Controller and Auditor-General
Tumuaki o te Mana Arotake

Performance audit report

Guardians of New Zealand Superannuation: Governance and management of the New Zealand Superannuation Fund

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Guardians of New Zealand Superannuation: Governance and management of the New Zealand Superannuation Fund

This is the report of a performance audit we carried out under section 16 of the Public Audit Act 2001.

May 2008

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Foreword

The Guardians of New Zealand Superannuation have a significant responsibility ensuring that we will have enough money in the New Zealand Superannuation Fund to help meet our country's future superannuation needs.

They are entrusted with billions of dollars provided by the Crown to invest for the long term in global markets so that we are in a strong financial position to meet the superannuation costs of an increasing retired population.

Because of the highly specialised nature of the Fund, I appointed Ernst & Young under section 33(1) of the Public Audit Act 2001 to assist with our performance audit of the Guardians.

As a relatively new organisation, the Guardians have acted effectively to set up the types of systems, processes, and policies that will help them to invest wisely throughout the "ups and downs" of the global economy and short-term fluctuations in world markets such as those we have seen in recent times.

The Guardians are a well-run organisation, and their internal control and governance framework meets or exceeds internationally recognised practices and guidelines. Also, I am encouraged by the leadership that they have shown in the New Zealand public sector to find common approaches to responsible investment.

I thank the Board of the Guardians, the Chief Executive Officer, and the Guardians' staff for their assistance with our audit.

K B Brady
Controller and Auditor-General

21 May 2008

Contents

Figures

Glossary

An **active investment mandate** encourages an Investment Manager to seek a more aggressive investing strategy to exceed the performance benchmark.

Alternative assets are those in an asset class that is not publicly traded. This typically includes Private Markets investments.

The term **anti-money laundering** is mainly used in the financial and legal industries to describe the legal controls that require financial institutions and other regulated entities to prevent or report money laundering activities. Financial institutions globally are generally required to monitor, investigate, and report transactions of a suspicious nature to the financial intelligence unit of the central bank in the respective country. For example, a bank must perform due diligence by having proof of a customer's identity and that the use, source, and destination of funds do not involve money laundering.

Asset allocation is the process of allocating and recording funds in a portfolio based on the distinct asset classes where investments have been made. For example, property or New Zealand small cap equities (see also Strategic Asset Allocation).

An **asset class** is a type of investment, such as stocks (equities), bonds (fixed income) or cash (money markets).

A **benchmark** is a point of reference used by an Investment Manager to evaluate fund investment performance.

Business continuity management is the way that an organisation prepares for future events that could jeopardise critical operating functions to the detriment of its core objectives or long-term health.

A **Contribution Payment Schedule** is a forecast schedule of expected cash payments from the Crown (through the Treasury) available to the Guardians of New Zealand Superannuation for investment.

The term **control** refers to an existing process, device, practice, or action that minimises negative risks or enhances positive opportunities.

A **custodian** is an independent organisation entrusted with holding investments and settling transactions on behalf of the owner. A custodian maintains the financial records for the investments and may perform other services (such as performance measurement and investment mandate compliance) for the owner.

Disaster recovery is the process of regaining access to the data, hardware, and software necessary to resume critical business operations.

Due diligence is the process of investigating Investment Managers or potential investments to gain confidence about their abilities or future performance. This involves requesting, understanding, verifying, analysing, and evaluating information (such as financial, legal, historical, or criminal).

Funds under management is a measure of the total amount of funds being managed by an Investment Manager on behalf of the Guardians of New Zealand Superannuation or by the Guardians.

An **Investment Manager** is a firm or person appointed by the Board to manage and invest a portfolio of investments for the Guardians of New Zealand Superannuation. Investment Managers are governed by their respective investment mandates.

An **Investment Manager Agreement** is an agreement between the Guardians of New Zealand Superannuation and an Investment Manager. It sets out the contractual obligations, requirements, restrictions, and other terms and conditions for the Investment Manager to invest the New Zealand Superannuation Fund.

An **investment mandate** is a formal document that is part of the Investment Manager Agreement. It states the authorised investments and restrictions placed on the investment activities of the Investment Manager.

Liquidity is a term that refers to an asset's ability to be easily converted through an act of buying or selling without causing a significant movement in the price and with minimum loss of value.

The **Master Custody Agreement** is the agreement between the Guardians of New Zealand Superannuation and their appointed custodian (the Custodian) that sets out the contractual obligations, requirements, and other terms and conditions for the Custodian to carry out its responsibilities. (Expected service levels are set out in a separate document, the service level agreement.)

The **operational strategy** is a plan to achieve the operational goals of the Guardians of New Zealand Superannuation.

Outsourcing refers to the contracting out of parts of the Guardians of New Zealand Superannuation's activities to third party (external) service providers. While activities are contracted out, the responsibility for these activities still lies with the Guardians.

A **passive investment mandate** encourages an Investment Manager to meet its performance benchmark. It does not require an Investment Manager to attempt to actively outperform the benchmark.

A **performance fee** is a remuneration structure in an Investment Manager Agreement to reward the Investment Manager with more fees should it meet certain criteria. This fee is not paid if the criteria are not met.

Private Markets is a type of equity asset category where the equity securities are not freely traded on any recognised stock exchange.

Responsible investment refers to the requirement of the New Zealand Superannuation and Retirement Income Act 2001 that the Guardians of New Zealand Superannuation invest in a manner that avoids prejudice to New Zealand's reputation as a responsible member of the world community.

A **risk management framework** is a structured approach to managing uncertainty by assessing risk, developing strategies to manage risk, and assigning accountability. The strategies include transferring the risk to another party, avoiding the risk, reducing the negative effect of the risk, and accepting some or all of the consequences of a particular risk.

A **SAS 70 report** is a report under the Statement on Auditing Standards (SAS) No. 70 auditing standard set by the American Institute of Certified Public Accountants. The SAS 70 report is supplied by entities (for example, the Custodian) to the Guardians of New Zealand Superannuation to give assurance over the external provider's internal control effectiveness. The report includes an in-depth analysis of control objectives and control activities, including controls over information technology and related processes.

A **security** is an interest or right to participate in any capital, assets, earnings, royalties, or other property of any person. It may, for example, include an equity security, a debt security, or a unit in a unit trust.

A **service level agreement** is an agreement between the Guardians of New Zealand Superannuation and a service provider (for example, the Custodian) that outlines the service quality and deliverables that are expected as part of the contract.

Strategic Asset Allocation is the division of assets within an investment portfolio, taking the long-term view of the risk and return profile of those asset classes, designed to best achieve the portfolio's long-term objectives.

The **United Nations Global Compact** is an initiative to encourage businesses worldwide to adopt sustainable and socially responsible policies, and to report on them. The United Nations Global Compact has 10 underlying principles for responsible investment (UNPRI) that guide an organisation's policies. They include human rights, labour standards, the environment, and measures to combat corruption.

Volatility is a measure of the degree to which an investment's value fluctuates through time. Volatility is typically expressed in annualised terms, and it may be either an absolute number ($) or a fraction of the initial value (%).

Summary

Parliament and the public can be confident that the Guardians of New Zealand Superannuation (the Guardians) are putting in place the types of internal control systems, processes, and procedures needed to prudently manage and govern the New Zealand Superannuation Fund (the Fund). The Fund was set up to contribute to the future cost of providing superannuation.

Our performance audit at the end of 2007 found that the Guardians' internal control activities generally meet or exceed accepted international practices and guidelines for operating investment funds.

The Guardians' internal control and governance processes have matured considerably since the organisation was created in 2001 to manage and administer the assets of the Fund.

However, the Guardians are still in the early stages of a long-term role. We expect that they will continuously review and change their approaches as the organisation grows, and in response to the challenges of a constantly changing investment environment.

There are some areas where the Guardians could make improvements. We have made 24 recommendations, of which five deserve a high priority.

Background

New Zealand currently has a taxpayer-funded "pay-as-you-go" retirement income system, where eligible residents over the age of 65 receive a pension irrespective of their income or assets. This pension, known as New Zealand Superannuation, is funded out of general taxation.

As our population ages, there will be fewer people of working age compared to the increasing number of retired people. This will lead to significant pressure on fewer taxpayers to meet the increasing cost of providing New Zealand Superannuation in the next 20 to 50 years.

The Fund was created by the New Zealand Superannuation and Retirement Income Act 2001 (the Act) to invest Crown contributions to prepare for the expected growth in demand for pensions from an ageing population. The Government currently contributes about $2 billion a year to be invested in the Fund. The Guardians are a Crown entity established under section 58 of the Act to invest the Fund in a manner that is prudent and commercial, maximises return without undue risk, and avoids prejudice to New Zealand's reputation.

The relationship between the Fund and the Guardians is similar to that of a "fund" and a "fund manager". The Fund holds the assets of the Crown, which are used to provide a portion of the expected future cost of providing New Zealand Superannuation. The Guardians set investment policies and investment mandates. The Guardians reinvest all investment returns into the Fund on a long-term basis.

The Guardians appoint Investment Managers who then trade securities on behalf of the Fund, such as buying and selling assets subject to the agreed investment mandates. The Board of the Guardians (the Board) also appoints a Custodian to carry out day-to-day portfolio monitoring and transaction administration.

History

There have been three main stages in the history of the Fund and the Guardians to date, which together represent the "establishment" and "initial development" phases:

- setting up and determining the original Fund structure;
- developing the investment strategy, Strategic Asset Allocation and individual investment mandates, and the appointment of Investment Managers and the Custodian; and
- formalising the processes and executive management of the Guardians in accordance with their *Statement of Intent for the period commencing 1 July 2007 to 30 June 2010* (2007 Statement of Intent).

An independent committee was established by the Minister of Finance in October 2001 to nominate people for the Guardians' Board. On 26 August 2002, the Board met for the first time. The first task for the new Board was to establish the investment strategy and appoint advisers and senior managers.

In August 2003, the Guardians announced their first Strategic Asset Allocation for the Fund. On 30 September 2003, the Fund received an initial contribution of $2.5 billion from the Crown. Thereafter, the Fund received fortnightly contributions from the Crown based on an annual contribution schedule. The annual contribution schedule is determined and calculated by the Treasury, and sets out the timing and amount of each fortnightly payment from the Crown to the Fund. The cumulative amount in any given year represents the annual Crown contribution, which to date has been about $2 billion a year.

From September 2003 to August 2006, the Fund experienced significant growth. By June 2006, the Fund asset value was more than $10 billion and the Guardians had appointed a number of Investment Managers and a Custodian. The Guardians had also established information technology systems and business processes.

At the end of 2006, both management and the Board recognised that the establishment and early development phases of the Fund were complete. This created an opportunity to formalise processes through policies, procedures, and a risk management framework. The 2007 Statement of Intent set out a work programme for the Guardians to achieve this objective.

Our performance audit

We carried out a performance audit of the Guardians to provide independent assurance to Parliament about whether the Fund is being prudently governed and managed.

We assessed the Guardians' governance and management of the Fund. We did not assess the performance of the Fund in terms of investment returns or the appropriateness of the Guardians' investment strategy.

We engaged Ernst & Young to assist us because of the highly specialised nature of the Fund. We assessed:

- the performance of the Guardians in the governance, management, and administration of the Fund; and
- the adequacy of procedures performed by the Guardians in mitigating the risks arising from the rapid growth of the Fund.

This included looking at the effectiveness of:

- governance arrangements;
- policies related to application of the investment strategy;
- contracts with Investment Managers;
- monitoring and reporting Fund performance;
- information systems; and
- management practices and controls.

We compared the Guardians' governance and policy framework to standards promulgated by regulators such as the Financial Reporting Council of the United Kingdom, Monetary Authority of Singapore, and the New Zealand Securities Commission.

The Guardians have implemented all significant requirements of these frameworks. The governance and operational approach adopted by management, and endorsed by the Board, concentrates on the legislative requirement to maximise long-term risk-adjusted returns while maintaining New Zealand's reputation as a responsible member of the world community.

Our more significant observations and high-priority recommendations

We have made 24 recommendations (see Appendix 4 for the full list). Five recommendations are, in our view, a high priority for the Guardians to address. The others are more minor or relate to the ongoing work programme already initiated by the Guardians.

Our more significant observations and high-priority recommendations are summarised below.

Governance arrangements

While our performance audit has highlighted areas where the Guardians can further refine and improve governance structures, the purpose of the Guardians is clear and their performance can be assessed. The core governance arrangements of the Guardians have been in place since the start of the Fund. The 2007 Statement of Intent recognised the need to further develop executive processes and provide the Board with a broader reporting framework. The governance structures observed during our performance audit are largely consistent with what we would expect to see in a fund of this size and complexity.

The Board assesses the management of the Fund against commercial measures, including benchmarked returns and effective management of risk. The Board sets clear demands on management in terms of information, performance, and timeliness, and also seeks relevant independent advice where necessary to validate the accuracy and/or conclusions of management. The Board oversees the requirement for responsible investment by measuring actual performance against the policy of the Guardians.

The actions taken by the Guardians allow stakeholders to have confidence that adequate processes are operating to manage risks to the Fund.

Our high-priority recommendations for governance and risk management are:

- the need to develop a formal Board Charter, make it publicly available, link the Board's performance assessment back to elements of the approved Charter, and use the Charter to guide their external reporting (Recommendation 2);
- the need to integrate risk management within important areas of the Guardians' operations, including preparation of risk plans, incorporating risk management measures into executive performance assessment, and linking risk to service level requirements and policy development (Recommendation 3); and
- the need to benchmark the collective capability of the Board to international peer organisations and to conduct exit interviews as members retire from the Board (Recommendation 6).

Investment strategy

The Guardians' investment strategy for the Fund is to maximise long-term risk-adjusted returns. The Guardians achieve this by:

- establishing an appropriate asset portfolio (referred to as the Strategic Asset Allocation); and
- delivering returns for each asset class of the Fund's portfolio that exceed appropriate performance benchmarks.

The Strategic Asset Allocation is detailed in the Statement of Investment Policy, Standards and Procedures (SIPSP). The Guardians regularly assess whether asset allocations and associated benchmarks are appropriate. The Guardians also assess ongoing compliance with benchmarks and determine new investment strategies as appropriate.

The Guardians aim to deliver returns that exceed performance benchmarks by constructing investment mandates that give the Fund exposure to growth within individual asset classes. These investment mandates are then outsourced to Investment Managers who are recognised leaders in either the asset class or the growth requirement that the investment mandate is focused on. Where the Fund holds assets generating investment income, such as dividends, the income is reinvested in accordance with the related investment mandate.

The Fund's investment strategy is central to the activities of the Guardians. The Guardians obtain specialist advice, use global benchmarking, contract Investment Managers, and develop broad in-house capability to help ensure that the investment strategy supports the Fund's long-term objectives.

The investment strategy is largely based on economic fundamentals. This means that the Fund is exposed to short-term market volatility. The Guardians manage this volatility in a number of ways.

