

The Treasury

New Zealand Superannuation and Retirement Income Act 2001: Amendment to Section 59 Information Release

February 2023

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- [25] 9(2)(b)(ii) - to protect the commercial position of the person who supplied the information or who is the subject of the information
- [26] 9(2)(ba)(i) - to protect information which is subject to an obligation of confidence or which any person has been or could be compelled to provide under the authority of any enactment, where the making available of the information would be likely to prejudice the supply of similar information, or information from the same source, and it is in the public interest that such information should continue to be supplied
- [33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials
- [34] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions
- [35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment;
- [36] 9(2)(h) - to maintain legal professional privilege
- [39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

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Treasury Report: NZ Super Fund: Controlling Interest in Entities

Date:	26 August 2021	Report No:	T2021/1600
		File Number:	CM-1-3-96-5-2-1-2

Action sought

	Action sought	Deadline
Hon Grant Robertson Minister of Finance	<p>Indicate preference for external consultation</p> <p>Agree in-principle to the relaxation of the restriction for the NZ Super Fund to be able to take a controlling stake in entities</p> <p>Direct officials to report back with a draft Cabinet paper to initiate the law change process</p>	15 September 2021

Contact for telephone discussion (if required)

Name	Position	Telephone	1st Contact
Gopika Gnanakumar	Senior Analyst, Financial Institutions	[39]	N/A (mob) ✓
Joseph Sant	Manager, Financial Institutions	[35]	

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: Yes (attached)
[Section 59 review - 26 August \(Treasury:4507216v1\)](#)

Executive Summary

The Guardians of New Zealand Superannuation (the Guardians) has requested a review of a section of its foundation legislation. Section 59 of the New Zealand Superannuation and Retirement Income Act 2001 (the Act) prohibits the NZ Super Fund (NZSF) from holding controlling interests in entities.

Part of the original rationale for the control restriction was the maturity of the NZSF and the relatively small exposure to direct investments within the global practice of investment management in 2001. However, since then:

- The Guardians governance has evolved in line with NZSF investment capability, to provide effective oversight of complex investment strategies. This governance capability has been validated by the most recent independent review of the Guardians.¹
- Direct investment is a much more common feature of best practice portfolio management than in 2001, or the more recent review of section 59 in 2011.

It is also no longer meaningful that 'if the Government wished to own a business it would make this choice with a specific policy intention in mind'. Direct investments are a common method to get exposure to unlisted assets and would not significantly expand the Guardians operating model to move from minority to majority shareholdings.

The final policy rationale for restricting controlling interests is related to avoiding certain obligations through ownership:

- [36]
- The reality is the Guardians strong governance oversight is likely to be a positive impact that reduces the probability of these issues occurring in the first instance.

The risk of poor public perception and/or political pressure to undertake specific investments is a downside risk to the ability to take control of entities, ie. the Guardians mandate to deliver value through best practice portfolio management could run into tension with wider policy objectives.

This perception risk sets a tension where we believe it is desirable for the Guardians to have the flexibility of taking a controlling interest in entities, but governance settings should be for prudent use of this tool.

We considered a range of implementation options that could enforce prudent use of taking a controlling interest in entities. However, we favour a relatively light touch legislative option to ensure the investment independence of the Board is maintained.

Our recommendation is to remove the section 59 control restriction and include a new obligation within section 61 'contents of statements of investment policies, standards and procedures'. This will then require the Board to monitor the policy over time and Ministers

¹Review of the Guardians of New Zealand Superannuation – July 2019 – prepared by Willis Towers Watson
T2021/1600 NZ Super Fund: Controlling Interest in Entities

can receive assurance on the utilisation of the policy relative to global best practice through the one in five year independent reviews of the Guardians.

We have consulted with the Guardians on the detailed review and the recommendation. The Guardians has confirmed it is comfortable with the direction of travel and, for this reason, has not added a formal comment to the review.

