels so as to provide a buffer against factors that may impact adversely on the level of total Crown debt in the future, by ensuring that, until such levels have been achieved, the total operating expenses of the Crown in each financial year are less than its total operating revenues in the same financial year; and
- (b) Once prudent levels of total Crown debt have been achieved, maintaining these levels by ensuring that, on average, over a reasonable period of time, the total operating expenses of the Crown do not exceed its total operating revenues; and

¹⁴ However, the Fund is treated as if it were a body corporate for tax purposes [section 76(3)].

¹⁵ For a detailed analysis of the calculation of the contribution rate, see McCulloch and Frances (2001a).

¹⁶ A key assumption is the expected long-term investment returns of the Fund (McCulloch 2002b), an important element of which is estimating the market equity risk premium (McCulloch 2002a).

- (c) Achieving and maintaining levels of Crown net worth that provide a buffer against factors that may impact adversely on the Crown's net worth in the future; and
- (d) Managing prudently the fiscal risks facing the Crown; and
- (e) Pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.

The Government is required by the Fiscal Responsibility Act 1994 to establish and articulate its long-term policy objectives in accordance with these principles. The obligation to make contributions to the Fund needs to sit alongside these objectives. It was therefore not appropriate for the Government to be absolutely bound to make the full capital contribution calculated by the Treasury.¹⁷ However, should it choose to contribute less than the required capital contribution, the Government must explain its actions in the same way that it must explain any departure from the principles of responsible fiscal management [section 44].

Capital Withdrawals

Another way a future Government could seek to divert resources from the Fund is to make capital withdrawals greater than, or in advance of, the rate of withdrawal implied by the capital contribution algorithm. This is dealt with in two ways. First, the legislation only allows capital withdrawals up to the amount implied by the legislated algorithm [section 47(1)]. Second, no capital withdrawal is allowed in any case before 2020 [section 47(2)].

The Government is also precluded from requiring the Fund to purchase New Zealand government securities, which would amount to a tacit withdrawal.

Policy Credibility and Commitment

The bulk of this policy could have been established administratively without new legislation.¹⁸ However, it would then have been at continual risk of policy reversal from myopic political pressures and other incentives on both politicians and officials (Davis 1998). Establishing the Fund through legislation was therefore one way to enhance the credibility of the policy and to signal the Government's commitment to it. This is because the Government cannot unilaterally change legislation. Only the Parliament can amend or repeal legislation.

The Government sought to further enhance the credibility and commitment to the legislation by strengthening the process for making amendments to it. However, this needed to be subject to the principle of the sovereignty of Parliament in New Zealand. This means that legislation cannot limit the practice of Parliament and, in particular, a

¹⁷ Current Budget forecasts indicate that the Government should be able to meet the required capital contributions for the foreseeable future without compromising the other fiscal objectives.

¹⁸ In particular, Ministers could have charged a government ministry with responsibility administering the assets that would be informally designated as belonging to the Fund. A parallel arrangement already exists for the management of Crown debt by the New Zealand Debt Management Office, which is a division of the Treasury with no separate legal standing (<http://www.nzdmo.govt.nz>).

future Parliament cannot be bound by legislation. It was therefore not seen as practical to try to “entrench” the legislation (for example, by requiring a super-majority to make amendments), nor to prescribe how the Parliament shall proceed with amendments. However, a requirement was placed on the Government, when introducing amending legislation, to report to Parliament on the consultation process that was followed in formulating the proposed amendment [section 73(1) and 73(2)].

“... managed by an independent governing body ...”

A **separate Crown entity** – the Guardians of New Zealand Superannuation – has been established [section 48]. The board of this entity is responsible for investing the Fund [section 58(1)]. Several features have been incorporated to limit political influence over the board’s decisions. The board is required to comprise individuals with **expertise** in investment management selected by an independent **nominating committee** and board members can only be **dismissed** for good reason. The board has full **powers to establish a fund management infrastructure** and **no other responsibilities** that could create confusion about its role. **Conflicts of interest** are explicitly catered for. The Minister’s **powers of direction** of the Fund are explicitly limited and must be consistent with the legislated investment objectives. However, central control or influence over **board remuneration** and some **employment conditions** remain with the Government. Each of these bolded elements is expanded on in the sections that follow.

Separate Crown Entity

The governing board of a fund such as this requires a secretarial infrastructure in order to carry out its functions. One possibility would have been for the board to establish its secretariat as a part of the Fund, drawing on Fund resources as required. However, the board’s expenses would be so small compared to the flows in the Fund as a whole that there would be no effective check on the board’s direct spending.¹⁹ In particular, some capability was required to ensure that the cost-effectiveness of the board itself could be monitored, and the risks of profligacy or “gold plating” minimised, thus avoiding adverse publicity that could undermine the credibility of the policy. It was therefore decided to establish the board as a separate legal entity – the “Guardians of New Zealand Superannuation” – with a budget separate from the Fund [section 52]. As a Crown entity, this body is subject to an existing well-developed accountability framework under the Public Finance Act 1989. This includes production of an annual statement of intent prior to the start of each year and an annual report including audited financial statements. These elements of the governance arrangements are discussed further below.

However, having both the Fund and a separate Crown entity responsible for its administration is likely to raise issues from time to time regarding whether a particular cost should be treated as an expense of the Fund or just as an expense of the Crown entity. A particular example is if the board decides to carry out a direct fund management function

¹⁹ There also is evidence from US state and local pension plans that the practice of permitting administrative expenses to be charged to fund income, rather than to the state or local budgets directly, is associated with reduced average returns (Mitchell and Hsin 1994).

in-house, rather than engaging a fund manager, this could be considered an expense that is appropriately charged on to the Fund. However, this is a matter for judgement in each instance. In any case, all expenses of the Crown entity are required to be met out of money appropriated by Parliament for the purpose [section 52].²⁰ Leaving this “grey area” in cost allocation was seen as an unavoidable implication in obtaining a balance between the independence of the board and its budget accountability.

Expertise Requirements

A board member can only be appointed “who, in the Minister’s opinion, has substantial experience, training, and expertise in the management of financial investments” [section 55(a)]. This requirement for technical expertise was included for three reasons. First, it makes clear that board appointments for this Fund are to be made on the basis of individual ability and not as interest group representatives. Evidence from US state and local pension plans is that non-expert interest group representation has resulted in lower fund performance (Mitchell and Hsin 1994, Romano 1993). Second, this requirement for technical expertise reiterates the singular objective of the board, which is to invest the Fund on a prudent, commercial basis. Third, the effectiveness of this board would be critical to the success of this policy. This requires board members with a strong understanding of the issues relevant to investment fund management. A concern to ensure appropriate expertise among governing bodies has also been expressed internationally. For example, the United Kingdom Government has announced that it proposes to legislate to require appropriate expertise and “familiarity with the issues” from pension fund trustees.²¹

There are no requirements regarding New Zealand citizenship or residency. These are not normally included as requirements for appointment to public bodies in New Zealand. In any case, with the relatively strong expertise requirements, restricting the board membership to New Zealand citizenship or residency could have unreasonably limited the pool of suitably qualified candidates.

There is no restriction in the legislation on appointing individuals who happen to be officials or board executives. This potentially could create issues of independence of the board. However, it is not a normal practice in New Zealand for boards of public bodies to include *ex officio* members, such as board employees, ministry officials or ministers, so specific legislation on this point was not seen as necessary.²²

²⁰ “Expense” has a relatively well-defined meaning that is consistent with generally accepted accounting practice [section 5(2) of the New Zealand Superannuation Act 2001 and section 2(1) of the Public Finance Act 1989].

²¹ 12 March 2003 speech by Ruth Kelly, Financial Secretary to the UK Treasury. http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2003/press_38_03.cfm.