The Guardians' governing legislation creates a degree of certainty for the timeframe within which they can focus on growth of the Fund before they must also focus on liquidity. As the Fund approaches the point where Crown withdrawals start being made, its liquidity risk profile will need to change. Assets within the portfolio will need to generate investment income so the Fund can meet the Crown withdrawal requirements. The Guardians are aware of this and the likely effect it will have on the future asset allocation of the Fund. The periodic review of the Strategic Asset Allocation will ensure that growth assets are switched to income-generating assets in a timely manner.

We acknowledge the Guardians' leadership to date, and encourage them to continue to lead and work with other Crown financial institutions on a common approach, where applicable, to responsible investment.

Managing and monitoring Investment Managers

The Fund's investment strategy relies on identifying and realising growth within its asset classes. This approach has created the need for expert Investment Managers with specialised skills. The Guardians have adopted a deliberate programme to outsource investment management to meet this need.

The Guardians have recognised the risks associated with outsourced investment management and have developed appropriate processes to manage these risks. There is a high degree of awareness within the Guardians that, while processes can be outsourced, accountability for the outcomes cannot. This has led the Guardians to establish an extensive programme to select, monitor, and assess external providers. We reviewed this programme and concluded that it is consistent with all the material requirements of management practices for external providers that are promulgated by global regulators.

Monitoring and reporting of New Zealand Superannuation Fund performance

The Guardians have developed an extensive reporting structure for the Fund. This structure links Investment Managers, the Custodian, executive management, the Board, and the Minister of Finance to the reported information. There is limited intervention by the Guardians in information formally reported to these stakeholders. This increases the transparency and reliability of the information reported. Several processes operate outside this reporting framework to validate the accuracy and integrity of the information. These include reporting by the Custodian back to Investment Managers to validate month-end transaction processing, valuation of assets, and performance. Investment Managers are held accountable for information reported by the Custodian.

Information systems

The Guardians' information technology infrastructure is well managed. The most significant information technology risks relate to systems used by the Custodian. However, the Custodian's infrastructure and controls largely mitigate those risks and are regularly assessed by the Guardians.

The information technology risks to the Fund from the Guardians' own information technology infrastructure are minimal. Notwithstanding this, the Guardians have followed good practice in implementing the Control Objectives for Information and Related Technology control framework, although they are still to finalise an information technology strategy.

Internal management practices and control

The Crown set up the Fund with an initial contribution and subsequent fortnightly allocation of cash during its first five years of operation. The gradual growth of the Fund has meant that policy and operational requirements have changed significantly since the Fund's establishment. The 2007 Statement of Intent recognised the need to formalise policies and operational structures. It committed management to developing the operational infrastructure necessary to manage a mature Fund. This allows the Guardians to confidently manage the risks associated with their ongoing investment programme and operations.

The work programme completed under the 2007 Statement of Intent has established and formalised a considerable number of operational processes within the Guardians. However, at the time of our performance audit the Guardians did not yet have a final view on their preferred long-term operational and organisation structure, and how this best meets their investment strategy.

A major issue facing the Guardians is their ability to attract and retain highly skilled or specialised staff. The asset management industry is an internationally competitive talent market. It is common in their industry for key staff to be given strong incentives through targeted performance bonus schemes and remuneration arrangements. This industry-wide approach, combined with the specific asset growth focus of the Fund, creates a need for the Guardians to be able to compete to attract technical portfolio analysts with specialist asset management skills. If the Guardians cannot attract the right skills, they may suffer from lost opportunities or higher risks when implementing their investment strategy.

At the time of our performance audit, 26 of the Guardian's 28 policies and related operational processes had been recently established and were still being implemented.

Our high-priority recommendations in relation to internal management practices and control are for the Guardians to:

- prepare a long-term operational strategy (Recommendation 18); and
- put in place a transparent process that they can follow if they are required to set a level of remuneration for specialist skills outside the current approved levels (Recommendation 24).

Part 1
Introduction

1.1 New Zealand currently has a taxpayer-funded “pay-as-you-go” retirement income system, where eligible residents over the age of 65 receive a pension irrespective of their income or assets. This pension, known as New Zealand Superannuation, is funded out of general taxation.

1.2 The New Zealand Superannuation Fund (the Fund) was established under the New Zealand Superannuation and Retirement Income Act 2001 (the Act) to partially provide for the future cost of New Zealand Superannuation. The Government currently allocates about $2 billion a year to the Fund.

1.3 The Fund is governed by a Crown entity, the Guardians of New Zealand Superannuation (the Guardians). The role of the Guardians is to invest the Fund in a manner that is prudent and commercial, maximises return without undue risk, and avoids prejudice to New Zealand’s reputation. The Board of the Guardians (the Board) appoints external firms to carry out day-to-day portfolio management.

1.4 We carried out a performance audit of the Guardians’ governance and management of the Fund.

1.5 This Part explains:

- why we did the audit;
- the scope of the audit; and
- how we conducted the audit.

Why we did the audit

1.6 The Fund is a major public investment. Since the Fund began in September 2003, it has grown rapidly to $13.7 billion of assets under management as at 30 June 2007. The Fund is expected to reach a value of $120 billion by 2027.

1.7 The objective of our performance audit was to provide independent assurance to Parliament on whether the Fund is being prudently governed and managed.

1.8 Section 71(3) of the Act requires the Guardians’ performance to be reviewed and reported to the Minister of Finance at intervals of not less than five years. While our performance audit was not specifically for that purpose, our report may assist the Guardians to meet those review requirements.

Scope of our audit

1.9 Our performance audit assessed:

- the performance of the Guardians in the governance, management, and administration of the Fund; and

- the adequacy of procedures used by the Guardians to mitigate risks arising from the rapid growth of the Fund.

1.10 We covered areas of the Guardians' operations, including:

- governance arrangements;
- the investment strategy and related policies;
- contracts with Investment Managers;
- the monitoring and reporting of Fund performance;
- information systems; and
- management practices and controls.

1.11 We reviewed the processes used to select Investment Managers as stated in the Guardians' June 2007 Investment Manager Selection Policy. We reviewed how Investment Managers were selected before the policy was put in place and confirmed that the process followed was largely consistent with the policy.

1.12 We also looked for areas where the Guardians could improve. Our report makes 24 recommendations.

Out of scope

1.13 We did not assess the performance of the Fund in terms of investment returns or the appropriateness of investments made for the Fund.

1.14 While we reviewed how investment transactions are initiated and settled, we did not specifically test samples of transactions to validate that processes are consistently applied.

1.15 We did not review the selection process for each Investment Manager. However, we did review how the performance of Investment Managers is monitored and assessed.

1.16 While recognising that the role of the Custodian is critical for effective transaction management and investment mandate compliance processes, we did not review specific management procedures to validate compliance with the service level agreement between the Custodian and the Guardians. This was partly because of the short-term nature of our performance audit (some procedures occur only annually) and also because the Guardians were still negotiating reporting requirements with their new Custodian at the time of our performance audit.

How we conducted our audit

1.17 Because of the highly specialised nature of the Fund, the Auditor-General appointed Ernst & Young under section 33(1) of the Public Audit Act 2001 to assist with our performance audit.

1.18 We reviewed documents and assessed the adequacy of the Guardians' processes and activities. In particular, we compared the Guardians' governance charters and major policies against relevant best practice standards issued by regulators, such as the:

- Financial Reporting Council of the United Kingdom;
- Monetary Authority of Singapore; and
- New Zealand Securities Commission.

1.19 We also reviewed formal papers submitted to the Board, and reports produced by external advisors appointed by the Guardians.

1.20 We interviewed the:

- Chairman of the Board;
- Chairman of the Audit and Risk Committee;
- Chief Executive Officer; and
- staff of the Guardians.

1.21 We also benchmarked the processes and practices of the Guardians by:

- comparing them to those applied by similar organisations in New Zealand and overseas where it was appropriate to do so;
- using the various databases and resources of Ernst & Young, including its specialist financial services assessments; and
- considering accepted industry good practice frameworks.

Part 2
Background

2.1 New Zealand Superannuation is paid from general taxation raised from the working population.

2.2 One person in eight is over 65 years old, the eligible age to receive a pension. However, by 2030, the ratio of people over 65 is expected to have risen to one in four. This ageing of the population, an issue faced by many developed countries, is the result of a combination of increased life expectancy and lower birth rates.

2.3 The increase in the number of retired people relative to the working age population will lead to a significant increase in the cost of providing New Zealand Superannuation in the medium term. The Guardians' website says the net annual cost of superannuation is expected to rise from 3.4% of Gross Domestic Product (GDP) to about 5.6% by 2030, and to about 6.9% by 2050.[1]

2.4 In this Part, we outline:

- the role of the Fund;
- the role of the Guardians; and
- the Guardians' governance, management, and business operating structures.

Role of the New Zealand Superannuation Fund

2.5 Moving to a partially pre-funded superannuation system is an alternative to completely relying on the "pay-as-you-go" system, where payments in a given period are made from the tax revenue collected in the same period. A partially pre-funded superannuation system has been created through the Fund.

2.6 The role of the Fund is to build up a portfolio of Crown-owned assets while the cost of New Zealand Superannuation remains relatively low. Those assets will then be progressively drawn on to supplement the Crown's annual budget to meet the expected higher ongoing costs of New Zealand Superannuation.

2.7 The Fund was established in 2001 and is operated independently of the Government. It has a clear mandate set out in the Act that is sufficiently broad to ensure that all investment decisions are separate from the Government, while also meeting the Government's long-term objectives for the Fund. The Fund is expected to be a permanent part of the Government's balance sheet into the 22nd Century.

2.8 In September 2003, the Fund received an initial contribution of $2.5 billion from the Crown. Thereafter, the Fund received fortnightly contributions from the Crown based on an annual contribution schedule. The annual contribution schedule is determined and calculated by the Treasury, and sets out the timing and amount of

1 We acknowledge the New Zealand Superannuation Fund website www.nzsuperfund.co.nz as the source of some of this background information.

each fortnightly payment from the Crown to the Fund. The cumulative amount in any given year represents the annual Crown contribution, which to date has been about $2 billion a year. The Guardians reinvest all investment returns into the Fund on a long-term basis.

2.9 The Act prohibits capital withdrawals from the Fund before 1 July 2020. Capital contributions are made fortnightly by the Crown from general taxes and are projected to stop around 2028, at which time the Crown will start to make capital withdrawals from the Fund.

2.10 The Fund is projected to be a net contributor to New Zealand Superannuation from 2022, when tax paid by the Fund to the Crown is expected to exceed the Crown's capital contribution to the Fund. The Fund's assets are projected to peak at about 36% of GDP in 2037, and then gradually fall as a proportion of GDP.

Role of the Guardians of New Zealand Superannuation

2.11 The Act established the Guardians as a separate Crown entity responsible for managing and administering the Fund and its ongoing investment activities.

Investing requirements and restrictions

2.12 Section 58(2) of the Act provides that 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.*

2.13 The Act also sets certain requirements for the Guardians to fulfil while managing and administering the Fund. These include:

- restrictions on controlling interests;
- establishment and content of investment policies, standards, and procedures;
- the use of Investment Managers;
- appointing a Custodian; and
- responding to any directions given by the Minister.[2]

2 While accountable to the Crown, the Guardians operate at arm's length from the Crown. Under the Act, the Minister of Finance may give directions to the Guardians regarding the Government's expectations as to the Fund's performance, but must not give any direction that is inconsistent with the duty to invest the Fund on a prudent and commercial basis. The Guardians must have regard to any direction from the Minister. Any direction given by the Minister must be tabled in Parliament. (Source: www.nzsuperfund.co.nz)

2.14 Most of the day-to-day operations of the Fund are outsourced to Investment Managers working through an external Custodian. The Custodian has a major role holding and settling investments on behalf of the Guardians, and monitoring the investment activities of the Investment Managers appointed by the Guardians.

Governance structure

2.15 The Guardians have a Board of seven members and a management team headed by a Chief Executive Officer.

Appointment of the Board of the Guardians of New Zealand Superannuation

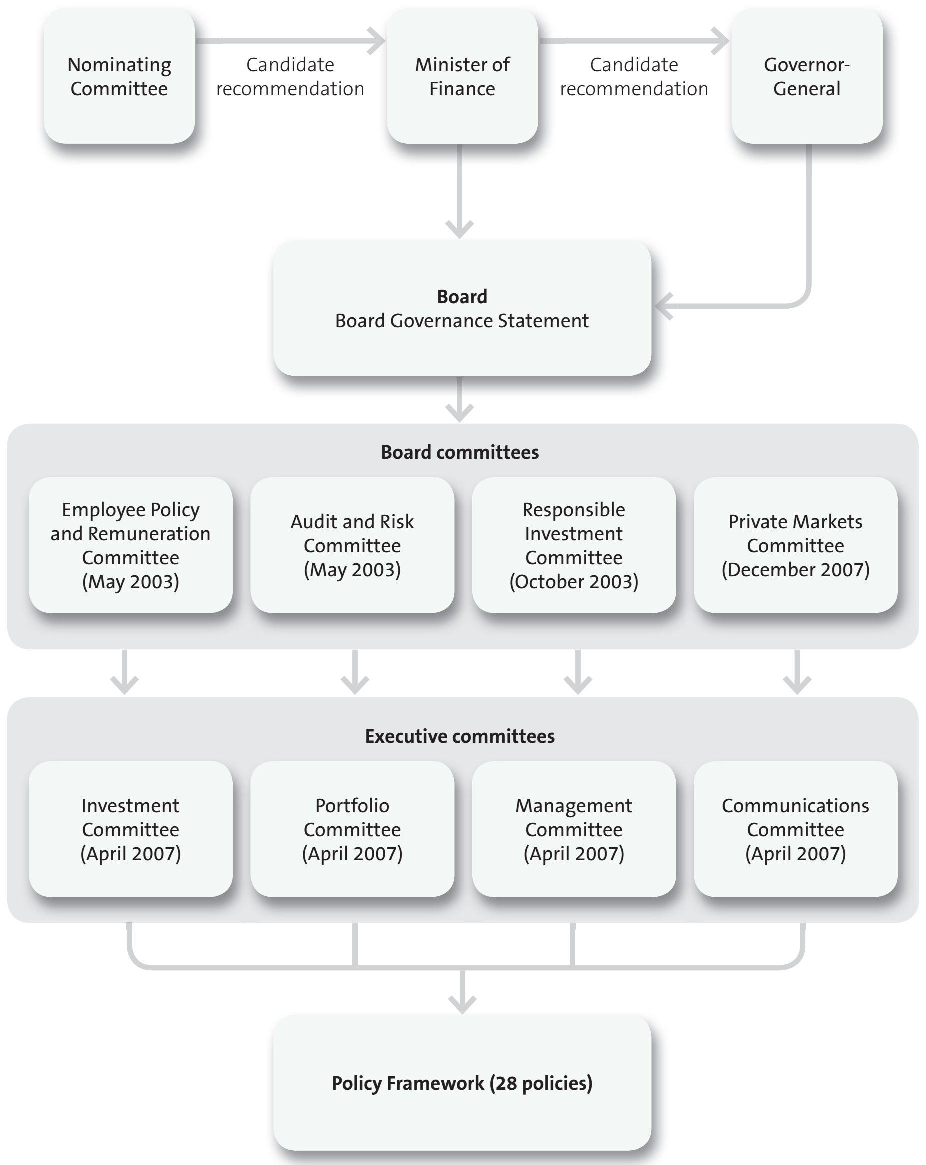
2.16 The Board is responsible for governance and overseeing management of the Fund. The appointment of Board members is subject to section 56 of the Act. This section requires the Minister of Finance (the Minister) to establish a nominating committee external to the Board and the Fund. The committee recommends candidates to the Minister, who then consults about the nominations with representatives of political parties in Parliament. The Minister then recommends Board appointments to the Governor-General.