Recommended Action

We recommend that you:

- a **note** that a detailed first principles review is attached to this summary briefing. We recommend this is read should you be unsure of the recommendations below
- b **note** that this review was largely a desktop exercise with limited, targeted engagements with public sector organisations and we have not consulted widely on the review findings
- c **note** that by moving from minority to majority ownership, we do consider there is a heightened reputational risk for adverse business outcomes, but that this risk exists for any ownership interest and can be mitigated through effective management
- d **note** that we consider the Guardians provide differentiation to financial institution risk appetite in capital markets. We do not consider there to be a significant risk to competitive neutrality for a large Government-owned fund to compete for deals relative to private sector, due to clear rules of procurement and market conduct
- e **indicate** whether you consider external consultation is important for this proposal, including with select members of the New Zealand business community to further validate findings of the review. (Treasury has a soft preference for consultation)

Do consult/Do not consult.

- f **note** that we consider the potential transactional and strategic benefits for the NZSF outweigh the original policy intent to restrict taking on a controlling interest
- g **note** that this is particularly true given the size of the NZSF now restricts domestic investment partners, and this will continue to grow for the next thirty to fifty years
- h **note** that the maturity of the Guardians governance provides confidence in the prudential oversight of a policy on where a controlling interest is strategically beneficial for the NZSF
- i **agree** in-principle to the relaxation of the control restriction under section 59 of the New Zealand Superannuation and Retirement Income Act 2001

Agree/disagree.

- j **agree** that legislation should require the Guardians Board to establish and maintain a new statement of investment policies, standards, and procedures (section 61 of the Act) for the selection and monitoring of controlling interests in entities

Agree/disagree.

- k Should you consider further consultation is necessary, **direct** officials to report back with an update on external consultation and validation of findings
Yes/No

Or

- I **direct** officials to draft a cabinet paper to initiate the implementation of a legislative change to amend section 59 of the Act
Yes/No

Joseph Sant
Manager, Financial Institutions

Hon Grant Robertson
Minister of Finance

Treasury Report: NZ Superfund: Controlling Interest in Entities

Purpose of Report

1. This paper outlines the findings of a first principles policy review of section 59 of the New Zealand Superannuation and Retirement Income Act 2001 (the Act). This clause prohibits the NZ Super Fund (NZSF) from holding controlling interests in entities; ie. its shareholding in all entities that are not NZSF Fund Investment Vehicles (FIVs) must be 50% or less.
2. You agreed to this review in response to a request from the Guardians of New Zealand Superannuation (Guardians), included in its 'Briefing to the Incoming Minister' in 2020. This report outlines the benefits and risks of amending section 59 and provides options to removing or amending the control restriction.
3. Attached to this briefing is the detailed report reviewing the decision to amend section 59, including the long-list of options that was considered and discounted. This summary briefing provides the recommended option only. We advise that you read the attachment for further information if you are unsure of this decision.
4. Consequently, this paper seeks your view on whether a further, targeted consultation is required to validate the findings of the review prior to initiating a Cabinet and legislative process to amend section 59 of the Act.

Background

5. The Guardians has engaged with the Treasury for several years advocating for the removal of the control restriction under section 59 of the Act.
6. This clause prohibits the NZSF from holding controlling interests in entities. The original policy rationale for the control restriction included the views that:
 - a The NZSF was intended to be a portfolio of financial investments and not an operator of businesses
 - b It is/was normal practice for private investment funds to avoid controlling interests
 - c There may an implied guarantee by the Crown of the entity's liabilities in case of financial difficulty, and
 - d If it makes good public policy (including economic, social and/or environmental policy) for the Crown to have ownership control of a business, it would be better for the Government to make the decision directly.
7. The Treasury has previously reviewed section 59 in 2011. This review recommended changing the law to allow the Guardians to create and control FIVs.² FIVs allow for more efficient portfolio management, but the no control provision still applies to the entities the FIV has an interest in.
8. The 2011 review did not recommend a change to NZSF's ability to hold substantive controlling investments on the basis that there was no strong evidence that control can

² Section 59A of the Act: Investments of the Fund may be held in an entity that is formed or controlled by the Guardians for the purpose of holding, facilitating, or managing the investments of the Fund.

deliver superior risk adjusted commercial returns to an investee of the size and nature of NZSF.