²² Cabinet rules state that, in general, public servants should not be appointed to public bodies. See Cabinet Office Minute CO(02)5: <http://www.dPMC.govt.nz/cabinet/circulars/co02/5.html>

Nominating Committee

Partisan appointments to the board could potentially compromise its political independence. In order to mitigate this possibility, the Minister of Finance is required to make appointments only from a shortlist of candidates submitted by a nominating committee [section 56]. This procedure was adapted from similar provisions for appointment of the Canada Pension Plan Investment Board. However, it is a novel process for Crown entity or state-owned enterprise appointments in New Zealand.²³

The nominating committee is required to comprise at least four people “with proven skills or work experience that will enable them to identify candidates to the board who are suitably qualified” [section 56(2)]. A determined Government conceivably could use its power to appoint a partisan nominating committee in order to bias the nominations so this procedure is obviously not completely foolproof. However, it does add an additional element of independence to the whole appointment process.²⁴

The nominating committee for the inaugural board members followed the process set out in the discussion of the implementation experience below.²⁵ The nominating committee will need to be reconvened as required for new board appointments and reappointments.

Dismissal

Limiting the power of the Government to dismiss “politically unfavoured” board members helps to assure the independence of the board. However, this must be balanced against a need to be able to replace dysfunctional individuals who may be compromising the board’s effectiveness, or as the ultimate penalty for poor performance. Provision was therefore included to remove an individual for a reason that justifies the removal. This includes “any reason relating to the member’s performance, or ability to perform, his or her duties as a member, the board’s performance of its collective duties, or misconduct by the member.” [Schedule 3, clause 10]²⁶

A dismissed board member is not entitled to any compensation relating to removal from office [Schedule 3, clause 10(6)].

²³ Appointment of chief executives of New Zealand government departments does follow an independent process, in which the State Services Commissioner selects and recommends the candidate. If the Government chooses to appoint someone else, this must be disclosed publicly.

²⁴ The legislation does not preclude officials from being on the nominating committee. However, in the New Zealand environment, it was taken as given that officials would not normally be appointed to a committee such as this. See also footnote 22.

²⁵ See page 36.

²⁶ Members’ duties includes ensuring the Crown entity acts efficiently and effectively, consistently with its functions and powers, and in a financially responsible manner [Schedule 3, clause 7(2)]. Members are required to act in good faith, with reasonable care diligence and skill, and with honesty and integrity [Schedule 3, clause 7(1)].

Power to Establish Fund Management Structure

The board has wide administrative powers to enable it to carry out its function of investing the Fund [sections 49 and 53]. Specific provision was also included that the board may appoint investment managers and custodians [sections 62 and 63]. This may not have been strictly necessary because the board's broad powers probably already allowed this. However, the provisions already existed in the legislation of another public body with an investment function so, as a matter of drafting practice, it was included here as well to avoid any doubt.

One possibility could have been to require an existing agency, such as the Reserve Bank or the Treasury, to act as custodian or fund manager. There were two reasons for not pursuing this. First, there was a desire to avoid any perception of the Government placing constraints on the operation of the Fund that could be used as an excuse by the board for poor performance, or that could be seen as limiting the independence of the board in its investment decisions. Second, these agencies do not have particular experience as a custodian or fund manager across the range of financial instruments held by the Fund and no obvious competitive advantage over private sector firms in providing these services.

No Other Responsibilities

The board's sole function is to manage and administer the investment of the Fund [sections 51(1) and 58(1)]. In particular, it does not administer the benefits payment system, it has no responsibility for determining the levels neither of benefits nor of the Crown's capital contributions or withdrawals, and it does not administer any other funds. This avoids confusion about the board's role and it limits the possibility of the board's independence being compromised in carrying out that role.

Conflicts of Interest

In a small capital market like that of New Zealand, there is only a limited pool of suitably qualified candidates available for appointment to a board such as this. This is even though there is no residency requirement for appointment to the board. Conflicts of interest will therefore inevitably arise from time to time for individual board members. The emphasis therefore is not so much on avoiding conflicts of interest altogether, but more on ensuring that appropriate systems are in place for their identification and management. Examples where conflicts could arise include adviser appointments, manager appointments, and individual investment choices.

The legislation provides for conflicts of interest by requiring board members to disclose any relevant interests as they arise, and to stand aside from deliberation and decisions regarding the matter [Schedule 3, clauses 19 to 25]. This was seen as an important requirement for ensuring financial markets have confidence in the integrity of the Board. An active conflict of interest can also arise in the use or disclosure to others of inside information that is only available to a board member in that capacity. This is also proscribed [Schedule 3, clause 26]. In addition, the board and the Fund are subject to securities regulation in New Zealand and in other jurisdictions in which they might invest.

Management of conflicts of interest is also emphasised in the administrative processes surrounding appointments. This is reflected in the appointments process set by the Cabinet Office and in the guidelines published by the State Services Commission.²⁷

Ministerial Direction

With the desire to design the governance arrangements so that the board operates as independently as possible of the government of the day, it may seem strange that the legislation includes a power for the Minister to give directions to the board [section 64]. However, this provision is drafted so that a direction cannot be inconsistent with the board's duty to invest the Fund on a prudent, commercial basis and the direction is required to be published. Further, the board only has to "have regard to" a direction, not necessarily to comply with it blindly. Although this arguably renders a direction little different from any comment the Minister might care to make, this was seen as an important provision to make it clear that, despite the explicit independence of the board, the Government is nonetheless entitled to express a view about its expectations as to the Fund's performance.

No ministerial directions have been made to date.

Board Remuneration

The level of board members' remuneration is an important issue because the remuneration needs to be set at a level sufficient to attract appropriately qualified individuals, but without creating a perception of profligacy. It is long-standing Government policy in New Zealand that appointments to state bodies follow standard remuneration guidelines and that a responsible Minister can depart from those guidelines only after consultation with the State Services Commissioner.²⁸ The guidelines are relatively detailed and are based on criteria designed to determine the size of the role. This is implemented in the legislation by requiring the Minister to approve board members' remuneration [Schedule 3, clause 12].

Having the Minister set board members' remuneration raises the potential for political influence. An alternative practice could have been to leave it as a matter for the board to determine. For example, the Canada Pension Plan Investment Board is required to set its own remuneration and benefits "having regard to the remuneration and benefits received by persons having similar responsibilities and engaged in similar activities" [Canada Pension Plan Investment Board Act of 1997, section 10(10)]. This approach was not adopted for the New Zealand Superannuation Fund because of a desire to remain consistent with the standard remuneration guidelines that apply to New Zealand Crown entities.

²⁷ See <http://www.dPMC.govt.nz/cabinet/guide/6.html> - 6.27 and <http://www.ssc.govt.nz/board-appointment-guidelines>.

²⁸ See Cabinet Office Minute CO(01)8: <http://www.dPMC.govt.nz/cabinet/circulars/co01/8.html>

Employment Conditions

A related constraint on the board is that it must consult with the State Services Commissioner and the Minister of Finance regarding the conditions of employment of its chief executive officer [Schedule 3, clause 46]. Like the requirement for consultation over board remuneration, this is a standard requirement in New Zealand for Crown entities. The chief executive officer can appoint other employees without further external consultation [Schedule 3, clause 47].

The legislation also includes other standard provisions that are applied to New Zealand state sector bodies. These include requirements to provide safe working conditions and equal employment opportunities [Schedule 3, clause 48]. These are considered to be moral obligations of any good employer.

“... with explicit commercial investment objectives ...”

The **legislated investment objectives** for the Fund provide a complete basis for the administration of the Fund. The Guardians must invest the Fund on a prudent, commercial basis and, in doing so, must manage and administer the Fund in a manner consistent with best-practice portfolio management; and **maximising return without undue risk to the Fund as a whole**; and **avoiding prejudice to New Zealand’s reputation as a responsible member of the world community**.

The Fund is subject to the same **taxation** regime as other privately owned entities. However, constraints have been put in place over the ability of the Fund to **borrow** money and to take **control over companies**. There are no constraints – neither maxima nor minima – over **domestic investment**.

Each of these bolded elements is expanded on in the sections that follow.