Governance Framework

2.17 The Board adopted a corporate governance framework for the Fund (the Governance Framework) that is consistent with most commercial organisations. The Governance Framework is subject to the governance structures required by the Act and those determined necessary by the Board.

2.18 Figure 1 outlines the Governance Framework, including the committees that oversee the Guardians' activities. There are four Board committees (see paragraph 3.11) and four executive committees (see paragraph 3.13).

Figure 1
Governance framework for the Guardians of New Zealand Superannuation at the time of our audit



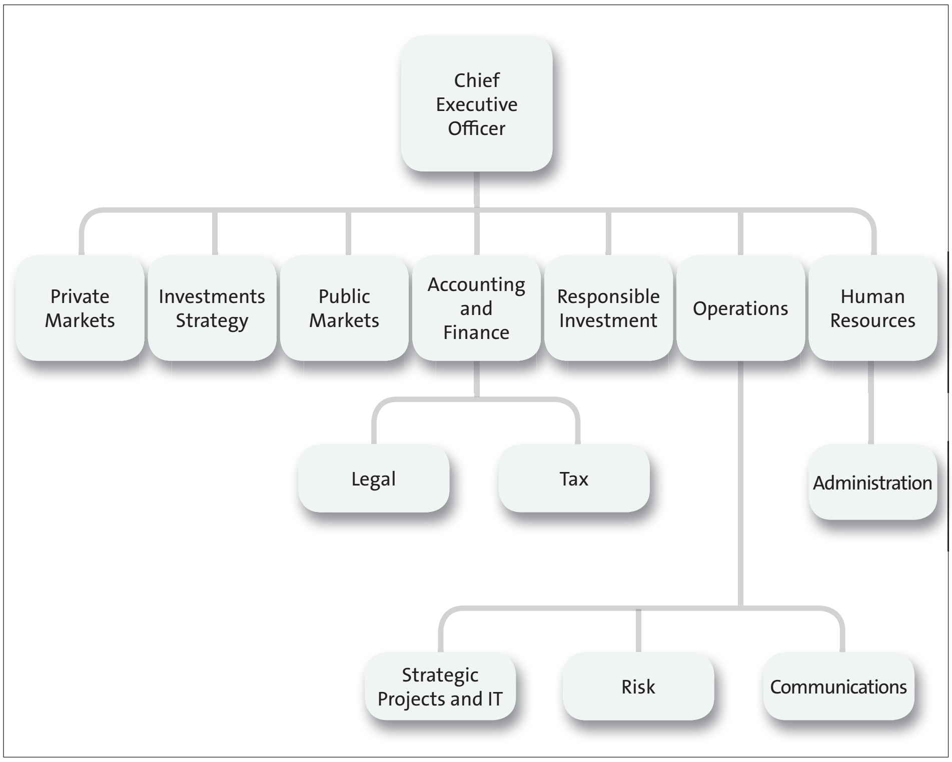
Note: The dates in this Figure refer to when the committees were established.

Organisational structure

2.19 The Guardians' staff are divided into teams, reporting through managers to executive management. Figure 2 shows the organisational structure at team level at the time of our audit.

Figure 2

Organisational structure for the Guardians of New Zealand Superannuation at the time of our audit



Business operating structure

Use of outsourcing

2.20 The Guardians chose to outsource the management of the Fund's asset portfolio. This was so they could obtain the skills to deal with the diversity of the asset classes and the specialised objectives within each asset class under the Guardians' investment strategy.

2.21 The Guardians' outsourcing business operating model allows them to hold significant and diverse international investments, and to apply specialist techniques designed to expose the Fund to growth elements within individual asset classes.

Role of Investment Managers

2.22 Specialist skills are obtained by outsourcing investment management to Investment Managers. An Investment Manager is a firm or person appointed by the Board to manage and invest a portfolio of investments for the Guardians subject to an agreed investment mandate. Some Investment Managers have more than one investment mandate.

2.23 The role of Investment Managers is to conduct investment activity on behalf of the Fund, subject to terms agreed in the investment mandate. The use of Investment Managers gives the Fund access to expert systems, research, and investment techniques.

Role of the Custodian

2.24 Having external Investment Managers also means there is a strong business case for outsourcing custodial activities and investment administration processes to specialists. Consequently, the Guardians have outsourced custodial and investment administration.

2.25 The role of the Custodian is to manage the day-to-day transaction processing, settlement, ownership registration of the various investments, reporting of the Fund, and investment mandate performance.

Operating functions carried out in-house

2.26 The combined effect of outsourcing investment management and the custodial and administration processes means that very few of the Fund's day-to-day operating functions are retained in-house by the Guardians.

2.27 The remaining operating functions, which continue to be carried out in-house, include:

- investment strategy, analysis, and long-term forecasting;
- reporting to stakeholders;
- managing external providers;
- identifying and selecting Investment Managers;
- monitoring and managing the performance of Investment Managers;
- funding and liquidity management;
- financial administration of the Guardians; and
- administering processes for responsible investment.

Part 3
Governance arrangements

Key messages

- Effective leadership and strong governance have been consistent themes throughout the first four years of the Fund's operations. This is demonstrated in the approach adopted by the Guardians in selecting and monitoring external providers.
- The growth of the Fund and the increased number of investment mandates have increased the need for formalised governance processes and operating frameworks. The Guardians' 2007 Statement of Intent addresses this. The document is important for the Guardians, as it focuses on developing effective management controls with high levels of accountability.
- The actions taken by the Guardians allow stakeholders to have confidence that adequate processes are operating to manage risks to the Fund. However, the Guardians could do more to integrate risk management in important areas of business operations.
- The Guardians need to adopt a formal Board Charter, make it publicly available, and incorporate the measures adopted in the Charter as part of their annual Board performance assessment process.
- The Guardians have a sound Assurance Framework for assessing decisions made by management.
- We acknowledge the Guardians' leadership to date, and encourage them to continue to lead and work with other Crown financial institutions on a common approach, where applicable, to responsible investment.

3.1 In this Part, we outline milestones in the relatively short history of the Guardians and report on how well the Guardians' governance arrangements were working when we examined them at the end of 2007. The governance arrangements are fundamental elements of managing investment performance. For these arrangements to be functioning well, we expected to find:

- sound governance processes;
- adequate application of governance processes;
- effective and timely overseeing of management decisions; and
- governance activities relevant to measuring the Fund's performance.

3.2 We examined how the Guardians apply governance processes to meet the legislative requirement to invest in a way that avoids prejudice to New Zealand's reputation as a responsible member of the world community.

Our findings

3.3 The Guardians' governance arrangements are consistent with the context and nature of the Fund's legislative requirements.

3.4 The Guardians' 2007 Statement of Intent acknowledges the need to change governance arrangements in response to changes in the Fund's environment and its growth. The Statement of Intent sets out a work programme to formalise the executive governance and internal control infrastructure. Implementation of the work programme will lead to further separation of responsibilities between the Board and management.

3.5 In our view, the timing and scope of the work programme set out in the 2007 Statement of Intent was appropriate.

3.6 Our performance audit was conducted just after the work programme was implemented. As such, at the time of our audit, some elements were only recently operational or were nearing completion. Our comments relating to the newly established framework should be read in this context. Many of our recommendations relating to terms of reference, charters, documents, and policies are likely to have occurred during the implementation process. It is also likely that the Guardians will identify further changes during the process beyond our recommendations in this report.

History of the Guardians and the Fund

3.7 The Guardians' first tasks were to devise an investment strategy for the Fund, agree investment mandates, and set up infrastructure for the Fund to receive and invest regular capital contributions from the Crown. A vital part of developing the infrastructure was appointing a Chief Executive Officer and a supporting management team. This was mostly complete by the end of 2006.

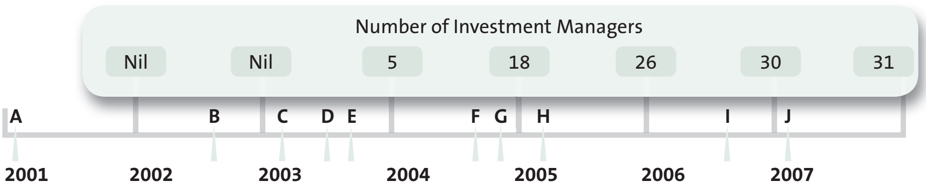
3.8 The way the Fund was established meant there was initially limited distinction between the Board and management. To start with, the Board performed some management functions. This mitigated the need for a complex governance structure. However, the growth of the Fund and the increased number of investment mandates have increased the need for formalised governance processes and operating frameworks.

3.9 The Board recognised the changing focus and approved a detailed programme to establish policies and procedures and operating infrastructure as part of the Guardians' *Statement of Intent for the period commencing 1 July 2007 to 30 June 2010* (2007 Statement of Intent).

3.10 Figure 3 shows major milestones in the history of the Guardians.

Figure 3

Milestones in the history of the Guardians of New Zealand Superannuation to 2007



A: October 2001
Minister of Finance appointed independent committee to nominate people for the Guardians of New Zealand Superannuation Board

B: August 2002
Guardians of New Zealand Superannuation Board appointed

C: March 2003
First Chief Executive Officer appointed

D: August 2003
Board announced initial Strategic Asset Allocation

E: September 2003
Custodian appointed

F: September 2004
Two new appointments to the Board

G: November 2004
First independent review of the Guardians of New Zealand Superannuation

H: March 2005
Changes to Strategic Asset Allocation announced

I: August 2006
Chief Executive Officer resigned

J: January 2007
New Chief Executive Officer appointed
New Custodian appointed (effective 1 July 2007)

Governance arrangements

Governance structure

3.11 The Board and four Board committees govern the Guardians' activities. The committees are:

- Audit and Risk Committee (established May 2003);
- Employee Policy and Remuneration Committee (established May 2003);
- Responsible Investment Committee (established October 2003); and
- Private Markets Committee (established December 2007).[1]

3.12 This governance structure reflects common practice, the requirements of the Fund's governing legislation, and the specific nature of the Fund's investments. All members of the committees are Board members, who are appointed to the committees depending on their specific skills. All committees are governed by terms of reference approved by the Board that outline specific responsibilities, scope, and any Board-approved policies.

3.13 In April 2007, as part of the governance infrastructure development programme set out in the 2007 Statement of Intent, the Guardians established four executive committees to support the Board's committees. Comprising members of senior management, the executive committees are:

- Investment Committee;
- Portfolio Committee;
- Management Committee; and
- Communications Committee.

3.14 The Board or the applicable Board committee approves the terms of reference of each executive committee. The terms of reference for each executive committee contain all the material requirements that we would expect in such documents. However, we found minor areas where the terms of reference could be improved to bring them into line with governance standards promulgated by a selection of global regulators.[2] (Our suggested improvements to the terms of reference are set out in Appendix 1).

1 This committee was established by the Board and management to help the Board assess the merits of complex instruments that mostly relate to unlisted markets.

2 Financial Reporting Council of the United Kingdom, *The Combined Code on Corporate Governance*; Monetary Authority of Singapore, *Combined Code of Corporate Governance*; New Zealand Securities Commission, *A Handbook for Directors, Executives, and Advisors.*

Recommendation 1

We recommend that the Guardians of New Zealand Superannuation update the terms of reference documents for their Board committees and executive committees to better reflect governance standards promulgated by global regulators.

Board charter and performance review

3.15 Most organisations with a board have a board charter setting out the scope of responsibilities and how those responsibilities will be met. The purpose of a board charter is to document:

- the role of the board;
- the structure of the board;
- matters relating to board members;
- the committees of the board; and
- standards and requirements for:
  - integrity and ethical behaviour;
  - financial reporting;
  - timely and balanced disclosure;
  - communication with shareholders;
  - recognition and management of risk; and
  - performance evaluation.

3.16 A board charter records basic information about how major decisions are made, how risks are managed, and how performance is assessed. This information is generally made available to the public, as it communicates the tone of the organisation, particularly in relation to core governance functions.

3.17 There is no formal published charter for the Board. However, there is a Board Governance Statement (in place since November 2003) that covers the material elements of a board charter, apart from minor areas where the document could be improved. At the time of our performance audit, the Board Governance Statement was not publicly available, and was being reviewed. We were told that our recommendations for improvement were being incorporated as part of this review.

3.18 The absence of a formal board charter may affect the objectivity of a board's performance assessment as there are no predefined measures against which that board can be held publicly accountable. However, in making this observation, we note that the Board has engaged qualified independent consultants to carry out annual performance assessments.[3]

3 Governance Effectiveness Review – BOARDWORKS International July 2007.

3.19 The annual performance assessment involves each Board member completing a questionnaire covering various elements of governance. This approach to performance assessment is consistent with global practice and our experience is that New Zealand boards rarely conduct this type of assessment. The most recent independent performance assessment of the Board did not identify any significant issues.

Recommendation 2

We recommend that the Guardians of New Zealand Superannuation adopt a formal Board Charter, make it publicly available, incorporate the measures adopted in the Charter as part of their annual Board performance assessment process, and use the Charter to guide their external reporting.