9. Since the last review in 2011 the NZSF has grown from \$19 billion to \$59 billion, and the projected size of the NZSF is now significantly greater.³ This projected growth in assets has led the Guardians to review the future state of the NZSF and its investment strategy, focusing on areas that are scalable, including direct investment.
10. The Guardians highlights that the control restriction limits its direct and other investment activities. In its view, a relaxation of the control restriction would provide it with an important “tool in the toolbox” that can have a wide range of benefits.
11. In very broad terms, these tools include a larger investable universe (particularly domestically), the opportunity to obtain additional value through purchase/exit strategies, access to a wider range of co-investment partners, greater ability to support investees with growth capital and greater ability to ensure good environmental, social and governance (ESG) outcomes within investments.
12. While the main focus of this paper is direct investment activities, a relaxation of section 59 may also enable control of entities via the Guardians’ other access points. For example, external managers could hold a controlling interest in a business and manage it on the Guardians’ behalf.
13. More recently, the NZSF approached you in February 2021 to discuss the potential of taking on a controlling interest in Kiwi Group Holdings Limited (KGH, parent of Kiwibank). NZSF currently has a 25% interest in KGH and its proposal to further invest is dependent on the repeal of (or a specific exemption to) the section 59 controlling interest limitation.
14. While NZSF’s proposal regarding KGH encompasses its most recent advocacy for the repeal of section 59, this first-principles review has been undertaken with a broader policy context lens, and not specific to any implications this may have for your separate decisions regarding KGH ownership.

Objectives of the review

15. The objective of the 2021 review was to undertake a targeted, first principles review of section 59 of the Act, to determine if it remains in the interests of New Zealanders and make any recommendations necessary to future proof it. The starting point for this was to retest the findings of the 2011 review.⁴
16. The 2021 review includes consideration of:
 - a Investment opportunities for the NZSF and potential impact on performance
 - b Trends amongst other sovereign wealth funds and benefits they gain from control
 - c Operational risk and complexity stemming from a potential change
 - d The benefits and/or risks to the New Zealand economy, and
 - e Benefits and risks to government.
17. Out of scope is a deep dive review of NZSF’s direct investment portfolio performance under the current settings. We have assessed that there is a clear strategy and appropriate governance (risk management and reporting requirements) for direct

³ Budget Economic Fiscal Update (BEFU): NZSF 40 year AUM projections: 2018 (pre-Covid): 2061 AUM \$610bn, BEFU 2021: 2061 AUM \$530bn.

⁴ A copy of the 2011 review can be provided on request. The 2021 review is a stand-alone review and judgement.

investments and are satisfied that these core controllables are drivers of investment performance.

Approach to the review

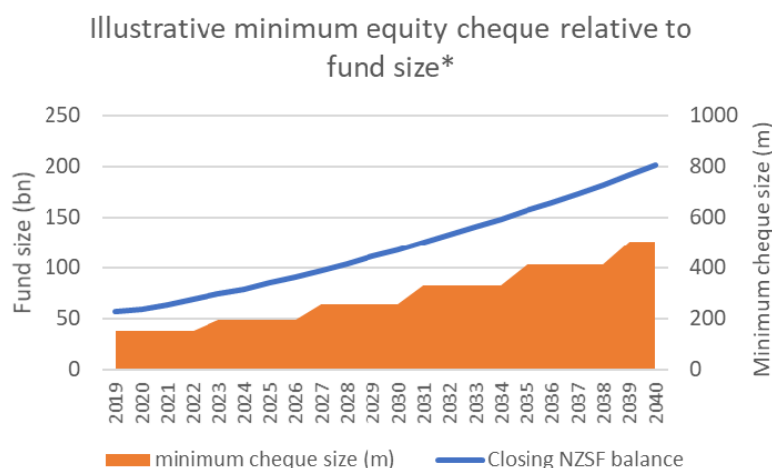
18. This was primarily a desktop review. We also utilised targeted consultation with a limited number of public sector organisations including the Guardians, the Accident Compensation Corporation (ACC) and the Infrastructure Commission. We did not consult broadly with private market institutions to avoid the risk of the question being interpreted prematurely as a position of government policy.
19. We could undertake wider consultation (outside of that invited via a Parliamentary process where legislation change is reviewed) should you seek further assurance on the options for change, particularly in relation to benefits/risks to the New Zealand economy.
20. One concern we had at the outset of the review was the Guardians' competitive advantage due its large balance sheet, and the perception risk this would have on the New Zealand Government promoting equity and fairness in the New Zealand economy. As part of discussions with the Guardians we are comfortable that the opportunities that would be considered as part of a direct investment strategy are of such scale there are limited actors in the market and our view is that the Guardians role could diversify capital markets to support economic resilience.
21. Therefore, we do not think consultation is necessary but may be advantageous to maintain a positive engagement with the New Zealand business community. Consultation could be conducted with the BusinessNZ Council and similar representative organisations. We have a soft preference for completing this step before progressing with a public legislation process.