Legislated Objectives

The legislation explicitly sets the investment objectives for the Fund [section 58]:

The Guardians must invest the Fund on a prudent, commercial basis and, in doing so, must manage and administer the Fund in a manner consistent with—

- (a) best-practice portfolio management; and
- (b) maximising return without undue risk to the Fund as a whole; and
- (c) avoiding prejudice to New Zealand’s reputation as a responsible member of the world community.

Along with any non-binding ministerial “direction” as to the Government’s performance expectations (discussed above), the board is free to interpret these objectives in determining the investment strategy for the Fund.

A key element of the policy was that the Fund would not be available to the government of the day to use for any other purpose. This requirement placed a clear boundary on the scope of investment objectives for the Fund. It implied that the investment strategy must be value-maximising for the Fund as a distinct unit and that this is the primary investment objective. It implicitly excluded other potential objectives for the investment strategy, including:

- broader social outcomes;
- performance of the domestic economy; and
- financial and fiscal management of the Crown as a whole.

The poor performance internationally of public pension funds is largely attributable to investments being directed into these areas (Iglesias and Palacios 2000). This does not imply that these are unimportant areas that the Crown should not devote resources to. However, they are distinct from the purpose of the Fund. If it is good public policy to devote Crown resources to these areas, there is no reason for it to be done through the Fund.

Broader Social Outcomes

There is a range of broader social outcomes the investment objectives could have been applied toward achieving. These include:

- Limitations on investment in socially undesirable firms and industries. Possible areas include tobacco, genetic modification, native forest logging, polluters, unsustainable fishing, disfavoured nations, weapons, gambling, and alcohol.
- Requirements to invest commercially in particular areas. Possible areas include regional development, reducing foreign ownership of local firms, hospitals, high technology, and venture capital.
- Requirements to invest "socially" in particular areas. That is, to invest/spend money in areas where there is not a full commercial return to the Fund, but some social outcome is achieved. This includes grants, sponsorships, fellowships, soft loans, etc. Topical areas include sport, culture, education, research, ethnic policy, subsidised housing, aid to distressed firms and public infrastructure.

All of these areas of broader social outcomes are clearly excluded by the sole purpose of the Fund being to finance New Zealand Superannuation. Of course, it may well be that there are good commercial reasons for the Fund, for example, to provide venture capital, or to avoid firms with tobacco interests. However, it was determined that such decisions would be made on a commercial basis, and not by compromising the performance of the Fund. Within that, the Fund is required to “avoid prejudice to New Zealand’s reputation as a responsible member of the world community” [section 58(2)(c)] and to disclose its policy regarding ethical investment [section 61(d)]. These provisions are discussed further below.

Performance of the Domestic Economy

A large government-controlled portfolio of financial assets potentially could be used to contribute to active management of the domestic economy. The investment objectives could possibly be designed to enable a host of economic variables to be affected, including exchange rates, interest rates, levels of investment in the domestic economy generally or in specific sectors, domestic market depth and liquidity.

However, as for the social outcomes discussed above, achieving outcomes for the domestic economy would be likely to compromise the primary objective of financing New Zealand Superannuation. Further, other, more transparent instruments are available to the Government pursue these outcomes.

Financial and Fiscal Management of the Crown as a Whole

The third area of potential influence on the investment strategy is implications for the financial and fiscal management of the Crown as a whole. This area is not as easily excluded as the other areas. This is because the Fund is a part of the Crown and its capital and returns ultimately revert to the Crown. The Crown therefore bears the full financial risk of the Fund. The Fund will comprise a large proportion of the Crown's financial assets for several decades and so there could well be significant financial synergies to the benefit of the Crown as a whole if the investment objectives for the Fund took into account those Crown-wide interests. Examples of possible financial synergies across the Crown include:

- Credit risk management: coordinating investments across the Crown to avoid excessive overall exposure to default on a particular type of investment.
- Crown portfolio composition: directing the composition of the Fund's assets to construct a desired overall Crown portfolio. For example, the Crown is already highly exposed to the domestic economy so there are likely to be diversification benefits for the Crown as a whole from weighting the Fund's portfolio more heavily in international assets. The Fund is likely to be large relative to other financial stocks and flows of the Crown so its portfolio effect could be significant.
- Natural hedges: identifying financial risks faced in different parts of the Crown that offset one another and so avoid undertaking extra transactions to manage those risks separately. For example, the exchange rate risk related to foreign-denominated financial assets held in one part of the Crown may be offset by financial liabilities in those currencies in another part of the Crown. The saving is from avoiding the costs of separately hedging each item.
- Risk pooling: self-insuring classes of uncorrelated risks across the Crown, rather than each sub-entity of the Crown separately insuring its own risks. This may not be a particular issue in the case of the Fund if it is large enough to undertake risk pooling on its own account.

- **Cash management:** pooling overnight surplus cash balances across the Crown to offset against debt. This is already done in respect of government departments' cash balances.

However, while it seems sensible to take advantage of such financial synergies across the Crown arising from the existence of the Fund, there is a fine line between integrated financial management in the interests of the Crown as a whole, and raiding the returns on the Fund to address short-term priorities other than New Zealand Superannuation. Given this fine line, and that the long-term financial interests of the Crown are best served by avoiding raiding, it was decided to explicitly state the investment objectives in the legislation and to focus the management of the Fund on those objectives, rather than on broader social or economic objectives. As discussed above, the ability of the government of the day to direct the Fund was limited to non-binding statement about the Government's expectations as to the Fund's performance.

Stability

Establishment of the Fund was intended to bring a measure of stability to retirement income policy. The investment strategy adopted could affect whether this stability is achieved by affecting the likelihood of policy reversal. This made stability a potentially relevant investment objective, especially as the Fund would very likely be investing in risky capital markets. In adopting a relatively risky portfolio, the chances are significant of the Fund performing poorly, especially over the short time horizons over which political performance is invariably judged. This has the potential to compromise the stability of retirement income policy if it raises doubts about the effectiveness and the longevity of the Fund. In particular, if there is poor financial performance over the first few years of the Fund, political resolve to stay independent of the Fund may evaporate, along with public confidence and support. This was recognised in the legislated investment objectives by requiring the Fund to be managed on a "prudent, commercial basis" [section 58(2)]. This term is clearly subjective but it did give the flavour of the balance of stability that was being sought.

Maximising Return without Undue Risk to the Fund as a Whole

The requirement of maximising return without undue risk to the Fund as a whole recognises the relationship between risk and return inherent in capital market investment. It is up to the board to determine what constitutes "undue risk" and to determine the appropriate balance between risk and expected return.

The specification that the risk relates to the Fund "as a whole" is an important element. It recognises that the Fund is to be treated as a portfolio, so the relevant risk of an individual investment is its contribution to overall portfolio risk.

Avoiding Prejudice to New Zealand's Reputation

There was a concern that the independent, commercial flavour of the objectives be tempered by recognition that the Fund is ultimately a part of the Crown and should behave accordingly. This was reflected in the clause on "avoiding prejudice to New Zealand's

reputation as a responsible member of the world community.” This is arguably an implicit requirement on all agencies responsible for public money and public affairs. Including this provision explicitly in the legislation was seen as necessary to ensure that this implicit obligation was not overlooked by a board with an independent mandate explicitly charged to meet commercial objectives.

It has been argued that including this clause is a defect in the policy because it makes it impossible to hold the board accountable for financial returns since it can always use that clause as an excuse for any poor performance (Pozen 2002).²⁹ There are two reasons to doubt this. First, the legislation requires the statement of investment policies to state the board's policy regarding the "avoiding prejudice" clause [section 61(d)]. This means that the board cannot use this clause an ex-post "excuse" for poor performance. Second, the sentiment underlying that clause is arguably an implicit requirement on all agencies responsible for public finances.