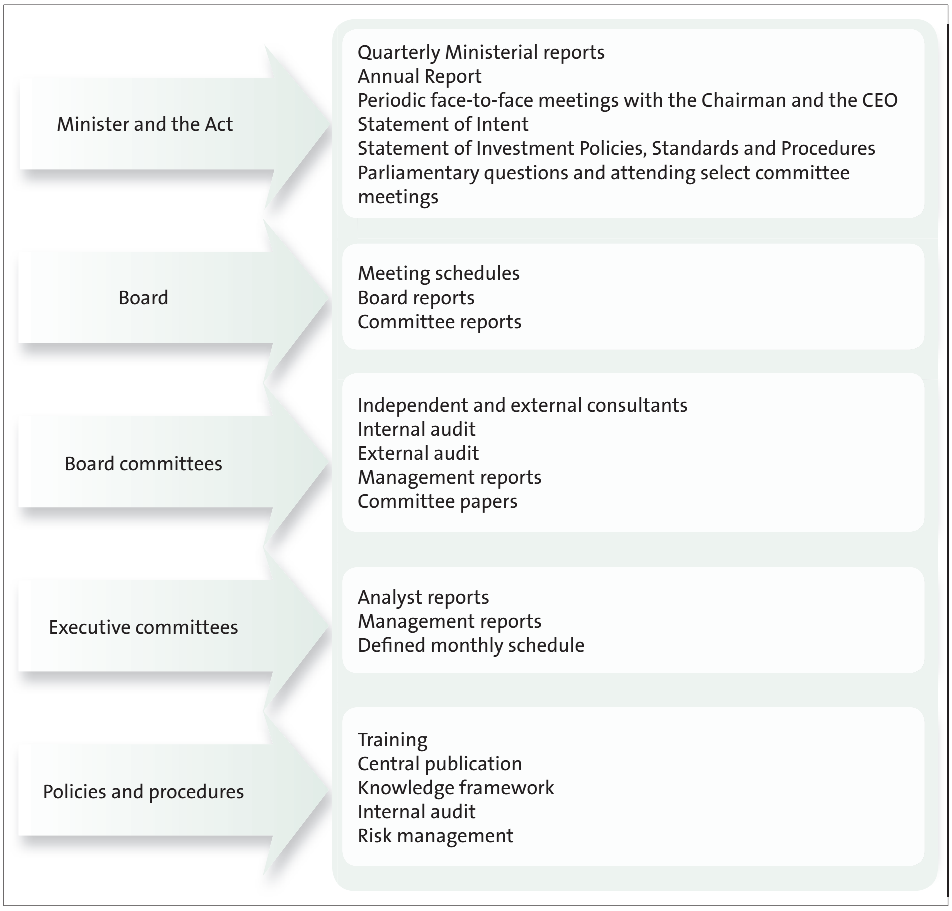
3.20 This is a high-priority recommendation because the published document provides assurance to stakeholders that the Guardians are complying with generally accepted standards of governance. A formal Board Charter would also provide basic measures of performance for the Board and related committees to be measured against.

Applying the governance arrangements

Governance elements and associated processes and activities

3.21 The Guardians' governance arrangements operate at multiple levels and involve many processes and activities. Figure 4 shows the main elements of the governance arrangements and the associated processes and activities.

Figure 4
Governance elements and associated processes and activities



3.22 We reviewed how the governance elements outlined in Figure 4 have been implemented. In most areas, implementation meets or exceeds the relevant generally accepted governance standards. These standards include the governance standards of national and global regulators, and standards set out in other associated publications, such as those of the Committee of Sponsoring Organizations of the Treadway Commission (COSO)[4] and the Control Objectives for Information and Related Technologies (COBIT)[5] frameworks. The following activities, relating to policies, were under way at the time of our performance audit:

- training staff on the requirements and expectations of corporate policies and procedures;

4 COSO focuses on controls for financial processes. Internal controls promote efficiency, reduce risk of asset loss, and help to ensure the reliability of financial statements and compliance with laws and regulations.

5 COBIT is an open standard published by the IT Governance Institute (ITGI) and the Information Systems Audit and Control Association ISACA). It is an information technology control framework based on the COSO framework. ISACA is a global organisation with members in 160 countries. ITGI was established by ISACA in 1998.

- central publication of the policies and procedures so they are available to all staff; and
- ensuring that the procedural requirements of policies are recognised as part of the treatment of risks under the Guardians' Risk Management Framework.

3.23 At the time of our audit fieldwork, we were satisfied that the training of staff and central publication of policies would be completed as part of the work programme for the 2007 Statement of Intent. The Guardians have since confirmed that these activities are complete.

Risk Management Framework

3.24 Risk management is a crucial component of governance. Until 2007, the Guardians did not have a formal risk management framework. The absence of such a framework from the outset of the Fund has not been ideal. However, risk has been managed by the Guardians in a structured manner.

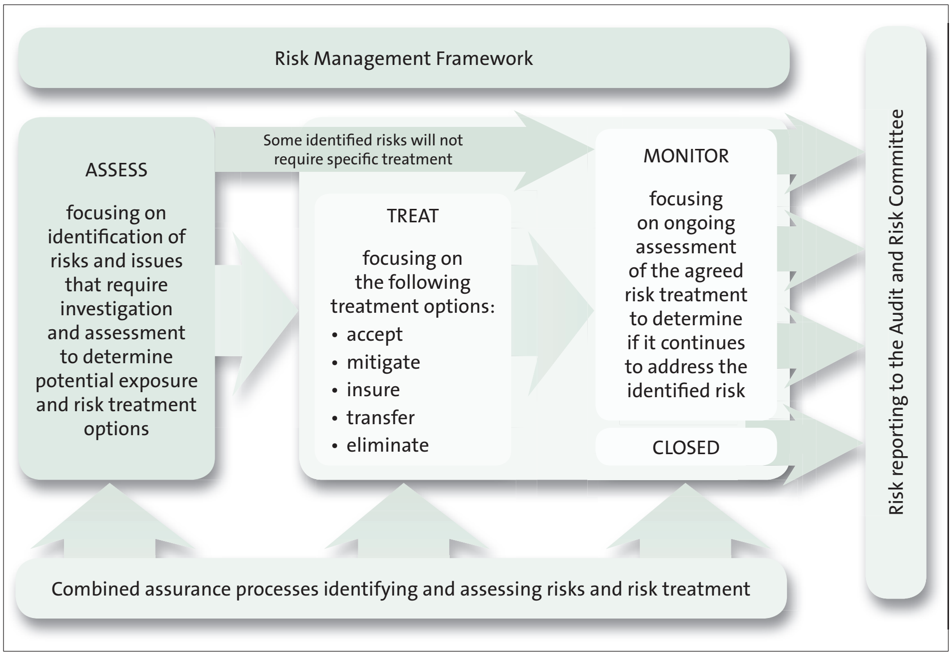
3.25 From 2004, the Guardians have been developing risk capability. Risk papers were reviewed by the Audit and Risk Committee in 2004, 2005, and 2006. In 2007, the Guardians appointed a Chief Operating Officer to formalise risk management for the Fund in accordance with the 2007 Statement of Intent. The Chief Operating Officer has been largely responsible for developing the policy programme in 2007/08 as well as the Risk Management Framework approved by the Audit and Risk Committee in October 2007.

3.26 The primary purpose of the Risk Management Framework is to:

- identify the major risks that could prevent the Guardians from realising their objectives;
- understand the activities applied by the Guardians to manage these risks and determine the adequacy of the activity;
- link the risk management activity to the operational business processes;
- provide ongoing measurement of the effectiveness of the risk management activity; and
- ensure that assurance from management and independent assurance providers over major risks and their related management activities is aligned with controls.

3.27 Figure 5 shows the main components of the Guardians' Risk Management Framework. It reflects the various stages of the risk management process from initial assessment through to ongoing monitoring or closure.

Figure 5
How the Guardians of New Zealand Superannuation's Risk Management Framework operates



3.28 The main focus of the Guardians' Risk Management Framework is to document and link risk management activity throughout the operations of the Guardians. A knowledge management project has been established by the Guardians to document core processes and procedures. The Guardians told us that they intend to implement the remaining elements of the Risk Management Framework in 2008.

3.29 We reviewed implementation plans for the Guardians' Risk Management Framework and noted opportunities to further integrate risk management processes into business operations. These include:

- preparing a risk management policy (see paragraph 8.18);
- linking high inherent risks to processes by documenting how risk relates to processes;
- documenting how major risks (and the process for risk assessment) relate to service level agreements with external providers (to ensure that important requirements are addressed);
- documenting how executive monitoring and performance measures relate to the ownership and management of major risks;

- documenting how the risk measurement criteria (that is, likelihood and effect measures) relate to the strategic objectives of the Guardians; and
- documenting how risk management is used to assess project risks and project significance, to demonstrate that projects are managed based on risk rather than cost.

Recommendation 3

We recommend that the Guardians of New Zealand Superannuation update their Risk Management Framework so that relevant risk management activity is identified in important areas of the operations. This update should include preparation of risk plans, incorporating risk management measures into executive performance assessment, and linking risk to service level requirements and policy development.

3.30 This is a high-priority recommendation because embedding the Risk Management Framework throughout the Guardians' operations will give management and the Board confidence that major identified risks are appropriately managed. It would also help to ensure that management action plans are appropriate and are being complied with.

Risk-based internal audit

3.31 Under a good governance framework, a board typically appoints an internal auditor to review the assessment and management of risk throughout the organisation. The internal audit scope and plan of work is based on a risk assessment completed in conjunction with the organisation's risk management framework.

3.32 In the absence of a risk management framework, the Guardians' internal audit function has not had a formal process for determining a risk-based internal audit plan. Therefore, most of the internal audits have been management initiatives based on the Guardians' Statement of Intent, and risks identified by management and the Board. Internal audit plans have been approved by the Audit and Risk Committee and management.

3.33 While this approach made sense during the phased development of the Guardians' operations, internal audit plans should start to use the Risk Management Framework to demonstrate how core assurance is provided over high risks. This approach will become increasingly important as the Guardians continue to separate the roles of management and the Board, and can be done by linking internal audit coverage to processes for managing high risks (see paragraph 3.29).

Recommendation 4

We recommend that, in their 2008/09 internal audit plan, the Guardians of New Zealand Superannuation target high-risk processes as identified by their Risk Management Framework for assurance on a set timetable (for example, every two years).

Overseeing management decisions

Role of the Board

3.34 The usual role of a board is to oversee management decision-making, and where appropriate, approve decisions of strategic importance to the organisation.

3.35 Initially, the Board was responsible for a lot of day-to-day decision-making. This included strategic decisions that we would expect the Board to be involved in and some non-strategic decisions that we would not normally expect the Board to be involved in. This meant the Board initially acted in a quasi-executive role rather than in a fully independent governance role.

3.36 Since then, the Board has progressively delegated decision-making activities to management (for example, assessing potential Investment Managers). The 2007 Statement of Intent work programme has allowed the Board to step away from operational roles with the confidence that expectations of roles are clear.

3.37 The work programme completed under the 2007 Statement of Intent set in place formal structures and processes to be applied to the operations of the Guardians. Many of these processes are measurable, but at the time of our audit were not supported by a reporting framework to measure and assess compliance. The Guardians are in the process of addressing this reporting deficiency.

Recommendation 5

We recommend that the Guardians of New Zealand Superannuation further develop and refine standard reporting to support the separation of Board and management responsibilities. This should include assessing management decision-making within predefined parameters approved by the Board.

Board capability

3.38 The Board has professional members and maintains significant institutional knowledge through its remaining founding members. Our assessment of the Board in place at the time of our performance audit was that it is effective and capable of challenging and questioning management's technical decisions.

3.39 The Board engages with international investment strategy specialists and regularly meets with management. There is clear evidence of detailed technical analysis and challenge of management in minutes of meetings of the Board and its committees. For example, a decision to establish a Private Markets Committee resulted from discussions between the Board and management on risk matters relating to Private Markets, time taken at Board meetings to address the issues, and the need for more Board attention in this area.

3.40 The ability of the Board to oversee the Fund effectively depends on the Board's collective competency and understanding of:

- the Fund and the Guardians;
- the Guardians' investment and management strategies;
- the business operating environment; and
- the investment environment.

3.41 The ability of the Board to effectively question and challenge management decision-making will become more important as the founding members retire and the Fund moves into more complex asset classes. In addition, there are ongoing governance challenges facing the Guardians related to:

- being located in New Zealand; and
- the requirements of the founding legislation.

3.42 The governance challenges include:

- The size of the Fund relative to the New Zealand asset management industry, which means that some investment strategies are likely to be unique within a New Zealand commercial context. This may require specialist skills not easily found in New Zealand.

- Board members are remunerated under the Crown remuneration framework,[6] which so far has not limited the ability of the Guardians to attract and retain high calibre Board members. However, in time this could limit the ability of the Guardians to attract and retain appropriately qualified international board members, should that be necessary.

3.43 Leading global regulatory bodies recommend that board member appointment, board performance assessment, and board remuneration be performed by a nominating committee comprising independent members receiving external advice.

3.44 Sections 55 and 56 of the Act require the Minister to establish a nominating committee of at least four people with relevant skills and experience, whose function is to identify suitably qualified candidates for appointment to the Board. This is different from most other Crown entities, and the provision in the Act for a nominating committee reflects the importance of the Board's appointment. The Minister can choose only from the list proposed by the nominating committee.

3.45 We are aware that the Treasury has regular discussions with the Board Chairman about Board capability. There is also dialogue between the Board and the Minister.

3.46 The Board periodically reviews its performance using a self-assessment process, but it does not assess or benchmark its collective capability against peer organisations. In our view, an independent review of Board capability is necessary given the international investment focus of the Fund and the specialist nature of some of its investments. An independent review would help to identify any potential risks and provide the Treasury with an objective basis to assess collective Board capability. The Board is aware of the capability risks and uses an expert reference group to provide feedback on investment governance.

6 The Department of the Prime Minister and Cabinet (Cabinet Office circular CO(06)08), *Fees Framework for Members of Statutory and Other Bodies Appointed by the Crown*.
The following discussion is from a footnote in the Auditor-General's good practice guide *Audit committees in the public sector*, March 2008. It provides context relevant to the issue noted in paragraph 3.43.
Several entities have raised with us specific concerns about the remuneration levels set by the Cabinet Office's fees framework (CFF). Many felt that remuneration levels within the CFF are too low for an entity to be able to secure the necessary skills and expertise for their audit committee to provide proper scrutiny, advice, and insight. We share this concern. In our view, even allowing for an element of public service, the fees paid under the CFF are low. There is a limited pool of people who are willing and able to provide services at the level required for the current rates.
If government departments consider that the fees payable are too low to attract people with the required skills, they can seek advice from the State Services Commission (SSC). A Crown entity should pursue the question through its monitoring department. For departments, the CFF allows for exceptional fees (up to a prescribed limit and where clearly justified) for the chairperson and members of audit committees, subject to consultation with the responsible Minister and the Minister of State Services in each case. The SSC has advised us that such approval is rarely sought. Based on comments made in the interviews we conducted, some may see the approval process as unduly difficult, while others are unaware that it exists. If government departments consider that an exceptional fee above the CFF limit is justified, they should discuss the matter with the SSC.
The SSC has advised us that the CFF is reviewed biennially and that our concerns will be noted during the next review (in June 2008).

Recommendation 6

We recommend that the Guardians of New Zealand Superannuation assess the scope of the Board's current and future capability by initiating a regular independent assessment of the Board's combined capability relative to appropriate international peer organisations, and by conducting exit interviews as members retire from the Board.

3.47 This is a high-priority recommendation because the capability of the combined Board has not been compared to Boards of similar organisations. In our view, it is not possible to effectively compare the Fund, and the Board, to peer organisations based in New Zealand. In making this recommendation, we have not had access to relevant Board assessments performed outside the Guardians.

Board assurance

Assurance Framework

3.48 To fulfil its overseeing role effectively, a board relies on access to relevant information to assess management decision-making. Board assurance refers to all processes and activities that provide information about whether business processes are functioning adequately, risks are being appropriately managed, and policies are being complied with. This includes information provided by auditors, advisers, and management.