Rationale for change

22. Sovereign Wealth Funds (SWFs) generally seek direct exposure to private markets to diversify their portfolio in pursuit of an improved risk/return trade off. Over time, the flexibility around management of direct investments is likely to maximise returns as SWFs have greater ability to actively select and manage these investments for optimal portfolio allocation.
23. The benefits of a relaxation of the control restriction from a government perspective include:
 - a The potential for economic development through enabling a more attractive environment for domestic investment, particularly in the infrastructure space.
 - b Responsiveness in a crisis: a large institution with a counter-cyclical risk appetite can provide a capital response to businesses where other financial market participants might see a tightening risk appetite.
24. The benefits of a relaxation of the control restriction from the Guardians perspective includes a wider toolkit to execute investments, a larger opportunity set for New Zealand investments and potential to increase the risk adjusted return of the NZSF. In broad terms this is due to the limited number of suitable co-investment partners who are able to match the scale of the NZSF or have the same patient capital approach for a long time horizon for certain investment opportunities.

NZSF Direct Investment Strategy

25. The potential for a larger addressable market and opportunity set is a key driver for the Guardians advocating for change. The Guardians claim to have a competitive advantage in New Zealand due to informational and reputational advantages and claim the control restriction is a constraint on its direct investment activities.
26. The NZSF currently targets direct investments with a minimum size of \$200m to \$300m. The Guardians believes that by effectively capping the maximum number of investee companies, it can provide greater focus per investment and mitigate monitoring risk. In turn, this keeps the operating model to a manageable size relative to the assets under management.
27. The minimum transaction size is expected to rise as the NZSF grows over time (as shown below). This means it is likely that the potential addressable market/opportunity set in New Zealand will decline in the future, as the size of the NZSF grows at a rate faster than the wider economy. An increased infrastructure programme or larger stakes in domestic businesses are potential options resolve this constraint.
28. Complexities of scale is consistent with experience of other SWFs as they go through different stages of maturity. Initial growth will need to be matched by capability to take on a significant direct investment strategy. However, this may represent a closing window of opportunity as fund scale moves beyond domestic markets.



* Graph assumes constant ratio of minimum cheque size to fund size, adjusted every 5 years.

29. Increasing minimum transaction sizes creates a challenge to find the right co-investment partner and opportunities that are big enough to have a material impact on fund performance, particularly in the domestic market. When suitable co-investors with an interest in New Zealand run out, the Guardians will need to look for direct investment opportunities overseas where there are more willing co-investors. The removal of the control restriction would allow for a more enduring focus on domestic direct investments, by reducing the dependency on the small cohort of suitable partners.

Trends among Sovereign Wealth Funds

30. Globally SWFs are a heterogeneous group of institutional investors and are not directly comparable. There is also no consistent regulatory approach relating to restrictions on SWFs.
31. Even for peer funds that can hold controlling interests, a common reason for avoiding taking a controlling stake is the effort needed to manage reputational risk. This can arise from public perception around 'government owned' businesses for compliance

with ESG factors and/or potential pressure to bail out failing businesses (see section below for further detail).