Taxation

The Fund is subject to the same income tax regime as other equivalent privately owned entities [section 76]. This is despite the fact that the Fund is property of the Crown so that the Crown is effectively just taxing itself. The reason for having the Fund subject to tax arises from the strong independence of the board in making its investment decisions. In particular, if the Fund was not subject to tax there could be some undesirable outcomes that the Government would not be in a position to mitigate through other controls over the board's activities. There are two main sources of undesirable outcome.

First, if the Fund were not subject to tax, the fund managers would have strong incentive to maximise their returns by engaging in avoidance behaviour in concert with other, taxed, entities, and effectively rorting the New Zealand tax system. Current tax-exempt organisations, such as charities, have engaged in complicated schemes to take advantage of this kind of opportunity. Fund managers might not see any inconsistency in engaging in this kind of activity, despite the fact that the Fund is owned by the Crown, as they may argue that their responsibility is to maximise returns to the Fund alone. It would be irrelevant to them that they are not maximising returns to New Zealand as a whole. Further, taxable entities and their advisers will also face strong incentives to manufacture schemes and encourage the Fund to engage in joint ventures with them. This incentive would increase through time as the Fund's resources grew, and the magnitude of the risk to the integrity of the tax base would rise with it. It was not considered possible to implement governance restrictions that would accurately replicate the effect of making the Fund taxable. Governance structures that remained robust over the long life of the Fund would have been particularly difficult to formulate given the ongoing development of new financial structures and instruments, and the ingenuity of professional tax planners.

Second, if the Fund were not subject to tax, it would have an incentive to avoid investments in entities subject to New Zealand tax. This could lead it to own businesses

²⁹ He also asserts that this clause was included "because of legislative pressures". In fact, this clause was included in the original draft bill that was introduced to the legislature.

outright rather than investing through a company intermediary,³⁰ or to favour investments that did not carry the tax imputation credits that taxpayers value (such as fixed interest investments or equities that do not pay New Zealand tax). Neither of these is necessarily favourable as far as the Crown as a whole is concerned.

A consequence of having the Fund subject to tax is that, since the board's responsibilities only relate to the Fund, their natural focus would be on maximising the after-tax returns of the Fund. However, the Crown benefits not only from the capital withdrawals that ultimately will be made from the Fund but also from the tax receipts from the Fund over its life. It is therefore the total returns of the Fund that are relevant to overall Crown financial management. This begs the question of whether it might be better for the Crown as a whole if the board were to focus on maximising pre-tax returns, rather than after-tax returns.³¹ Even if we assume that the behavioural outcomes described above could be mitigated, it is not self-evident which of these alternative Fund objectives would result in a Fund investment strategy that was better for the Crown as a whole. This would require taking into account the financial characteristics of the rest of the Crown's portfolio, including its financial instruments (assets and liabilities), real assets, and expected future tax and benefit flows.³² It is an issue that we have examined on various dimensions over time (Bradbury, Brumby and Skilling 1999, Davis 2001, Davis and Fabling 2002, Grimes 2001, Huther 1998). The main firm conclusion to arise from this body of work is that public policy is likely to be best served by holding each financial sub-entity of the Crown responsible for its own strategic asset allocation on the basis of its own assets and liabilities. The decision to have the Fund subject to tax was therefore made on the basis of avoiding the potential undesirable outcomes that could arise with a strongly independent, tax-free Fund. This does not preclude the board from having an eye to the multiple interests of the Crown in respect of the Fund,³³ but it does make it clear that the Fund's status as a part of the Crown is not to be traded on.

No Borrowing

The Fund is ultimately property of the Crown [section 40]. Borrowing by the Fund, including the incurrence of liabilities or contingent liabilities, is therefore equivalent to Crown borrowing.³⁴ It was considered that if it was sensible for the Crown as a whole to

³⁰ The provision precluding taking control over companies [section 59] does not resolve this because the most likely strategy to avoid paying tax altogether would be to dismantle the company structure and then run the business directly as an unincorporated venture of the Fund.

³¹ This issue is particularly relevant in New Zealand, where the tax rules for funds of this type favour a strongly passive investment strategy (because capital gains are not taxed in that situation). However, it requires a ruling from the revenue authority in the case of each taxpayer who seeks to use this tax concession, and it is quite possible that the Fund would not be granted a favourable ruling.

³² For example, the Crown already has a significant exposure to domestic capital markets through its tax base, it has a heavy negative exposure to New Zealand government securities, and it has significant exposure to particular industries through its state-owned enterprises.

³³ Indeed, the board's performance is likely to be examined publicly along a range of dimensions.

³⁴ Since the Fund itself is not a Crown entity or body corporate, section 54 of the Public Finance Act 1989 (regarding Crown not being liable for the debts of Crown entities) does not apply.

increase its borrowing, this was better done in a coordinated fashion by the New Zealand Debt Management Office.

However, there are various types of transaction that it might be sensible for the Fund to undertake as part of a prudent commercial investment strategy that are technically borrowing and involve incurring liabilities or contingencies. While some examples can be immediately identified (normal credit terms, certain types of financial instrument that are used to manage risks, capital calls, etc.) the full range of such transactions cannot be easily categorised and legislated for in advance. The legislation therefore provided that borrowing (and this was defined widely) is not allowed except with the approval of the Minister of Finance in respect of a transaction or a class of transactions [section 50].

Control Over Companies

The Fund is intended to be a portfolio of financial investments, not an operator of businesses. Further, if the Fund was to end up controlling other entities, there could be wide-ranging consequences. There is a range of legislation that applies specifically to the Crown and the entities under its control. These include the Public Finance Act 1989, the Public Audit Act 2001 and the Official Information Act 1982. These place obligations on Crown-controlled entities, and constraints on their operations. Further, under the accounting principles that the Crown is required to follow, all entities ultimately controlled by the Crown must be included in the Crown Financial Statements. Another consequence is that, if the Crown ultimately controlled an entity, there could be an implied guarantee by the Crown of the entity's liabilities in case of financial difficulty.³⁵ In order to avoid these consequences, the Fund was precluded from taking controlling interests in other entities [section 59].

A proscription on taking controlling interests is not thought to be a significant constraint on the Fund's behaviour because normal practice for private investment funds also is to avoid controlling interests. There are two main reasons for this. First, holding a controlling interest in a business limits the liquidity of that investment. Second, the controlling owner inevitably gets drawn into strategic management issues that require a closer operational involvement than that usually sought by a portfolio investor. This provision therefore was not seen as a significant limitation on the ability of the Board to administer the investment of the Fund.

If it makes good public policy (including economic, social and/or environmental policy) for the Crown to have ownership control of a particular business, it would be better for the Government to make that decision directly. This is because the Government would be better placed than the board to determine what constitutes good public policy and it would be better for the investment to be made directly by the Crown and not through the Fund because having the Government direct the board on investment strategy would compromise the board's independence.

³⁵ This implied guarantee could possibly arise despite the provision in section 54 of the Public Finance Act 1989 that states that the Crown is not liable for the debts of Crown entities.

Limiting control over companies conceivably could result in the board having to forego a commercial investment opportunity that required taking control of a company. In the context of a large, widely diversified fund, this should not be a significant problem. In particular, it does not preclude the Fund having investments in particular sectors in which taking a controlling interest is a common investment strategy (for example, venture capital and real estate) because various facilities are available that enable individual investors to jointly invest through an investment manager without any one investor taking a controlling interest in any individual company.

Domestic Investment

Consideration was given to whether there should be constraints, either maxima or minima, on the level of domestic investment by the Fund. No such constraints were implemented for several reasons. First, if legislating to require greater domestic investment by domestic investment funds was good public policy, there was no reason why this constraint should be placed on the Fund alone and there was no political will to place domestic investment constraints on all domestic funds.³⁶

Second, the Crown is already heavily exposed to the New Zealand economy through its tax base. It therefore was not clear that a binding minimum on domestic investment would be in the best interests of the Crown. Further, as noted above, the Government would be better placed to make such investment decisions directly and not through the Fund.