3.49 The Guardians' Assurance Framework comprises three elements common to most organisations:

- **Management assurance**, representing procedures performed by management and external providers. The specific objective of management assurance is in relation to timely and accurate organisational performance.
- **Internal assurance**, representing internal audit and other independent review of controls to validate that processes and activities are performed effectively and efficiently. The specific objective of internal audit is to assess policy compliance, management of identified risks, and the adequacy of internal control procedures.
- **External audit assurance**, where the Board and other relevant stakeholders derive assurance over financial controls from the work carried out by the external auditor to audit the annual financial statements.

Management assurance

3.50 A significant portion of Fund assurance comes from management assurance activities. This reflects the extensive review procedures performed by the Guardians' Operations team to verify that the Custodian controls are working. Other assurance is also provided by the Custodian, through checks to ensure that all operational external providers are subject to regular reviews as well as specific assurance reports such as a SAS 70 report. These checking procedures occur because the Guardians recognise that they can outsource the activity but not the responsibility for the activity.

3.51 The two main operational risks for the Fund relate to transactions and valuations. Transaction risk relates to the fair and transparent exchange of cash for investment assets. Valuation risk relates to the correct valuation of assets for investment performance and portfolio management purposes.

3.52 Generally, controls over these risks are separated into primary and secondary controls. Primary controls relate to system-based controls enforcing segregation of duties, or forcing certain actions to occur before a transaction can be processed. Secondary controls relate to the independent review of processes and activities to verify completeness and accuracy. Most of the Fund's primary controls are outsourced.

3.53 The primary controls performed by the Guardians, such as payroll, cash management, and accounts payable, are less risky compared to the primary controls performed by external providers. This is because the Fund's bank accounts are separate from those of the Guardians, which reduces exposure to the risk of inappropriate transactions and activity.

3.54 The Guardians have outsourced a significant portion of the Fund's investment operations. This has implications for their assurance processes because contracts with external providers establish predefined performance measures, which are monitored and assessed by various parties.

Internal audit assurance

3.55 Deriving value from internal audit is more challenging when investment operations are outsourced. Where all processes are performed in-house, the internal auditor will be reviewing controls performed by the entity. In an outsourcing environment, the internal auditor either reviews controls, checking the work of the third party, or reviews reports provided by the third party and their auditors. There is limited internal audit review of primary controls given the outsourcing environment. The Guardians recognise this and have appropriately focused internal audit activity on areas where risk is retained in-house.

3.56 The Guardians conduct quarterly meetings with assurance providers to ensure that there is no scope overlap between internal and external audit, and that both assurance functions are fully aware of ongoing management assurance activity.

3.57 The internal audit function of the Guardians is contracted to a third party provider. This is a common approach given the specialised nature of internal auditing. However, the Guardians do not have a formal service level agreement in place with the provider. Instead, there is an existing Internal Audit Policy and a protocol agreed with the provider for initiating audits, determining scope, obtaining sign-off, and agreeing dates to complete and provide feedback. This protocol does not reflect all the relevant guidance of the Institute of Internal Auditors.

Recommendation 7

We recommend that the Guardians of New Zealand Superannuation formalise their internal audit framework by establishing an Internal Audit Charter (consistent with the guidance of the Institute of Internal Auditors), a service level agreement with their internal audit provider, and by carrying out three-yearly peer reviews of the services provided by their internal audit provider (consistent with the Institute of Internal Auditors' peer review framework).

Governance of responsible investment

3.58 We have reviewed how the Guardians manage investment activity to avoid prejudice to New Zealand's reputation as a responsible member of the world community.[7]

3.59 In the absence of a Crown-wide definition of what constitutes prejudice to New Zealand, the Guardians have applied the international responsible investment framework, as defined by the United Nations Principles for Responsible Investment (UNPRI). In taking this approach, the Guardians believe they have satisfied the intended requirements of the governing legislation. They also believe that the risk of prejudicing New Zealand's reputation through the investment activities of the Fund is extremely low.

Responsible Investment Policy

3.60 The Guardians have developed a detailed Responsible Investment Policy in response to their obligations under the Act. The policy is benchmarked to leading global practice. It requires the Guardians to take responsible investment seriously. This includes a considerable annual commitment of resources to responsible investment activities.

3.61 We have reviewed the Guardians' policy standards and procedures and compared them with relevant practices applied elsewhere in the public sector and to global investing entities subject to similar responsible investment obligations. The

7 Section 58(2) of the Act.

Guardians' Responsible Investment Policy covers the Fund's requirement to have an ethical policy and a policy on voting. Other policies of the Guardians cover broader governance and Investment Manager due diligence.

Responsible Investment Framework

3.62 The Guardians' Responsible Investment Framework includes policies, standards, and procedures. The framework concentrates on acting as a responsible shareholder and fostering transparent corporate governance rather than necessarily excluding shares or securities. This is achieved by adopting standards such as the UNPRI and the United Nations Global Compact for monitoring corporate behaviour.

Monitoring for responsible investment

3.63 The Guardians engage external responsible investment agencies such as Innovest Strategic Value Advisors, Institutional Shareholder Services, and the Morgan Stanley Capital International universe of potential investments to monitor the majority of the Fund's portfolio. Mostly, these agencies look to analyse companies' environmental, social, and governance performance.

3.64 The Guardians use this monitoring information to exercise the Fund's vote as an active shareholder, to engage with companies, or to identify companies for exclusion. Responsible investment is also achieved by managing how the Fund votes, engages, invests, and divests as a shareholder. The framework is diverse and approaches responsible investment on a number of fronts, including active shareholder actions, shareholder voting strategies, screening, and share exclusion.

Responsible Investment Committee

3.65 The Responsible Investment Committee oversees the framework. Its responsibilities include:

- preparing, for Board consideration, responsible investment policies, standards, and procedures to meet obligations outlined in sections 58 and 61 of the Act;
- monitoring the Guardians' implementation of responsible investment policies, standards, and procedures on behalf of the Board through regular reporting;
- recommending to the Board any external parties to be contracted to assist the Guardians in relation to their responsible investment obligations;
- requesting specific guidance from management on any specific responsible investment issues that have been raised; and
- reviewing and making recommendations to the Board on advice received on responsible investment matters.

3.66 Where the activities of an entity are found to potentially prejudice New Zealand's reputation, there are various options for the Guardians to manage the exposure. These include engagement with the entity using shareholder groups, through to share exclusion.

3.67 Share exclusion means removal of the shares from the Fund's portfolio through divestment or specific instruction to the Investment Manager to never hold the shares in the portfolio. Share exclusion is a last resort for the Guardians. It will occur only if the Guardians cannot bring about a positive outcome through exercising their shareholder rights. Share exclusion decisions are based on receiving information from subscriber organisations specialising in investigating and reporting matters of corporate responsibility, or where the activity of a company is contrary to New Zealand law.

Managing responsible investment risk

3.68 Despite the work that has been done and the extensive management framework based on global investment principles, a number of challenges still face the Guardians in managing their responsible investment risk. These include:

- Generally, the Fund is not a substantial shareholder in any entity in its own right. Therefore, the Guardians could be less effective if they operated alone in engagement with companies or divesting. Instead, the Guardians increase their effectiveness through collaboration with other investors. Principally, this occurs through the Guardians' involvement with the UNPRI. The Guardians depend on these organisations making decisions that are consistent with their "avoid prejudice" requirement.
- The Guardians have a responsibility to assess the effect of exclusion on investment risk and returns.
- Identifying which companies to exclude can present challenges and requires a specialist screening agency (for example, checking for a company's involvement in landmine manufacture).
- For some asset classes, it can be difficult to understand all activities of the entity that the Fund has invested in. This can make it difficult for the Guardians to assess the appropriateness of the activity.
- It is not always possible for the Fund to identify all activities in pooled investment structures such as unit trusts.

Communicating about responsible investment

3.69 The Guardians are often asked for information about their actions as a responsible investor. Each year, the Guardians publish their responsible investment approach and programme within the Statement of Intent. This is the Responsible Investment Policy, Standards and Procedures. However, this issue is complex, emerging, and of high public interest. We consider that the Guardians could more effectively communicate their primary responsible investment strategy of working through shareholder engagement groups to influence the behaviour or operations of an organisation in which they have invested.

Taking a leadership role in responsible investment

3.70 The Guardians meet regularly with other Crown financial institutions to discuss responsible investment, and have encouraged the other institutions to adopt the UNPRI approach. A common definition of responsible investment could evolve from this.

3.71 Recognising the significant investment made by the Guardians and their expertise in responsible investment, we consider that there is merit in the Guardians taking a leadership role in this area within the public sector. Largely, this has been occurring through the Guardians encouraging other Crown financial institutions, although this role has not been formalised within the public sector. There is also no formal initiative to harmonise how Crown financial institutions address responsible investment issues.

3.72 We acknowledge the Guardians' leadership to date, and encourage them to continue to lead and work with other Crown financial institutions on a common approach, where applicable, to responsible investment.

3.73 We consider that, overall, the Guardians have taken an appropriate and pragmatic approach to responsible investment.

Investment screening process

3.74 The current investment screening process is limited to equity positions and sovereign securities held by the Fund. The screening process does not check for any debt securities that the Fund may hold in an "excluded entity". This can lead to a situation where a company or entity is placed on an "excluded list" by the Guardians, but the Fund continues to hold debt or fixed interest securities in the same company or entity. We recognise that the risk of this occurring is low because the Fund currently holds only New Zealand-based corporate bonds.

Recommendation 8

We recommend that the Guardians of New Zealand Superannuation extend their screening of investments in excluded companies or entities to all security positions, including debt or fixed interest securities.

Our conclusions

3.75 Effective leadership and strong governance have been consistent themes throughout the first four years of the Fund's operations. This is demonstrated in the approach adopted by the Guardians in selecting and monitoring external providers. While our performance audit has highlighted areas for consideration and improvement, this reflects the evolution and development of the Guardians rather than any perceived deficiency in their current governance framework.

Part 4
Investment strategy and related policies

Key messages

- The Guardians have developed and implemented an investment strategy that meets the objectives of their founding legislation.
- The investment strategy is supported by clear and measurable risk parameters that are regularly assessed and considered in the investment management process. In our view, the Guardians use appropriate due diligence processes to test the appropriateness and reliability of the investment strategy.
- The investment management structure is appropriate for the agreed funding model.
- The Guardians are in the early stages of their rolling 20-year investment horizon and will need to continuously assess and change their strategies to address the liquidity requirements of the Fund and the changing investment environment.

4.1 Investment funds are generally established to achieve particular aims, such as the provision of superannuation benefits, the continued support of an institution (such as a university), or to allow investors to buy a share of a pool of assets diversified in one or many sectors. Whatever its aim, an investment fund needs to have a strategy to guide its ongoing investment activity and to support this strategy with appropriate policies and procedures.

4.2 In this Part, we discuss the Guardians' investment strategy and related policies and how they relate to the Fund's legislative mandate and stakeholder expectations. We consider how the investment strategy is set, executed, and monitored by the Guardians, and report on how well related policies were working when we examined them at the end of 2007.

4.3 For the arrangements to be functioning well, we expected to find:

- an established investment strategy;
- measurement and management of investment risk; and
- effective management of the Fund's liquidity.

Our findings

4.4 Since the Guardians were established, they have concentrated on defining and refining an investment strategy, which is formalised in the Statement of Investment Policies, Standards and Procedures (SIPSP).

4.5 Section 60 of the Act requires the Guardians to "establish, and adhere to, investment policies, standards, and procedures for the Fund that is consistent with their duty to invest the Fund on a prudent, commercial basis". The purpose of the SIPSP is to set out how the Fund’s assets are invested and how performance is measured. Management prepares the SIPSP and the Board reviews it annually. The SIPSP is a public document available on the Guardians’ website and in their annual publications.

4.6 The SIPSP sets out the investment strategy of the Fund, how the Fund measures and manages risk, and how liquidity is managed through the investment programme. The core consideration whenever investment opportunities are assessed is their fit and relationship with the SIPSP.

4.7 In our view, the Guardians use appropriate due diligence processes to test the appropriateness and reliability of the investment strategy.

Investment strategy

4.8 Section 58(2) of the Act requires the Guardians to invest the Fund on a prudent, commercial basis and to manage and administer the Fund in a manner consistent with:

- best-practice portfolio management;
- 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.

4.9 The Act does not provide any guidance as to what is meant by “best-practice portfolio management”, “maximising return”, or “avoiding prejudice”. The Guardians have defined these requirements in the SIPSP.

4.10 There are two elements to the Fund’s investment strategy:

- overall Strategic Asset Allocation; and
- underlying targeted investment mandates.

Strategic Asset Allocation

4.11 The SIPSP requires the Guardians to adopt a Strategic Asset Allocation to determine the proportion of the total Fund to be held in any single asset class. The Strategic Asset Allocation is designed to balance the Fund’s assets across market sectors, which will maximise returns in the long term while ensuring that the Fund is not over-exposed to risk from a particular security or market segment. The Strategic Asset Allocation is prepared by management and reviewed and decided by the Board. It is also subject to periodic external peer review.

4.12 As expected, the weighting applied to each asset class has changed over time. The weighting reflects the Fund’s assessment of how changing market conditions affect each asset class relative to the expected risk and return. This approach demonstrates the Guardians' commitment to maximising long-term returns without taking undue risk.

4.13 The Fund manages investments in eight broad asset classes:

- fixed interest and cash;
- global small cap equities;[1]
- global large cap equities;[2]
- emerging markets equities;
- New Zealand equities;
- property (global and New Zealand);
- private markets (alternative assets); and
- Commodities (alternative assets).

Targeted investment mandates

4.14 The requirement to maximise long-term returns guides the Guardians towards constructing investment mandates that focus on asset growth strategies rather than income generation strategies. For example, investment mandates focus on assets generating net risk-adjusted returns rather than income, and can be designed around a particular element within the asset class that is expected to grow. This might include selecting:

- growth industries;
- securities in a business that has adopted a growth strategy;
- securities that are managed in a certain way; or
- securities with specific financial characteristics.

4.15 The Fund had five Investment Managers in 2003, increasing to more than 30 Investment Managers in 2007. Each investment mandate sets out how the funds that are passed from the Guardians to the Investment Manager will be invested. This includes:

- restrictions on the types of securities held;
- concentration of the portfolio;
- markets from which securities can be traded; and
- securities that the Guardians have excluded on responsible investment grounds.

4.16 The individual investment mandates collectively implement the Strategic Asset Allocation.

1 Small cap refers to stocks with a relatively small market capitalisation. The definition of small cap can vary among brokerages, but generally it is a company with a market capitalisation of between $300 million and $2 billion.

2 Large cap refers to companies with a market capitalisation between $10 billion and $200 billion.

Hedging strategy

4.17 The size of the Fund relative to the New Zealand market and the requirement in section 59 of the Act to avoid long-term significant shareholding and controlling interests means that the Guardians will find it difficult to hold significant New Zealand-based assets in the Fund's portfolio.[3] Therefore, the Fund holds a diverse range of foreign assets and is exposed to foreign currency movements.