32. Fund maturity is a key feature of determining rights to control entities. Typically, when a SWF is created in its early stages, third-party fund managers will be used with a high proportion of assets being held in equity and fixed-income securities traded on recognized and liquid public markets.
33. As SWFs mature and develop their internal expertise, more capital is often gradually managed in-house, and exposure to other more complex alternative asset classes is sought, again using third-party asset managers. The final stage of development is to make direct investments, often initially as sizeable minority positions in publicly quoted companies, then as co-investors in private investments, typically alongside an alternative investment manager, and ultimately as a lead investor.
34. The evolution of the NZSF aligns with the notion that as the fund grows and matures it may seek out a lead investor role. The maturity here refers to capability, operating model and size.
35. The Guardians has strong governance capability and settings that promote independence. It has delivered solid overall performance against the legislative obligations for investment of the NZSF⁵. These governance settings will remain in place, and along with the NZSF's direct investment strategy, risk allocation processes and historic track record, provide for assurances around capability to take controlling interests and manage associated monitoring and ownership responsibilities.
36. The Guardians state that the removal of the control restriction would add another 'tool to the toolbox' and is unlikely to change its direct investment strategy in the short-medium term. We are comfortable that there is no requirement to expand the operating model to enable this but the Guardians acknowledge that there may be periods of escalation should idiosyncratic issues arise.
37. Requiring the Board to have a dedicated policy to manage where the NZSF might take a controlling interest would allow oversight for Ministers. Statutory independent reviews could include a specific reference for how the direct investment strategy is monitored, with particular respect to allocating risk to controlling stakes in entities.

Key concerns

38. Our key concerns are consistent with the literature review of other SWFs, namely a perception risk – that actions are viewed through non-commercial, or a public policy lens. This could be through political pressure to undertake specific investments and reputational risks to the Crown should business investments underperform, including bail out expectations. These risks cannot be fully mitigated but can be minimised through strong governance, transparency and effective accountability mechanisms.

⁵ 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.*

Political pressure

39. Independence of investment decision making is a critical success factor for the NZSF. Removing the control restriction may come with a wider opportunity set but this could also lead to crossover with Ministerial interest. We do not recommend any change to the investment independence of the Guardians Board.
40. The perception of political interference and influence may create pressure on the Minister of Finance, due to a lack of understanding around the independence of decision making. As is currently the case, a healthy dialogue on investment options is likely to be welcomed but the risk of lobbying from other portfolio Ministers could become more pronounced with the ability to take controlling interests in private New Zealand entities and/or lead large-scale infrastructure projects.
41. The concern is that the NZSF is required to invest on a prudent, commercial basis, with best practice portfolio management, avoiding undue risk. Politically directed investments could lead to attempts to prop up inefficient firms or industries and ultimately come at the cost of New Zealand tax payers through lower returns. Policy-oriented investments should be made through other vehicles to ensure accountability remains clear to the decision maker.

Reputational risks to the Crown

42. NZSF is ultimately part of the Crown and it behaves accordingly. This is reflected in the mandate to avoid 'prejudice to New Zealand's reputation as a responsible member of the world community'.
43. The Board of the Guardians determines the investment policies in respect of the NZSF. The Board is publicly accountable and is exposed to reputational risk. However, the Guardians' sovereign status means the Crown is also exposed to reputational risk by association.
44. Reputational risk to the Crown will be heightened with controlling interests. The Guardians in recent years has been exposed to increased reputational focus due to ESG/Responsible Investing (RI) related matters. The latest is media attention accusing the NZSF of holding shares in companies that are linked with the Myanmar military.⁶ Another example is attention around investments in Chinese companies linked to human rights violations.⁷
45. The majority of ESG/RI issues which have received media attention have been related to small minority holdings in listed companies. The NZSF is unlikely to seek control investments in businesses with significant ESG risk profiles and is exposed regardless of size of the investment.
46. The counter argument to increased risk through a controlling stake is that it also provides the greatest ability to influence and mitigate ESG risks.