Third, as a practical drafting matter, distinguishing between domestic entities and overseas entities is problematic. New Zealand is a small economy. Its growth and prosperity depends on its interaction with international markets, both suppliers and customers. Many New Zealand-owned entities have significant overseas operations and many significant domestic activities are undertaken by entities that are partly or entirely foreign-owned. Without being specific about what public policy objective is being achieved in each particular instance, it was not possible to draft a definition of “New Zealand entity” that was both narrow enough to be meaningful, and broad enough to capture the full range of potential businesses that it could conceivably be good public policy for the Crown to own.

A related issue was whether there should be constraints on the Fund owning domestic government stock. One potential way for a Government to make a “backdoor” raid on the assets of a public fund would be to require the fund to be invested in domestic government stock.³⁷ However, as noted above, the provisions for the New Zealand Superannuation Fund do not allow the Government to direct the investment strategy. This policy risk is therefore avoided. It was therefore decided not to preclude the Fund from owning domestic government stock, should it choose to do so.

³⁶ This contrasts with some other jurisdictions, such as Canada, where their “Foreign Property Rule” limits the proportion of investment funds that can be allocated to “foreign” assets.

³⁷ Requiring a public fund to invest in government stock is not necessarily an illegitimate action. It effectively transfers responsibility for risk and investment management of that money to the centre. Depending on the relative governance arrangements, this could well be the most efficient means of overall financial management.

“... and clear accountability.”

Personal liability of board members is limited and, as noted above, dismissal powers are also limited. The focus is therefore on public accountability. The board is required to establish a **statement of investment policies, standards, and procedures**. Before the start of each year, the board is also required to include information about its plans for the Fund in its **statement of intent**. At the end of each year, the board is required to produce **audited financial statements** for the Fund, which are to be included in the board’s **annual report to Parliament**. This emphasis on self-reporting is balanced by a requirement for a periodic **independent performance review** of the practice of the board and the performance of the Fund. The board is also required to **report to the Minister** on request and to disclose **official information** publicly on request. Being property of the Crown, the Fund and the Guardians Crown entity are included in the consolidated **Crown financial statements**. Each of these bolded elements is expanded on in the sections that follow.

Personal Liability of Board Members

There are two aspects to the personal liability of board members: immunity and indemnity.

- **Immunity:** Board members acting in good faith are not personally liable to the Fund for any liability of the Fund, nor for any deed or misdeed of the board or of its functionaries [Schedule 3, clause 8(1)]. This is a common provision for members of public bodies.
- **Indemnity:** Board members acting in good faith are indemnified by the Fund for any civil liability or for the cost of a successfully defended criminal action [Schedule 3, clause 8]. This also is a common provision in recent legislation for New Zealand Crown entity board members. It is similar to the provisions that apply to private sector corporations in New Zealand [Companies Act 1993, section 162].

These immunities and indemnities provide important protection for board members who act in good faith. However, it does underscore the importance of appointing board members who are suitably qualified. These immunities and indemnities also apply to board employees [Schedule 3, clause 8(4)].

As noted above, a board member can be dismissed for “any reason relating to the member’s performance of, or ability to perform, his or her duties or responsibilities as a member, the board’s performance of its collective duties, or misconduct by the member.” [Schedule 3, clause 10(2)] However, in the New Zealand environment, this provision is unlikely to be used on a routine basis as a sanction on board members if the Fund performs poorly. Nonetheless, this provision does provide an ultimate backstop against dysfunctional board members.

Statement of Investment Policies, Standards and Procedures

The board is required to establish, and adhere to, investment policies, standards and procedures that are consistent with its duty to invest the Fund on a prudent, commercial

basis [section 60(1)]. They must be reviewed at least annually [section 60(2)], a statement of them must be included in the board's annual report [section 68(e)], and the board and chief executive must certify annually whether or not they have been complied with [section 60(f)]. In addition, the periodic independent performance reviews (discussed below) must evaluate their appropriateness and the board's compliance with them.

Without limiting what a statement of investment policies, standards and procedures can cover, the legislation requires it to include [section 61]:

- the classes of investments in which the Fund is to be invested and the selection criteria for investments within those classes; and
- the determination of benchmarks or standards against which the performance of the Fund as a whole, and classes of investments and individual investments, will be assessed; and
- standards for reporting the investment performance of the Fund; and
- ethical investment, including policies, standards, or procedures for avoiding prejudice to New Zealand's reputation as a responsible member of the world community; and
- the balance between risk and return in the overall Fund portfolio; and
- the fund management structure; and
- the use of options, futures, and other derivative financial instruments; and
- the management of credit, liquidity, operational, currency, market, and other financial risks; and
- the retention, exercise, or delegation of voting rights acquired through investments; and
- the method of, and basis for, valuation of investments that are not regularly traded at a public exchange; and
- prohibited or restricted investments or any investment constraints or limits.

Establishment of investment policies is routine practice in investment fund management. However the approach taken for the Fund has some distinguishing characteristics. First, the legislation makes clear that the board is responsible for setting these policies. The Government does not determine them. The listing in the legislation of topics to be covered is simply a disclosure requirement. It is not prescriptive of the particular policies, standards or procedures to be adopted. A particular example of this is the requirement for the statement to cover "ethical investment, including policies, standards, or procedures for avoiding prejudice to New Zealand's reputation as a responsible member of the world community" [section 61(d)]. This simply requires the board to have a policy regarding ethical investment. It does not prescribe any particular approach to, or emphasis on, ethical investment.³⁸ The latter phrase on "avoiding prejudice to New Zealand's reputation as a responsible member of the world community" comes from the investment objectives

³⁸ This is similar to the disclosure requirement placed on private pension funds in the United Kingdom under the Pensions Act 1995.

[section 58(2)(c)]. It was included here so as to obtain explicit disclosure of the board's policies in that regard.

Second, public disclosure of the statement of investment policies, standards and procedures provides a basis by which the public can judge the board's management of the Fund. Third, the disclosure is not simply a statement of good intentions. Both the board and the chief executive are required to certify compliance with the statement of investment policies, standards and procedures [section 68(f)].

The statement of investment policies, standards and procedures also provides the vehicle for disclosure of the board's investment strategy for the Fund, by requiring coverage of "the classes of investments in which the Fund is to be invested and the selection criteria for investments within those classes; and the determination of benchmarks or standards against which the performance of the Fund as a whole, and classes of investments and individual investments, will be assessed".

The required disclosures are not necessarily all the board would disclose in its statement of investment policies, standards, and procedures. The board's obligation to manage and administer the Fund in a manner consistent with best-practice portfolio management [section 58(2)] may well result in additional information being included in this statement.

Statement of Intent

A feature of the accountability requirements for Crown entities of any significant size in New Zealand is the publication of a statement of intent at the start of each financial year [Public Finance Act 1989, Part V]. As noted above, the corporate form of the governing body of the Fund is a Crown entity, the "Guardians of New Zealand Superannuation", that is separate from the Fund itself. Since it is listed in the Sixth Schedule of the Public Finance Act 1989, this Crown entity is required to produce a statement of intent covering a range of issues relating to the administration of the Crown entity for the coming year, including its objectives, nature and scope of activities, performance targets, and accounting policies. Some additional disclosure requirements have been added to the requirements for the Guardians' statement of intent in order to provide ex ante information about the board's intentions for the Fund for the period ahead. These are [section 65]:

- a statement of the board's expectations about the performance of the Fund over the next financial year, in sufficient detail to enable meaningful assessment against those expectations after the end of that financial year; and
- a statement of the key risks to the performance of the Fund over the coming year and the actions being taken by the board to manage those risks; and
- forecast financial statements of the Fund for the next financial year, including a statement of accounting policies.