4.18 The Guardians operate a hedging strategy that is largely passive. The primary objective of the strategy is to hedge 70% to 100% of the Fund's foreign currency exposures[4] into New Zealand dollars by using forward exchange contracts.[5] The hedging strategy is agreed by the Board and outsourced under a separate investment mandate.

4.19 The Guardians manage exposure to foreign currency by measuring the net foreign currency risk for the entire portfolio. The hedging mandate restricts the external provider from operating outside predetermined risk bands or from using alternative instruments to manage currency risk. This reflects the passive nature of the hedging strategy.

4.20 Foreign currency forward-exchange products initiated by the Guardians are placed through the New Zealand Debt Management Office (NZDMO). We did not specifically review the processes adopted by the NZDMO as part of this performance audit. However, we understand that the NZDMO manages currency risk at an aggregate level for the Crown.

4.21 We reviewed the hedging mandate and discussed its purpose with the Chief Investment Officer in relation to the overall investment strategy, to understand why the Guardians elected to hedge some currencies and not others in light of the long-term investment horizon. After these discussions and a review of Board papers, we understand that the currencies in emerging markets are not hedged because the holdings are small, spread across a large number of currencies, and typically incur high transaction costs.

4.22 The Fund's main currency risk is from changes in the value of the New Zealand dollar and, to a lesser extent, changes in the major currencies in which the majority of its offshore investments are held. The Guardians can effectively and relatively cheaply manage this currency risk by hedging the largest exposures, which are to developed markets. This approach is also consistent with most major investment funds in developed countries. In our view, the Guardians' hedging strategy for the Fund is implemented appropriately and efficiently.

3 As at 31 October 2007, 24% of the Fund's assets were New Zealand-based.

4 In this context, exposure is the measure of risk associated with holding a proportion of investments of a portfolio in a particular type of asset category, country, or other.

5 The seven foreign currencies are American dollars, Euros, British pounds, Japanese yen, Australian dollars, Canadian dollars, and Swiss francs.

Setting and changing investment strategies

4.23 The process to set and refine the investment and hedging strategies is iterative and ongoing. There are a number of factors that require the Guardians to continuously challenge the Fund's Strategic Asset Allocation. These include the emergence of new products and new markets, and global events that affect the risk profile of certain investments.

4.24 The Guardians' investment strategy is determined by management and approved by the Board. Management considers a range of information in setting the investment strategy. This includes:

- external and internal research;
- changes in the expected future returns of asset classes;
- opportunities in emerging markets;
- the need to ensure that the portfolio is diversified; and
- relative exposures within the existing portfolio.

4.25 The investment strategy includes tolerance limits for each asset class. This recognises that changes in the market values of securities can also change the weighted value of each asset class. The Guardians have adopted tolerance bands to avoid making unnecessary and costly transactions to change their buy and sell positions in order to rebalance the Fund's portfolio. The Portfolio Committee is responsible for monitoring the portfolio's compliance with the Strategic Asset Allocation within the agreed tolerance bands. Section 3 of the Guardians' Investment Funding Policy sets out the process for the Portfolio Committee to make unplanned rebalancing in response to unforeseen events or market volatility.

4.26 We reviewed the process to set, implement, and change the investment strategy. In our view, the Guardians use appropriate due diligence processes to test the appropriateness and reliability of the investment strategy. The due diligence processes are supported by the detailed portfolio analysis done by the Guardians, and the clearly defined decision-making framework set out in the Portfolio Committee's terms of reference.

4.27 However, we noted limited scope in the delegated authorities, investment mandates, and the management committees' terms of reference for management to influence investment activity without the Board's direct input.[6] In our experience, global pension funds and sovereign investors can appropriately delegate to management investment decision-making that does not have a material effect on the portfolio. Given the growth of the Fund, it is possible the Board will expend considerable effort in approving investment decisions that do

6 That is to say, beyond the management's standard allocation of the fortnightly distribution to Investment Managers, or the re-weighting of the asset allocation model.

not significantly affect the portfolio. One commonly used method of addressing this issue is to create bands within which management can make decisions.

Recommendation 9

We recommend that the Guardians of New Zealand Superannuation review how the Board approves investment activity to ensure that responsibility for investment decisions is delegated to management where appropriate.

4.28 The 2007 Statement of Intent required the Board and management to consider ways to make more dynamic asset allocations. The Board recently reviewed a process for changing asset allocations. We examined that process and noted that it is appropriate and supports the formal separation of the Board and management.

Process for entering into new investments

4.29 The Guardians review the Strategic Asset Allocation periodically and consider changes to existing investment strategies for each asset class. The review is conducted by management and approved by the Board, along with any required changes. The review considers the broad investment strategy relative to the investment mandate of the Fund, and changes to the markets within which funds are invested. Outside this broad planning process, management continuously analyses and considers new approaches for investing within each asset class, subject to Board approval. This analysis includes ongoing assessment of existing investment mandate performance, consideration of new market opportunities, and assessment of risk.

4.30 The Board assesses management's review of the annual investment strategy against the Strategic Asset Allocation. If a change or new strategy is considered appropriate, the Board will also determine appropriate risk parameters. The Guardians' approach is consistent with processes applied by leading investment funds to develop new products and investment mandates.

4.31 Once a new or updated investment mandate is finalised, the Guardians select an Investment Manager to execute the investment mandate. The Guardians' selection process is sound and consistent with the requirements of external provider selection processes promulgated by regulators. We discuss the Guardians' selection, management, and monitoring of contracts with Investment Managers in Part 5.

4.32 The investment mandate arrangements agreed with Investment Managers clearly address the requirements of the Fund's investment strategies. The Portfolio

Committee is responsible for ensuring that the individual investment mandates collectively correspond to the overarching Strategic Asset Allocation.

4.33 We assessed the processes for reviewing the investment strategy and establishing new investment mandates. The Guardians' processes were sound and applied widely used techniques for assessing investment performance and risk. The primary purpose of the Guardians' processes is to either reaffirm or reassess the investment principles and related strategy. The review process considers changes to market conditions, new investment opportunities, and the ongoing appropriateness of previously adopted strategies.

External review of investment and hedging strategies

4.34 The Guardians have considered the reasonableness of investment and hedging strategies for the Fund by:

- benchmarking the objectives of the Fund to peer organisations with consistent objectives; and
- obtaining advice from external experts.

4.35 Internally, the Guardians review asset class performance against several benchmarks, for example, general index and market benchmarks, and those internally determined. All investment mandates include benchmark performance indicators for assessing an Investment Manager's performance. Benchmarking also extends beyond individual investment mandate performance to include benchmarking of the Strategic Asset Allocation to organisations with similar long-term investment objectives. Further, in accordance with the August 2004 Review of Currency Strategy, the hedging strategy is benchmarked to New Zealand dollars, recognising that the Guardians define their role as producing returns from the Fund in excess of the cost of Crown debt.

4.36 We reviewed the February 2005 "Finalisation of the Revised Strategic Asset Allocation" presented to the Board by management. We concluded that the Guardians are thorough in selecting who provides advice on the investment and hedging strategies, and in ensuring that this advice challenges the current position.

4.37 However, it has not always been clear whether the appointed investment adviser was selected by the Board or by management. It is important that the Board, because of its overseeing role, directly selects the investment adviser who will perform the periodic peer review of the Strategic Asset Allocation and related investment strategy. Ongoing advice, consultation, and review by external parties are important because asset allocation provides about 80% of the returns to the Fund under its investment strategy.

Recommendation 10

We recommend that the Guardians of New Zealand Superannuation formalise the periodic independent review of the Strategic Asset Allocation, and consider independence from management when selecting the investment adviser to conduct the review. The scope of work agreed with the adviser should also include validation of individual asset class benchmarks applicable to the Strategic Asset Allocation.

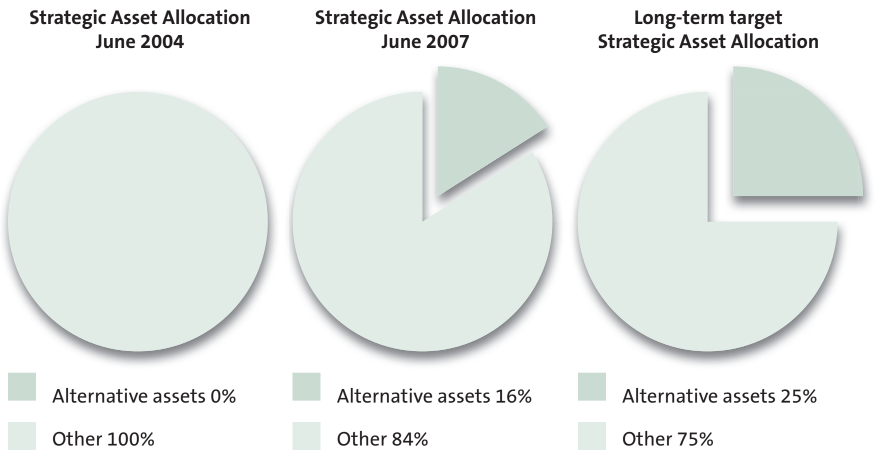
Alternative asset classes

4.38 The Guardians have diversified asset allocation since a review in June 2004.[7] Specifically, the Guardians have increased the Fund's exposure to alternative asset classes. The Guardians see the role of alternative asset classes during the life of the Fund as important and have set a long-term goal for 25% of all Fund assets to fall under this category – referred to as Private Markets.

4.39 Given the mission of the Guardians to maximise long-term investment returns without undue risk, the Strategic Asset Allocation places a strong emphasis on growth assets. Growth assets, such as shares and property, typically generate high levels of capital growth with moderate levels of income over time. Alternative assets are privately traded assets geared toward capital growth. The Guardians have identified Private Markets in constructing the Strategic Asset Allocation to focus on growth assets. Private Markets are more difficult to trade than listed securities. These include New Zealand and global private equity, timber, and infrastructure. The growing significance of alternative assets in the Fund's Strategic Asset Allocation is illustrated in Figure 6.

7 *Independent Review of the Guardians of New Zealand Superannuation*. The first Independent Review of the Guardians, conducted by Jonathan Eriksen, was tabled in Parliament in November 2004. The review is available on the Treasury's website at www.treasury.govt.nz.

Figure 6
Increase of alternative assets in the Strategic Asset Allocation since 2004



Note: At the time of our audit, alternative assets included Private Markets and Commodities.

4.40 There is a high degree of awareness within the Guardians of the risks associated with investing in alternative asset classes. Private Markets and alternative assets are not always subject to the same degree of transparency as public securities and assets. Public securities are subject to public scrutiny and accountability through market regulatory processes, which enables their market value to be more easily assessed in terms of price-to-asset ratios. Private Markets and alternative assets face increased risks relating to accurate valuation, responsible investment, and determining the risk-adjusted returns of the asset class. These are market risks that all investors in alternative assets have to manage.

4.41 The Guardians' awareness of these matters is illustrated by additional processes they have put in place to manage alternative assets:

- establishing a Private Markets Committee to oversee all investments in this asset class;
- applying additional due diligence procedures for Investment Managers of alternative assets;
- seeking to pay performance fees to Investment Managers of alternative assets over a longer time horizon to be consistent with the long-term nature of the investment; and
- embedding governance and internal controls in investment mandates for alternative assets. This means that the Investment Manager is required to invest in assets that have formalised governance and assurance frameworks.

4.42 In addition to the current processes, the Guardians plan to establish a Private Markets team by the end of 2008. The focus of the Private Markets team will include ongoing due diligence procedures for existing and new Private Markets investments and Investment Managers.

4.43 Currently, the target allocation for Private Markets assets of 25% of the total asset allocation includes:

- one fifth to commodity futures (that is, 5% of the total asset allocation); and
- four-fifths to remaining Private Markets (that is, 20% of the total asset allocation). This is defined as infrastructure, timber, private equity, and “other”. Each of these has an individual range (mostly 0% to 10% of the remaining Private Markets assets) as well as collective ranges (10% to 30% of the remaining Private Markets assets). The characteristics of each asset class have been well defined. The allocation to “other” represents 5% of the remaining Private Markets assets. The Fund currently has no assets in this category. The 5% “other” is designed to allow for new investment opportunities arising outside the annual Strategic Asset Allocation review process. The Guardians can invest in any asset class under this category that is not already defined by the existing 95% of allowable assets. Controls over new investments and portfolio compliance ensure that asset purchases cannot be made under this category without appropriate Board approval.

4.44 The Guardians’ definition of Private Markets is specific and applies restrictions on assets within this class. However, the decision-making authority that the Board has delegated to management is not linked to these definitions or the form by which these investments can take place. The Guardians’ current definition of Private Markets includes a category of “other”. This is open-ended and as such does not exclude assets that they do not intend the Fund to hold, or which should be subject to different considerations and delegations. This is because relevant asset classes have not been defined within the definition of Private Markets assets. This is not an issue for the Guardians because the current authority delegated to management does not extend to specific investment or divestment decisions. At the time of our performance audit, the Guardians had no intention to delegate such authority.

Management of investment risk

4.45 All investment fund managers need ways to manage investment risk in accordance with their strategy. We reviewed the Guardians’ approach to investment risk management by examining risk management policies, interviewing senior management, and observing various risk management processes.

4.46 We identified four main methods of managing investment risk:

- understanding and accepting risk exposures of individual investments relative to their asset price and expected return;
- diversification of assets and strategies within assets, to spread and, where possible, to offset risk within the asset portfolio;
- analysis of market sensitivity analysis to forecast the potential effect of possible changes in markets in the future; and
- use of derivatives to cap or control risk exposures.

Understanding and accepting risk

4.47 The Guardians perform ongoing analysis to consider the expected return ratio for investments and re-weight the Fund portfolio accordingly. Changes in price affect the asset value within the portfolio, and sharp changes in market prices for the specific asset classes requires the Guardians to reassess and possibly change the target Strategic Asset Allocation. The Guardians can make "out of cycle" changes to the Strategic Asset Allocation if risk increases relative to prices or if expected returns change. This includes the use of derivatives, selling positions (subject to the approval of the Board), or changing the asset allocations in the Strategic Asset Allocation (subject to the approval of the Board).

Diversification

4.48 The Guardians achieve diversification in different ways:

- The Guardians have a long-term investment horizon, and seek to take long-term positions in various asset classes consistent with their long-term asset allocation strategy. This allows the Fund to continue to hold assets when faced with short-term market fluctuations.
- The Guardians generally take small interests in a security. All of the Guardians' investment mandates prevent Investment Managers from taking large holdings in a single security. This means that, within the total portfolio, the Fund holds a large number of relatively small positions.
- Portfolio monitoring is performed every day by the Guardians' Investments Operations team, which receives daily checks on information provided by the Custodian.
- Every two weeks, the Portfolio Committee formally reviews the portfolio relative to the Strategic Asset Allocation. If asset weighting is outside predetermined tolerance bands, assets will be sold or purchases made to reposition the portfolio within acceptable bands. This process is managed through the Portfolio Committee in accordance with its terms of reference. The portfolio review ensures that the overall asset mix within the portfolio remains consistent with the requirements set out in the Strategic Asset Allocation.