Bail out expectations

47. One of the original policy intents behind imposing the restriction includes a concern that there could be an implied guarantee by the Crown of the entity's liabilities in case of financial difficulty.

⁶ <https://www.rnz.co.nz/news/political/442353/nz-super-fund-holds-shares-worth-100m-in-companies-linked-to-myanmar>

⁷ <https://www.stuff.co.nz/national/stuff-circuit/300278880/super-fund-money-invested-in-chinese-companies-linked-to-human-rights-violations>

48. [36]
49. The key concern here is the hypothetical situation where the NZSF may choose not to support a failing company due to commercial reasons – but the government is pressurised to support or bail out the company due to political reasons or to avoid reputation risks.
50. This is not a new risk but one that could be heightened with controlling interests. We are comfortable that settings can be easily explained and that this is supported by maintaining appropriate independence of investment decisions with the Board.

Options

51. In our view, there is a case for change, and hence a relaxation of the control restriction under section 59 of the Act.
52. Options to implement a change should consider the following principles:
- a **alignment to purpose and mandate** – i.e. investing in a prudent, commercial basis with best practice portfolio management, maximising return without undue risk and avoiding prejudice to New Zealand reputation.
 - b **operational independence** – the institutional design of the governance of NZSF should credibly insulate it from political pressure, strengthen accountability, ensure oversight, and bring technical skills to bear on investment decisions.
 - c **a significant level of transparency** – particularly on individual domestic investments and their financial performance
53. Some (if not most) of the above are already in line with how the Guardians already operates but any change to the current settings should consider how these principles are impacted in practice and how they can be strengthened during implementation.
54. The relaxation could take the form of an amendment or a complete removal. The potential options can be grouped into three categories:
- a no change (*not recommended*)
 - b amend – with some limitations
 - c full removal of the control restriction
55. The long list of options to amend the control restriction, but with limitations to, for example, investment sector, jurisdiction and/or time horizon. Our view is that legislation is not the place to set specific restrictions, but is best placed to determine the objective of the change.
56. We favour a full removal of the control restriction with the caveat that this decision should be reviewed within ten years. The purpose for a time-bound review is i) to consider the impact that the change in legislation has had on the NZSF and a wider set of stakeholders and ii) continue to monitor the restriction relative to the size of the NZSF over time.
57. While we state this preference is for removal of the restriction, we consider this to be a transfer of accountability from policy makers to the Board. We recommend that a new statement of investment policy, standard or procedure is incorporated that requires appropriate policy and oversight of how the NZSF direct investment strategy is given effect, including where the option to take a controlling stake is utilised.

58. This would require a small amendment to section 61 of the Act, which is then overseen by the Guardians Board. The section 71 requirement for an independent performance review of the NZSF every five years includes a mandated requirement to review the section 61 policies, thereby enabling Ministerial oversight for how the Board gives effect to the direct investment and controlling interest policy.

Next steps

Section 59 – Consultation and subsequent Cabinet approval

59. Should you provide an in-principle agreement to the option described above, we recommend:
- a Further legal advice, including consultation with the Guardians, on implementation options.
 - b Optional consultation with members of the business community and a random selection of businesses that the NZSF has had significant ownership stakes in over the last five years. This is intended to validate the desktop review and canvas for any concerns that have not been included within the review.
 - c If the case for change still stands post consultation, and the Minister of Finance is supportive of the change, then we recommend seeking Cabinet approval for the law change. Your colleagues are likely to be interested in this change as a significant change in policy, particularly the Minister for Economic Development and other Infrastructure Ministers.
60. Any potential consequential amendments and clarifications of legal positions can be covered through an amendment Bill. We would work with the Parliamentary Council Office and Treasury Legal to inform on the approach to this Bill and the expected time period to accomplish legislation change. We expect this to be a minimum of six months but have not validated this assumption.

[25], [33]