Regarding forecast financial statements for the Fund, the performance of the Fund will depend very much on the performance of volatile equity markets, so the predictive value of these forecasts is therefore limited. They will, nonetheless, provide information about the board's expectations for the behaviour of the Fund over the coming year. Forecasts

financial statements for the next four years for the Crown as a whole, including the Fund, are included in the *Budget Economic and Fiscal Update* and in the *December Economic and Fiscal Update*.³⁹

Audited Financial Statements

The board is required to produce annual financial statements for the Fund that follow generally accepted accounting practice [section 66].⁴⁰ This is common to all public sector and private sector reporting entities in New Zealand.⁴¹ This includes full accrual accounting and consistency with financial reporting standards.

Since the Fund is property of the Crown, its financial statements are required to be audited by the Auditor-General [section 67].⁴² The audited financial statements are then required to be included in the board's annual report to Parliament [section 68]. Normal practice is then for a committee of Parliament to scrutinise such reports in public and to call board members or officials to answer questions, usually in public.

The Auditor-General also has wide powers under the Public Audit Act 2001 to review the performance of any part of the Crown, including both the Fund and the Guardians Crown entity.⁴³

Annual Report

Another common feature of the accountability requirements on Crown entities in New Zealand is the production of an Annual Report after the end of each financial year [Public Finance Act 1989, Part V]. In addition to the standard requirements relating to the Guardians Crown entity, the board's annual report is required to include the following information regarding the Fund [section 68]:

- the financial statements of the Fund for that financial year prepared under section 66; and
- a statement of responsibility for the financial statements of the Fund, signed by the chairperson of the board and the chief executive of the Guardians (if any), and comprising the

³⁹ See <http://www.treasury.govt.nz/budgets/>.

⁴⁰ In New Zealand, the term “generally accepted accounting practice” is used with the same meaning as the term “generally accepted accounting principles” that is used in other jurisdictions.

⁴¹ New Zealand financial reporting standards are largely consistent with the financial reporting standards published by the International Accounting Standards Board (<http://www.iasb.org.uk/>). The Accounting Standards Review Board (<http://www.asrb.co.nz>), which sets financial reporting standards in New Zealand, has announced that it intends to require international financial reporting standards to be adopted in full by all New Zealand reporting entities by 2007.

⁴² Much of the financial statement audit work of the Auditor - General is tendered out to private sector audit firms, especially where specialist industry expertise may be required. This is yet to be determined for the Fund.

⁴³ See <http://www.oag.govt.nz> for detail about the functions and powers of the Office of the Auditor - General, including a copy of the Public Audit Act 2001.

same statements that are required by section 42(2) of the Public Finance Act 1989 as if the Fund were a Crown entity;⁴⁴ and

- the audit report on the financial statements; and
- an analysis and explanation of the performance of the Fund over that financial year, including a comparison with the Guardians' expectations about the performance of the Fund that were set out in the statement of intent relating to that financial year; and
- a statement of the investment policies, standards, and procedures for the Fund established by the Guardians under section 60; and
- a statement signed by the chairperson of the board and the chief executive of the Guardians (if any) certifying whether or not the investment policies, standards, and procedures for the Fund have been complied with throughout that financial year; and
- a schedule of the investment managers and custodians used by the Guardians during that financial year and the classes of investments for which each was responsible.

The board's obligation to manage and administer the Fund in a manner consistent with best-practice portfolio management [section 58(2)] may well result in additional information about the Fund being included in this annual report. For example, both the Canada Pension Plan Investment Board and the Norwegian Petroleum Fund disclose detailed lists of their holdings at year-end.

Normal parliamentary practice is for Crown entities' annual reports to be referred to a select committee of Parliament for its consideration. Board members or officials may well be called before the committee, usually in public, to answer any questions about the board's administration of the Fund and the Fund's performance.

Performance Review

The main mechanism of the accountability arrangements described above is self-reporting by the board of its practice and performance, along with scrutiny by a parliamentary select committee. Provision has also been made for an independent review of the performance of the board to be commissioned and published at least once every five years [section 71]. The reviewer is required to form an opinion about:

- whether or not the investment policies, standards, and procedures, established by the Guardians are appropriate to the Fund; and
- whether or not the investment policies, standards, and procedures, established by the Guardians have been complied with in all material respects; and
- the investment performance of the Fund.

⁴⁴

In the statement of responsibility, the chairperson and chief executive take responsibility for the preparation of the annual financial statements and the judgments used therein, along with responsibility for establishing and maintaining a system of internal control designed to provide reasonable assurance as to the integrity and reliability of financial reporting. They also make a statement that, in their opinion, the annual financial statements for the financial year fairly reflect the financial position and operations of the Fund.

This provision for a regular performance review was included in the legislation despite that fact that the Minister already has the power to commission such a review. It was included for two reasons. First, without specific authority, a detailed review such as this might have been interpreted as a challenge to the board's independence. Second, setting a schedule for the process overcomes the political inertia that would result in such a review being avoided until problems are clearly apparent, by which time it may well be too late to be effective.

Reporting to Minister

There is a range of information requirements to enable the Minister and Treasury to monitor the operation of the Fund and to meet broader Crown accountability requirements over time. For example, regular information on Fund performance is required for inclusion in Budget forecasts, and in the monthly and annual Crown financial statements. There is therefore a general provision to produce information to the Minister as required [section 69].

Official Information

The board is subject to the Official Information Act 1982. This legislation applies the principle that all official information is to be publicly available on request unless there is good reason for withholding it.⁴⁵ An exception allowed in the legislation is when disclosure could prejudice the commercial activities of the entity or of the Crown. However, the general rule is that information is to be made available and a case for withholding information needs to be made in each circumstance. An independent Office of the Ombudsmen rigorously investigates complaints against agencies for withholding information.⁴⁶

Crown Financial Statements

The Fund is property of the Crown [section 40]. It is therefore included in the Crown financial statements.⁴⁷ These are required to be produced monthly throughout the year, with audited financial statements being produced annually.⁴⁸ These provide an additional layer of information that puts the performance of the Fund into the context of the financial management of the Crown as a whole.

Policy Development in Public Sector Management

The accountability requirements (and the governance arrangements, generally) regarding the Fund are built around, and expand on, the existing well-developed framework of accountability that applies to all New Zealand Crown entities. This overarching framework

⁴⁵ For more detail, see: http://www.justice.govt.nz/pubs/other/pamphlets/2001/info_act.html.

⁴⁶ <http://www.ombudsmen.govt.nz>

⁴⁷ The Guardians Crown entity is also owned by the Crown and therefore also included in the Crown financial statements along with all other Crown entities.

⁴⁸ See <http://www.treasury.govt.nz/financialstatements/>.

is subject to continuous improvement. In particular, there is current interest in increasing the consistency of governance arrangements across the Crown and in ensuring that mechanisms are in place so that “whole of government” objectives can be required to be pursued by the individual entities on a consistent basis. This could lead to specific governance arrangements described in this paper being modified over time.

Implementation Experience

The timeline for the establishment of the Fund is summarised in Table 1 and is explained in more detail in the following sections.

Table 1: Timeline of Events

November 1999	Labour Coalition Government formed following General Election.
November 2000	New Zealand Superannuation Bill introduced to Parliament.
June 2001	Bill reported back from Finance and Expenditure Committee of Parliament.
July 2001	The Government starts to set aside amounts for capital contributions to the Fund. \$600 million for 2001/02, in fortnightly instalments.
October 2001	New Zealand Superannuation Act is passed and becomes law.
October 2001	Nominating committee appointed.
March 2002	Public information campaign of the Fund, including TV adverts, a brochure mailed to households, and an information website.
June 2002	Proposed board members announced and consultation commenced.
July 2002	The Government continues to set aside amounts for capital contributions to the Fund. \$1,200 million for 2002/03, in fortnightly instalments.
July 2002	General Election. New Labour Coalition Government formed.
August 2002	Board of Guardians of New Zealand Superannuation appointed.
February 2003	Investment advisor (Mercer) appointed following a competitive selection process.
February 2003	Chief executive appointed. Commenced position March 31.
Pending ⁴⁹	Appointment of advisor for investment manager selection.
Pending	Investment managers and custodian(s) appointed.
Pending	Capital contributions to date are drawn down by the board and investment strategy is implemented.