Market sensitivity analysis

4.49 The Guardians have developed a data warehouse to receive investment information from the Custodian. This information is used to analyse the risks associated with particular asset types within the Fund's portfolio and to generate reports that simulate market movements. This allows the Guardians to forecast the effect of market movements if changes are made to securities held by the Fund. The process is used to assess ongoing exposure to various classes of investment risk.

Derivatives

4.50 The Guardians also use derivatives to manage the effect of market volatility. Derivatives can be used to cap an exposure to a particular market cycle depending on the objective of the Guardians.

4.51 At the time of our performance audit, the Guardians had only ever used derivatives to gain exposure to market risk rather than limiting market exposure. However, scope exists within existing policies and delegations to use derivatives for financial risk management purposes. In markets where a significant portion of the Fund's portfolio is invested the Guardians split the responsibility across the pool of Investment Managers. It would not be appropriate or efficient for the Guardians to ask individual Investment Managers to manage market risk. As such, the use of derivatives to manage financial risk is appropriate given the strategy of the Fund and the use of external Investment Managers.

Management of fund liquidity

4.52 Liquidity management is the process of managing cash flows arising from investment activities. For the Fund, this includes the fortnightly capital contributions from the Crown and the cash flows arising from the sale and purchase of securities, dividend and interest receipts, and settlement of derivative contracts. We reviewed the process to set and receive funds from the Treasury on behalf of the Crown, and management of investment transaction activity.

Determining funding levels

4.53 Section 43 of the Act sets out how the total annual capital contribution to the Fund will be calculated by the Treasury. The Guardians have no specific role in determining whether future pension obligations are under-funded or over-funded. It is the Treasury's role to determine the Crown's Projected Superannuation Obligation in relation to New Zealand Superannuation.

4.54 The Treasury is required to calculate the annual contribution amount in accordance with the Act. Once this amount is determined, the Guardians agree a Contribution Payment Schedule with the Treasury. That schedule states how and when cash will be passed to the Fund. The Guardians are not required to check the Treasury's calculation of the annual contribution amount.

4.55 The Guardians use the agreed Contribution Payment Schedule to forecast and manage Fund liquidity. The primary objective of this process is to ensure that funds are passed to Investment Managers in a timely manner, based on a predetermined allocation. This is to minimise the opportunity cost to the Guardians associated with holding cash. This process is also used to manage cash for the purposes of acquisitions and disposal of assets of the Fund.

4.56 The Portfolio Committee is responsible for the allocation of funds to Investment Managers for management under their respective investment mandates using their funding model. This is a planned and systematic process designed to keep the Fund in compliance with its Strategic Asset Allocation. However, where major acquisitions or outward cashflows occur (for example, tax) this process is also used to source the necessary funding from current mandates or asset classes.

4.57 The actual date when the Crown is expected to start making withdrawals from the Fund has not yet been set, although section 47 of the Act prohibits any withdrawals before 2020. The withdrawals will ultimately be taken into consideration in the annual Strategic Asset Allocation review process as the first withdrawal date approaches. The size, extent, and method of withdrawal are not currently known. As the Fund approaches the date of cash delivery, it will become more significant for the cash delivery model to be agreed with the Treasury. In our view, the cash delivery model should be finalised and agreed at least five years before the date that cash flow streams start to go from the Fund to the Crown.

Our conclusions

4.58 The Guardians have developed and implemented an investment strategy that meets the objectives of their founding legislation. This strategy is supported by clear and measurable risk parameters that are regularly assessed and considered in the investment management processes. The Guardians' investment management structure is also appropriate for the agreed funding model.

4.59 The Guardians are in the early stages of their rolling 20-year investment horizon and will need to continuously improve their strategies and operations within a constantly changing investment environment.

Part 5
Contracts with Investment Managers

Key messages

- Outsourcing investment management has been an appropriate approach, given that the Guardians' investment strategy focuses on growth assets. The Guardians have a structured process for selecting Investment Managers and assessing their performance.
- The Guardians manage risks related to gaining and maintaining intellectual property for the Fund's investments, and they take an active approach to understanding and challenging the value they gain from their Investment Managers.
- The Guardians monitor the performance of Investment Managers through the Investment Manager Monitoring Policy and through the Custodian's investment mandate compliance process. Both of these processes provide a strong basis for the Guardians to gain assurance over transactions and the general performance of the Investment Managers.
- We are satisfied that the Guardians' measures to protect the Fund from negligent and inappropriate behaviour by Investment Managers are appropriate and consistent with global practices applied to outsourcing relationships.
- As the Fund grows, the Guardians have opportunities to standardise the Investment Manager fee structure, reassess the ongoing appropriateness of the business operating model, and build in-house knowledge and expertise.

5.1 In this Part, we report on how the Guardians established, managed, and monitored contracts with Investment Managers as at the end of 2007. For these contracts to be effective, we expected to find:

- a defined and established business operating model;
- a structured process for selecting Investment Managers;
- effective assessment and monitoring of risk associated with investment activity;
- effective performance management of Investment Managers; and
- effective monitoring of Investment Manager behaviour.

5.2 Investment fund managers generally adopt one of three business operating models:

- perform all investment operations in-house;
- outsource all investment operations to third parties; or
- adopt a hybrid business operating model combining the best of both in-house and outsourcing.

5.3 Although all investment fund managers tend to have consistent business processes, the choice between an in-house, outsourced, or hybrid business operating model will depend on the:

- specialist nature of the investment strategy and related investment mandates;
- volume of activity;
- proximity to major markets;
- access to relevant skills;
- requirements for infrastructure to process transactions;
- regulatory considerations;
- organisational maturity and experience; and
- business strategy and investor objectives.

Our findings

5.4 At this stage, the Guardians have generally chosen outsourcing as their preferred operating model for their business purposes. This has been necessary given the international investment focus of the Fund and the Strategic Asset Allocation objectives to establish investment mandates that outperform benchmark returns for the asset class.

5.5 Delivering returns in excess of the benchmark are referred to by the Guardians as "alpha" returns. Alpha returns are achieved by constructing investment mandates that expose the Fund to growth elements that have been identified within an asset class through:

- weighting the portfolio towards emerging markets;
- identifying entities likely to list within a predefined period; or
- focusing on investments with particular management principles and beliefs.

5.6 In many instances, specialist investment management skills are required to achieve the objective of the investment mandate. This is particularly relevant for growth asset classes.

5.7 The focus on delivering alpha returns has meant that the Guardians have deliberately chosen an outsourcing business operating model with all major risks managed through service level agreements and investment mandates. One clear and widely accepted advantage of outsourcing is that operational risks are typically lower.

5.8 At the time of our performance audit, the Fund had 44 investment mandates covering a number of different global capital markets. Most investment mandates require the Investment Manager to transact in multiple markets and jurisdictions. Figure 7 shows the spread of the Fund's global network of Investment Managers.

Figure 7
Number and value of investment mandates, by Investment Manager location

Location of Investment Manager	Number of investment mandates	Funds under management (as at 31 October 2007 NZD)
New Zealand	12	3,242,501,326
United States	24	6,124,250,847
United Kingdom	3	258,421,259
Hong Kong	1	3,866,988
Australia	4	4,062,626,349
Total	44	13,691,666,769

Appropriateness of outsourcing as the business operating model

5.9 Outsourcing means that all aspects of investment management and related transaction processing, accounting, custodial, and investment mandate compliance are performed by third parties. As a result, the Guardians have developed extensive external provider management processes.

5.10 While the Guardians have identified a clear purpose and need for outsourcing, they are considering whether this will be the most appropriate business operating model in the future. In our view, the Guardians need to continuously assess the appropriateness of their business operating model. Key considerations for any business operating model the Guardians adopt include:

- parts of the Fund's portfolio can be classified as long-term passive positions. The largely buy-and-hold strategy applying to these parts of the Fund's portfolio may not require specialist skills of external providers;
- the hedging strategy is largely a passive strategy and does not require high levels of technical expertise;
- the Act prevents the Fund from holding a controlling interest in any entity. This increases the volume of transactions because smaller parcels of shares are held in a larger number of entities. This volume may provide an opportunity for some asset classes to be traded by an in-house team where the Fund has critical mass;
- the maturing nature of the Guardians' internal control environment suggests that operational risks associated with in-house management of some investment activities could be adequately managed. This was not a consideration at the outset of the Fund when operations were not formalised and management was focused on establishing the Strategic Asset Allocation and related processes;

- over time, the economics of in-house and outsourced investment management may change; and
- by continuing to outsource trade transaction processing, asset valuation, fund accounting, and custodial services, the Guardians can maintain segregation of duties for their transaction operations.

5.11 The Guardians' review of the current business operating model may not necessarily lead towards an in-house or hybrid model. Ultimately, the Guardians need to use a business operating model that is practical and relevant to their business objectives.

5.12 In our experience, fund managers in New Zealand and Australia tend to adopt a hybrid business operating model, rather than outsourcing all activities or doing everything in-house. It is also more efficient to engage Investment Managers for international investment mandates because of New Zealand's distance from global capital markets. Conversely, domestic outsourcing tends to be more costly relative to larger international markets. In our view, the Guardians need to ensure that they identify the comparative advantage of any business operating model that they adopt.

Recommendation 11

We recommend that the Guardians of New Zealand Superannuation review their business operating model periodically to ensure that all aspects of their business (including whether operations are outsourced or done in-house) enable the objectives of the Fund to be met effectively and efficiently.

Process for selecting Investment Managers

5.13 Investment Manager selection is governed by the Investment Manager Selection Policy (June 2007). The policy's objective is to establish:

> *… the process and criteria by which recommendations will be made to the Board of the Guardians of New Zealand Superannuation (Board) for the appointment of external investment managers.*

5.14 Initially, the Guardians' primary objective was to establish investment mandates and appoint Investment Managers. This was necessary so that funds received could be invested in accordance with the Strategic Asset Allocation. In the first years of the Fund, several new Investment Managers were appointed. As the Fund has matured, this activity has reduced as the focus moves from appointing Investment Managers to managing and monitoring Investment Managers.

Investment Manager due diligence

5.15 The Guardians apply a detailed due diligence process before appointing an Investment Manager. Once the Guardians have established a need to appoint a new Investment Manager, a Request for Information questionnaire is sent to prospective Investment Managers. In our view, the questionnaire is suitably detailed when supported by appropriate validation procedures and analysis. This includes review of supporting documents, interviews, and site visits. We saw all three elements when we examined in detail the appointment process for one Investment Manager.

5.16 The Board retains authority to approve Investment Manager appointments, the benchmarks against which Investment Manager performance is assessed, and the fees to be paid to Investment Managers. The implementation of the Investment Manager appointment process has been delegated to management.

5.17 When it receives the Investment Manager's response to the Request for Information, management assesses the information and, if satisfied, does a more detailed evaluation including:

- referee checking by Guardians' staff or by a qualified third party (where required);
- face-to-face due diligence performed at the Investment Manager's premises;
- a comprehensive analysis of the Investment Manager's investment strategy; and
- accounting, taxation, legal, and financial due diligence.

5.18 The completion of each of the above steps generally occurs but is not mandatory under the Investment Manager Selection Policy. This ensures that the process remains appropriately flexible, and relies on the Board's review and approval process to explain why certain steps have or have not been performed.

5.19 Once appointed, Investment Managers are monitored to ensure that they continue to meet the standards required by the Guardians. In our view, these procedures are sound by industry standards and, in all instances, they meet or exceed benchmark requirements applied by a selected regulator.[1]

Assigning a conviction rating

5.20 In addition to the requirements set out in the Investment Manager Selection Policy, the Guardians assign all prospective Investment Managers a "conviction rating". The conviction rating reflects the confidence that the Guardians have in the Investment Manager to achieve its investment mandate.

1 We have compared the Guardians' selection process with the requirements of the Australian Prudential Regulatory Authority.

5.21 The conviction rating is an overall score based on the different assessment elements included in the Investment Manager Selection Policy. Different weightings are given to different scoring elements, depending on the relative importance placed by the Guardians and whether the investment mandate relates to private or public markets. Investment Managers must achieve a certain conviction rating score before they are appointed. The Guardians regularly review the conviction rating of each of their appointed Investment Managers.

5.22 If the Investment Manager's conviction rating drops below a certain level, the Guardians have provisions in their contract to review and terminate the mandate with the Investment Manager. This may include active monitoring of the Investment Manager, stopping further allocation of funds, or ending the relationship with the Investment Manager. We reviewed one instance where the Guardians ended a relationship with an Investment Manager. In our view, the steps taken by the Guardians in that instance reinforced the strength of their rating and monitoring process.

5.23 The Investment Manager Selection Policy covers the whole due diligence process. In our view, while the Guardians need to retain some flexibility to determine detailed conviction rating procedures depending on circumstances and investment mandate, some important aspects of the due diligence process could be better documented. Improvements could include linking the Guardians' qualifying criteria for selecting Investment Managers to the conviction rating process, and documenting how elements assessed through the conviction rating process are set or changed. The Investment Manager Selection Policy could also document how to apply ratings and weightings to conviction rating assessment elements, and who can approve these.

Recommendation 12

We recommend that the Guardians of New Zealand Superannuation link their Investment Manager Selection Policy with their process for conducting due diligence over Investment Manager appointments. This includes linking qualifying criteria to the policy, documenting how ratings and weightings are applied, and documenting how assessment elements are set, changed, and approved.

Anti-money laundering measures

5.24 An emerging issue faced by all investors, fund managers, and financial service providers is the growing requirement to understand risks in relation to anti-money laundering. In our experience, there is no best practice guide for meeting these obligations. The Guardians use practices that are common within the financial services sector, such as checking the due diligence procedures used by Investment Managers when they invest money on behalf of the Fund.

5.25 Other probity considerations, commonly referred to as business intelligence checks, include asking:

- Who are the people involved with the Investment Manager?
- How does the Investment Manager understand the background of companies they typically invest with?
- Does the Investment Manager have any reputation or a policy in relation to ethical investment?
- What sort of association does the Investment Manager have with politics?
- What sort of relationships does the Investment Manager have with other companies?
- Does the Investment Manager or its staff have any criminal convictions?
- Are regular litigation checks performed?

5.26 Generally, financial institutions ask these questions over and above regular financial due diligence performed on the income statement and balance sheet. Increasingly, this type of analysis and business intelligence checking is consistent with information processes required to complete anti-money laundering requirements. We reviewed the Guardians' process for anti-money laundering and noted that most of the checks listed above are incorporated in the Investment Manager Selection Policy and related processes.

5.27 The Guardians have rigorous due diligence procedures in place for selecting Investment Managers. However, these procedures could be improved by clearly relating them back to anti-money laundering requirements. For example, the information collected through the Guardians' Request for Information could specifically focus on how the prospective Investment Manager manages anti-money laundering.

5.28 We identified additional processes the Guardians could put in place depending on the asset class being invested in. For example, they could check the United States of America's State Department list for banned companies or people.

Recommendation 13

We recommend that the Guardians of New Zealand Superannuation amend their Investment Manager Selection Policy to include an assessment of the anti-money laundering management philosophies of prospective Investment Managers, and that this assessment becomes part of the ongoing assessment process for Investment Managers.