Development and Passage of Legislation

Establishment of the New Zealand Superannuation Fund was an explicit policy of the Labour Party leading into the 1999 General Election. Following formation of the Labour Coalition Government, a small team was established in early 2000 to fully develop the policy for implementation. This team's location in the Asset and Liability Management Branch of the Treasury reflected recognition at the outset that this was primarily an issue of Crown financial management. The policy was worked up during 2000 and legislation was introduced to Parliament at the end of that year.⁵⁰ Following normal parliamentary Select Committee scrutiny, the New Zealand Superannuation Act was passed into law in October 2001. In March 2002, the Treasury undertook an information campaign on behalf of the Government. This included a brochure that was mailed to households, a television commercial, internet banner advertisements, and an information website.⁵¹

⁴⁹ At the time of completion of this paper, the items marked "Pending" in this table were yet to be completed.

⁵⁰ The key policy papers are published at <http://www.treasury.govt.nz/release/super/>.

⁵¹ <http://www.superfund.govt.nz>.

Board Appointment

The nominating committee was appointed in October 2001 immediately following the passage of the legislation. It comprised five members chaired by Vance Arkinstall, chief executive of the Investment Savings and Insurance Association. This committee engaged an international executive search agency to assist them with the identification and selection of suitable candidates. They also advertised widely and consulted with a range of individuals. They reported back to the Minister of Finance in March 2002 with a shortlist of eleven nominations for the five to seven board positions. At the request of the Minister, the nominating committee gave further thought to the Government's desire to have balanced representation of New Zealand society on public bodies, and then provided a further two names, bringing the final shortlist to thirteen.⁵² The Minister decided to appoint six board members from this list, leaving one board position vacant in the meantime. He then consulted with the other political parties in Parliament [section 56(6)] before recommending the appointments to the Governor-General. The appointments were eventually made in August 2002 following a brief delay because of the General Election held in July.⁵³ The appointments were made for staggered terms in order to provide for continuity in the future when board members' terms expire.

At the time the inaugural appointments were announced, the Minister of Finance described the appointees as follows:

The Chair is **David May**, the Deputy Chair of the Government Superannuation Fund Authority and the former Managing Director of the Colonial Group in New Zealand. His term runs until the end of May, 2007.

Sir Douglas Graham is Deputy Chair and will also serve a five-year term. Sir Douglas was a cabinet minister in the last National-led government and chairs the Lombard Group, a private banking firm with assets under management of around \$100 million.

Other appointees are:

- **Dr Michaela Anderson:** Director of Policy and Research for the Association of Superannuation Funds in Australia. [Term expires 31 May, 2006.]
- **Ira Bing:** a private investor with a strong investment banking background in Britain and with Merrill Lynch in Europe. [31 May, 2005.]
- **Brian Gaynor:** a respected independent investment analyst and a director of the New Zealand Investment Trust Plc. [31 May, 2006.]
- **Bridget Wickham:** Chief Executive of the University of Auckland Development and an experienced senior company executive. [31 May, 2005.]

The legislation does not prescribe New Zealand citizenship nor residency for board members. Two of the inaugural members were not New Zealand citizens and one was not a New Zealand resident.

⁵² This request was the result of a decision by the Cabinet to seek greater diversity in board appointments generally. See Cabinet Office Minute CO(02)16: <http://www.dpmc.govt.nz/cabinet/circulars/co02/16.html>

⁵³ It is a convention in New Zealand that significant appointments arising immediately before a General Election are held over for the new Government to determine.

Fund Establishment

Since its appointment, the board has been working to establish its infrastructure. Consistent with the board's independence from the Government and to avoid any perception of Government constraint on operational matters of the Fund, no "pre-establishment" structure was put in place. The board has been entirely responsible for establishing its administrative arrangements.

After engaging an interim secretariat, the board went through a competitive process to select and appoint an investment adviser and other advisers.⁵⁴ This process included probity review by the Office of the Auditor-General.

The board also undertook a formal executive search process to appoint a chief executive. The plan at this stage is to engage a small executive staff and to outsource investment management.

At the time of writing this paper, the board was about to announce the appointment of an adviser to assist in the selection of fund managers and custodian(s). This selection process will commence once the board has determined the investment strategy and developed the statement of investment policies, standards and procedures.

The legislation requires a review of the board's performance to be conducted every five years, with the first review being carried out "as soon as practicable after 1 July 2003" [section 71]. When this provision was originally drafted in 2000, it was envisaged that the Fund would have been in full operation by that time. Given the slower progress with the implementation, it has not yet been decided when would be the most "practicable" time for this first review to be undertaken.

Capital Contributions

The Government started setting aside capital contributions for the Fund from July 2001. The New Zealand Debt Management Office has held these for disbursement to the Fund once the Guardians are in a position to start administering it.⁵⁵ An amount of \$600 million was provided for in the 2001/02 financial year, \$1,200 million is being set aside in 2002/03, and \$1,800 million is planned to be set aside in 2003/04. After this transitional three-year period, the Government plans to make capital contributions at the full required rate as set out in the legislation.⁵⁶ These amounts are being set aside in fortnightly

⁵⁴ Mercer Investment Consultants (<http://www.merceric.com>) were appointed "to provide the board with investment advice relating to the long-term asset allocation for the Fund and portfolio construction issues." The board has indicated that additional appointments are expected to be made to provide "second opinion" advice on these issues.

⁵⁵ The New Zealand Debt Management Office is a division of the Treasury that manages the Crown's sovereign borrowings and the Crown bank account. See <http://www.nzdmo.govt.nz>.

⁵⁶ These transitional amounts are less than the "required" capital contribution estimated by the Treasury. For example, in the 2002 December Economic and Fiscal Update, the "required" rate for 2003/04 was estimated to be \$1,937 million, compared to the \$1,800 million that the Government has planned to set aside. This relatively small difference might raise a question of why a transitional path was necessary. However, when this transitional path was adopted in early 2000, forecasts at the time predicted that the "required" rate for 2003/04 would be somewhat higher, at about \$2,500 million.

instalments throughout the year. In order to reflect the time value of money, interest has been credited to the accumulating balance at the Official Cash Rate that is set periodically by the Reserve Bank of New Zealand.⁵⁷ Once the Guardians indicate that they are in a position to take up administration of the Fund, the accumulated balance at that date, including the compounded interest, will be disbursed to the Fund as an initial capital contribution. As at the end of January 2003, the accumulated balance amounted to \$1,388 million. This is about 1.1% of New Zealand's GDP.

⁵⁷ The current Official Cash Rate is 5.75% per annum. See <http://www.rbnz.govt.nz>.

Other Crown Financial Portfolios

The financial assets that form the New Zealand Superannuation Fund are a subset of the overall financial assets owned by the Crown. Forecasts of the distribution of financial assets and liabilities across the Crown are presented in Table 2. Also shown for comparison are forecasts of New Zealand's GDP.

Table 2: Crown Financial Assets and Liabilities (\$ Millions)

Year Ending 30 June ⁵⁸	2002	2003	2004	2005	2006
Financial Assets Held by Core Crown⁵⁹					
RBNZ	5,741	5,735	5,726	5,718	5,709
NZDMO	4,060	2,380	2,613	2,710	2,914
GSF	2,000	3,160	3,160	3,160	3,160
NZSF	600	1,890	3,898	6,277	8,944
Other Core Crown	6,336	6,731	7,965	8,871	9,803
Total Core Crown	18,737	19,896	23,362	26,736	30,530
Financial Assets held by Crown Entities					
ACC	3,522	4,019	4,715	5,480	6,303
EQC	4,144	4,417	4,715	5,027	5,353
Other Crown Entities	2,164	2,249	2,319	2,391	2,477
Total Crown Entities	9,831	10,685	11,749	12,897	14,133
Financial Assets held by SOEs	1,001	848	805	973	1,276
Eliminations ⁶⁰	-5,213	-5,407	-6,610	-7,195	-7,898
Total Crown Financial Assets	24,356	26,022	29,306	33,411	38,041
Non-Financial Assets	59,499	60,896	62,592	63,560	63,709
Total Crown Assets	83,855	86,918	91,898	96,971	101,750
Borrowings					
Sovereign guaranteed	30,476	31,348	33,579	34,298	34,944
Not Sovereign guaranteed ⁶¹	7,147	6,811	6,021	5,979	5,548
Other Liabilities	31,994	32,233	32,694	33,153	33,475
Total Liabilities	69,617	70,392	72,294	73,430	73,967
NZ Gross Domestic Product (Nominal)	120,309	124,964	131,293	137,201	143,026

Source: New Zealand Treasury 2002 Budget Economic and Fiscal Update⁶²

⁵⁸ RBNZ=Reserve Bank of New Zealand; NZDMO=Debt Management Office; GSF=Government Superannuation Fund; NZSF=New Zealand Superannuation Fund; ACC=Accident Compensation Corporation; EQC=Earthquake Commission; SOEs=State Owned Enterprises.

⁵⁹ "Financial Assets held by the Core Crown" excludes holdings of New Zealand Government Stock by these sub-entities.

⁶⁰ The "Eliminations" row nets out the New Zealand Government Stock held by the Crown entities and SOEs so that the actual total financial assets of the Crown as a whole (that is, financial claims on parties external to the Crown) is correctly stated. The borrowings and other liabilities are also stated net of eliminations (that is, excluding intra-Crown cross-holdings).

⁶¹ The borrowings and other liabilities of SOEs and Crown entities are not guaranteed by the Crown.

⁶² Refer to <http://www.treasury.govt.nz> for more detail.

Some of the financial assets are held by entities whose primary role is investment management, and others are held by operating entities for which the management of financial assets is an ancillary activity. These entities each operate under specific legislation that sets out their governance arrangements in detail. They operate with different levels of independence from the Government and they have adopted different investment strategies. This partly reflects the different sets of assets and liabilities for which the entities are responsible. It also reflects the history of their establishment. Since the passage of the New Zealand Superannuation Act, there has been a move toward lining governance arrangements up with that legislation. In particular, the legislation for the Government Superannuation Fund has already been amended, and ministerial directions that mirror the legislation in key respects have been made to the Earthquake Commission pending a more fundamental review of its governance arrangements.

The following sections provide brief descriptions of the circumstances of each of the main entities managing portfolios of financial assets.

Reserve Bank of New Zealand

The Reserve Bank⁶³ manages New Zealand's foreign-exchange reserves. These reserves are included in the Government's total portfolio and integrated into the Debt Management Office's asset and liability management process. This is done by the Debt Management Office directly financing the Reserve Bank's foreign-exchange reserves through foreign-currency deposits with the Reserve Bank. Under this structure, the Reserve Bank's task is to manage its position between its foreign-currency liabilities to NZDMO and the foreign-currency assets that make up the foreign-exchange reserves.

New Zealand Debt Management Office

The Debt Management Office⁶⁴ is a division of the Treasury that manages the Crown's sovereign borrowings. It holds a substantial portfolio of marketable securities and deposits denominated in foreign currencies to help meet the Government's policy of holding no net foreign debt.⁶⁵

New Zealand Superannuation Fund

The New Zealand Superannuation Fund is the subject of the earlier sections of this paper. Table 2 shows how it is expected to grow in significance over the next few years. It is the only entity with responsibility solely for investment management.

⁶³ <http://www.rbnz.govt.nz/>

⁶⁴ <http://www.nzdmo.govt.nz/>

⁶⁵ See footnote 9.

Government Superannuation Fund

The Government Superannuation Fund⁶⁶ is a defined benefit pension scheme for public servants. It was closed to new members in 1992 but there remain about 25,000 employee contributors and 47,000 annuitants. It has an actuarially assessed past service liability of about \$12 billion that is reflected in the Crown financial statements. With assets in the region of only \$3 billion, it is partly funded, with the Crown guaranteeing any shortfall. This guarantee, combined with the defined benefit nature of the scheme, means that the Crown bears all of the investment risk of the Fund. The Government's policy is to meet a portion of the unfunded amount each year so that the shortfall is met progressively over the remaining life of the scheme.

The Government Superannuation Fund Authority is responsible for both scheme administration and investment management. Its legislation was amended in 2001 to essentially the same provisions as those described above for the New Zealand Superannuation Fund. It has since developed an investment strategy diversified across capital markets and this is under implementation. It previously held primarily New Zealand Government stock.

Accident Compensation Corporation

The Accident Compensation Corporation⁶⁷ administers New Zealand's accident compensation scheme, which provides accident insurance for all New Zealand citizens, residents and temporary visitors to New Zealand. In return, people do not have the right to sue for personal injury, other than for exemplary damages. The continuing increase in the Corporation's portfolio of financial assets over the next few years reflects its movement from a largely pay-as-you-go scheme to full funding of its claims liabilities.

The Corporation is required by its legislation to invest its assets as if it were a trustee. The Corporation therefore sets its own investment policy. However, the Government has the power to make policy directions that the Corporation must comply with.

Earthquake Commission

The Earthquake Commission⁶⁸ provides natural disaster insurance for residential property in New Zealand. The Minister of Finance has the power to direct the Commission regarding its investment and reinsurance policies. Until recently, the Commission's Natural Disaster Fund has been required to be invested entirely in non-tradeable New Zealand Government stock.

In 2001, the Minister issued a direction on investment that essentially mirrored the principal provisions described above for the New Zealand Superannuation Fund. In particular, the Commission must invest the Natural Disaster Fund following the same

⁶⁶ <http://www.gsf.govt.nz/>

⁶⁷ <http://www.acc.govt.nz/>

⁶⁸ <http://www.eqc.govt.nz/>

objectives as set out in section 58 of the New Zealand Superannuation Act and it must prepare, and adhere to, a statement of investment policies, standards and procedures like that required for the New Zealand Superannuation Fund. The direction from the Minister also set out some more specific requirements surrounding the investment policy, allowing investment in New Zealand Government securities, global equities, and New Zealand bank bills, but requiring consultation with the Minister to go beyond an allocation of 35% to global equities or \$250 million in bank bills. The issuing of this direction is generally seen as an interim measure pending a more fundamental review of the governance arrangements surrounding the Earthquake Commission.

Other Items

- The other financial assets held in the “core” Crown include about \$4 billion of student loans.⁶⁹
- The financial assets held by state-owned enterprises⁷⁰ are primarily marketable securities and deposits held for working capital purposes.
- The main categories of non-financial assets are buildings (\$17 billion), state highways (\$12 billion) and land (\$7 billion).
- The “Other Liabilities” include the accrued past service liability for the Government Superannuation Fund (\$12 billion) and the outstanding claims liability of the Accident Compensation Corporation (\$8 billion).

⁶⁹ Established in 1992, the student loan scheme provides concessionary loans to tertiary students. See <http://www.studylink.govt.nz/student-loan/index.html>.

⁷⁰ State-owned enterprises are limited-liability corporations that operate at arm's-length from the Government. See <http://www.cmau.govt.nz/soe/overview.asp>.

Conclusion

The New Zealand Superannuation Fund has been established as a means of smoothing out the impact on the rest of the Crown's finances of the transition that will take place over the next fifty years or so to a permanently higher proportion of the population being eligible to receive payments of New Zealand Superannuation. An essential element of the success of this policy is establishing governance arrangements that ensure efficient management of the financial assets that constitute the Fund. This has been met with legislation establishing the New Zealand Superannuation Fund and its governing body – the Guardians of New Zealand Superannuation. The detailed governance arrangements were designed around an objective of establishing a clearly defined portfolio of Crown financial resources, managed by an independent governing body with explicit commercial objectives and clear accountability.

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