External advice for selecting Investment Managers

5.29 The Guardians do not always obtain external advice when appointing Investment Managers. Generally, the Guardians use external advice only when the Investment Manager is to be appointed for a specialist purpose or in a specialised asset class of the Fund's Strategic Asset Allocation. When they have sought external advice, the Guardians have used industry specialists, their existing investment advisory network, and peer network groups. For example, the Guardians appointed a recognised specialist to source and evaluate New Zealand Private Equity Investment Managers. The Guardians manage such appointments under the Adviser Selection and Appointment Policy.

Assessment and monitoring of risk associated with investment activity

5.30 The Guardians manage the risk associated with outsourcing investment activity to Investment Managers through the contracting and investment mandate process. They use rigorous processes in determining the investment strategy applied by each Investment Manager, and establish investment mandates that constrain Investment Managers with respect to:

- maximum exposures to any one listed security relative to the portfolio (that is, concentration);
- maximum exposures to any one listed security relative to that issuer's total capital (that is, controlling interests);
- maximum exposure to any one unlisted security;
- maximum exposure to collective unlisted equity;
- limits on the number of securities held (where applicable to the market);
- limits on derivative contract exposures;
- limits on related parties' transactions; and
- minimum credit rating (where money market securities can be held).

5.31 This approach is consistent with industry-wide practices to manage risks associated with outsourcing investment activity to Investment Managers.

Investment mandate compliance

5.32 The Custodian monitors compliance with the financial risk parameters agreed with Investment Managers each day. The Investment Management Agreements between the Guardians and the Investment Managers set out minimum reporting requirements. These requirements cover reporting to the Custodian and to the Guardians.

5.33 The Investment Managers report their transactions to the Custodian each day. Once the Custodian has processed the transactions in its investment management systems, it generates and reviews investment mandate compliance reports. If there is a passive (or minor) breach[2], the Custodian notifies the Investment Manager of the breach and asks the Investment Manager to resolve it. The Custodian notifies the Guardians immediately if there is an active breach, such as investing outside the investment mandate.

5.34 Under the rules of the service level agreement, the Custodian must rate and report breaches of investment mandates by the Investment Manager to the Guardians. The Custodian reports passive breaches to the Guardians only if the breaches are not resolved by the Investment Manager in a timely manner.

5.35 We have reviewed the processes applied by the Guardians and are satisfied that major risks relating to investment mandate compliance are being managed through:

- the processes agreed in the service level agreement with the Custodian;
- secondary controls applied by the Guardians;
- checking the Custodian's compliance against its investment mandate with the Guardians; and
- pre-trade clearance checks performed by the Investment Managers that include measures of investment mandate compliance.

5.36 We consider that the approach taken by the Guardians is pragmatic given the global reach of their Custodian. This allows timely resolution of investment mandate breaches with the predominantly global group of Investment Managers.

Monitoring and managing the performance of Investment Managers

5.37 The Guardians monitor the performance of Investment Managers through the Investment Manager Monitoring Policy and through the Custodian's investment mandate compliance process.

5.38 The Guardians set clear investment performance benchmarks for all Investment Managers. Each benchmark is directly related to the overarching Strategic Asset Allocation for the Fund. The relationship between the Investment Manager benchmarks and the Strategic Asset Allocation are communicated and discussed between the Board and management. This occurs annually and was last done in August 2007.

2 A passive breach is one caused by circumstances beyond the Investment Manager's immediate control – for example, market price movements.

5.39 The Guardians have developed a detailed framework for overseeing and controlling Investment Managers, which includes:

- overseeing transactions through the investment mandate compliance process, performed primarily by the Custodian and overviewed by the Guardians; and
- applying the Guardians' conviction rating and performance assessment process.

5.40 In our view, both of these processes provide a strong basis for the Guardians to gain assurance over transactions and the general performance of the Investment Managers.

Investment management fees

5.41 The Guardians apply a range of remuneration practices to Investment Managers, including performance fees and fees linked to the size of funds managed. Performance fees are used in different ways, depending on the nature of the investment mandate and the markets within which investing is to occur.

5.42 The Fund's public market investment mandates have benchmarks, and the performance of Investment Managers is easily assessed based on relevant indices. The ability to benchmark public market performance means that the Guardians can separate the performance of the market from the performance of the Investment Manager for these investment mandates.

5.43 Private markets generally cannot be benchmarked to any reliable index. The net risk adjusted return tends to be the base measure, making it difficult to separate market and manager performance. Overall, the Guardians tend to apply performance incentive fees to active investment mandates, as opposed to passive investment mandates.

5.44 To earn performance fees, an Investment Manager must outperform a benchmark. Typically, this will be a market-neutral benchmark reflecting the performance of the basket of securities held within a market for a predefined period. In many cases, performance fees are paid out over a prolonged period and are pegged to the ongoing ability of the Investment Manager to generate and maintain investment returns. Where excess returns are strong, performance fees will be paid. Where excess returns are inadequate, performance fees will not be paid.

5.45 The Guardians do not have a policy covering the setting, changing, and approving of Investment Manager fees. Historically, this has been managed by the Guardians when agreeing individual investment mandates. This approach was appropriate as the Guardians developed their investment mandate scope and fee payment method. However, as the number of Investment Managers has stabilised, the Guardians need to formalise their broader fee policy.

Recommendation 14

We recommend that the Guardians of New Zealand Superannuation establish a policy on fees for Investment Managers that sets out the types of performance fees available and criteria for awarding a performance fee.

Cost effectiveness

5.46 In November 2005, the Guardians engaged Cost Effective Management Inc (CEM) to benchmark the costs of the Fund to peer organisations and funds. This review highlighted that the Fund's cost was 44.3 basis points[3] while similar-sized funds operated at 31.3 basis points. The 13.0 basis point differential was explained by CEM as follows:

- costs associated with additional strategic advice, amounting to 2.9 basis points;
- costs associated with having more active investment mandates with Investment Managers, amounting to 2.2 basis points;
- higher relative Custodian costs amounting to 5.7 basis points; and
- other factors, amounting to 2.2 basis points.

5.47 Causes of the cost differential could be the growth focus of the Fund, the stage of the Fund's development, or compliance costs associated with the Fund's governing legislation. The Guardians have since addressed those areas within their control, such as the cost of Custodial services.

5.48 The fee structure for Investment Managers is an integral component of the conviction rating philosophy (see paragraphs 5.20-5.23) and the Strategic Asset Allocation strategy to maximise long-term risk-adjusted returns. The Guardians' approach needs to be considered in conjunction with their longer-term investment strategy. In the CEM benchmark review, the Fund outperformed its peer funds by 4.5%. The first four years of the Fund coincided with strong global markets and a period in which Investment Managers have outperformed their benchmarks. This, in turn, has meant that some Investment Managers achieved performance fees.

5.49 It is extremely difficult to determine the cost effectiveness of the services being provided by Investment Managers. The objectives of the Fund are to maximise returns net of fees. Investment mandates with performance hurdles focus on generating superior returns for the Fund, which means there is limited value in assessing cost effectiveness on the basis of simply minimising fees.

3 A basis point is a unit that is equal to 1/100th of 1% and is commonly used to denote the change in a financial instrument, the difference (spread) between two interest rates, or the measure of performance or relative cost against the funds under management.

5.50 The performance of the Fund in its first four years has meant that Investment Manager fees for funds under management are relatively high compared to a number of industry benchmarks.[4] The Fund's relative isolation from the majority of its major markets, combined with its growth focus, makes direct comparisons with peer funds difficult. The performance fee approach ensures that the interests of the Fund and its Investment Managers are aligned.

Access to information

5.51 Investment funds that outsource a large proportion of their investment activity face a risk that they will not retain necessary intellectual property relating to investment decision-making. While the Guardians have not formalised how they manage this risk, the operational structure creates a high degree of interdependence between the Strategic Asset Allocation developed by the Guardians and the individual investment mandates managed by the Investment Managers. Further, the Guardians have initiated a knowledge management project to collect some of this information.

5.52 In our view, the Guardians maintain a full understanding of the relationship and effect of specific investment mandates to the forecast performance of the Fund's Strategic Asset Allocation. Funds that outsource investment management tend to address this issue in several ways. In certain circumstances, a fund may choose to rely entirely on the Investment Manager, arguing that the fund has limited capacity to develop or question investment strategy. In other circumstances, the fund may choose to co-develop the strategy and constantly oversee the execution of that strategy. This latter method is more consistent with the approach of the Guardians. It is costly because more resources are required to effectively monitor the activity. However, it is also a lower risk option. We agree with this approach, given the significance of the Fund to the Crown balance sheet.

5.53 In addition, when appointing Investment Managers, the Guardians place considerable emphasis on the ability of their Investment Managers to share intellectual property and engage with the Guardians. In our review of correspondence between the Guardians and their Investment Managers, it was clear that there is a high degree of engagement between the two parties. There were numerous examples where the Guardians used their Investment Manager network to gain access to experts and specialist advice.

5.54 There were also several examples where the Guardians used their exposure to best practices through their Investment Managers to develop good practice processes. For example, several assessment measures were identified by the management team in consultation with external experts during development of the Guardians' Investment Manager Selection Policy. The assessment measures

4 From CEM research done for the Guardians.

are included in the policy, but are not mandatory, reflecting the different circumstances in which Investment Managers can be selected and appointed.

5.55 In relation to Private Markets, the Guardians face greater challenges to access reliable information. This is an industry-wide phenomenon arising because most information comes directly from the Investment Manager and cannot always be easily validated through independent sources.

5.56 The nature of Private Markets assets has meant that there is reduced disclosure for this type of investment. These investments are not subject to regulated disclosure requirements. Underlying assets are not publicly accountable and principal sponsors tend to protect their intellectual property. The Guardians have formalised their approach to managing this risk by:

- increasing due diligence checks of Investment Managers whenever investing in Private Markets;
- increasing the requirements for ongoing monitoring of Private Markets investments;
- establishing a dedicated governance committee at the Board level to oversee Private Markets investments until internal management control frameworks are prepared; and
- committing to establish in-house Private Markets capabilities, focusing on risk areas such as due diligence over Private Markets investment structure, and ongoing monitoring and testing of these investments.

5.57 In our view, the Guardians' initiatives represent a reasonable approach to Private Markets risk management. However, these initiatives will become more important to the Guardians as the Fund acquires more Private Markets assets. The risk is partially mitigated by diversification within this sector. This increases the Fund's exposure to the asset class, allowing benchmarking within its portfolio as well as providing a basis for determining appropriate disclosure by the Investment Manager. The greater the Fund's exposure to Private Markets, the greater the exposure of the Guardians to unreliable information about its investments.

5.58 The best approach for the Guardians to mitigate this risk is the approach they have taken – to continue to build their understanding of the sector and develop minimum operating requirements for their Investment Managers.

Monitoring the behaviour of Investment Managers

5.59 Investment fund managers that outsource a large proportion of investment activity face a risk that an Investment Manager might behave in a negligent or inappropriate way. The inherent risk associated with this exposure is no different to risks faced by active in-house trading functions.

5.60 The Guardians mitigate these risks by:

- performing upfront due diligence when selecting an Investment Manager;
- carrying out ongoing investment mandate compliance and overseeing processes;
- requiring daily reporting of transaction activity by Investment Managers to the Custodian; and
- getting the Custodian to perform operational risk management.

5.61 To a degree, some types of inappropriate behaviour are less likely to be detected when outsourcing. These include trades that attract inappropriate commissions, trading behaviour commonly referred to as market manipulation, and trading out of market rates or excessive deal commissions. However, the risks are partially managed by aligning the objectives of the Investment Manager with the Fund through the use of performance fees.

5.62 In our view, the Guardians' measures to protect the Fund from negligent and inappropriate behaviour by Investment Managers are appropriate and consistent with global practices applied to outsourcing relationships.

Our conclusions

5.63 The Guardians have adopted an outsourcing business operating model for investment management. This has been an appropriate approach, given the growth focus of their investment strategy.

5.64 The Guardians have developed a process for selecting Investment Managers and assessing their performance.

5.65 The Guardians manage risks related to gaining and maintaining intellectual property for the Fund's investments, and take an active approach to understanding and challenging the value of Investment Managers.

5.66 As the Fund grows, the Guardians have opportunities to standardise the fee structure for Investment Managers, reassess the ongoing appropriateness of the business operating model, and build in-house knowledge and expertise.

5.67 In our view, the Guardians have taken a reasonable approach to assessing the current business operating model.

Part 6
Monitoring and reporting of Fund performance

Key messages

- The Custodian provides high quality information from which a wide range of reporting can be prepared in a timely manner.
- The reporting infrastructure and effective controls help to ensure that high quality and accurate information is reported to stakeholders.
- From a cost perspective the Fund is well managed, with adequate justification for expenditure. There is an opportunity to improve cost management and accountability by allocating operating costs back to individual asset classes.

6.1 In this Part, we discuss the Guardians' monitoring and reporting of Fund performance. We summarise our main findings and set out our findings in relation to:

- the Guardians' system for reporting Fund performance;
- reporting of measures to manage major risks;
- overseeing by the Board and the Minister; and
- benchmarking of performance.

Our findings

6.2 Monitoring and reporting of performance is a critical aspect of any investment process. It allows timely and accurate information to be provided to stakeholders of the outcomes of the investment strategy.

6.3 The Custodian plays a vital role in reporting the investment performance of the Fund. The Custodian manages the systems and business processes that allow the Fund to process investment transactions and monitor Fund performance.

6.4 The Guardians use the following methods to monitor and report performance of the Fund:

- self-monitoring and reporting requirements set out in each Investment Manager's service level agreement;
- primary compliance monitoring processes conducted by the Custodian, and management through the Guardians' service level agreement with the Custodian;
- secondary compliance monitoring performed by the Guardians' Investment Operations team;
- two-weekly Strategic Asset Allocation compliance monitoring performed by the Portfolio Committee;

- monthly reporting of Investment Manager performance and attribution analysis by the Custodian;
- monthly reporting of performance to the Board and quarterly reporting of performance to the Minister; and
- monthly and annual reporting by Investment Managers as required by the investment management agreements.

6.5 Also, the Guardians' Investment Operations team performs ongoing monitoring of the investments. The information is generated from a data warehouse (see paragraph 4.49), based on data provided by the Custodian. The Guardians' Policy team also performs some sensitivity analysis to forecast the effect of market changes on the existing portfolio.

System for reporting Fund performance

6.6 The Guardians report Fund performance:

- cumulatively, since inception;
- annually (generally to coincide with the Fund's accounting period); and
- monthly.

6.7 The frequency of reporting is linked to who is using the reports and the intended purpose of the report. In our view, the coverage, scope, and frequency of reports are appropriate for the Fund.

6.8 Assurance over the accuracy of performance information used by the Guardians is derived in four ways:

- The Custodian provides performance reports to the Investment Managers who then check the information against their own data. There is an escalation process back to the Guardians where material unresolved differences arise between the Investment Manager and the Custodian. This provides assurance on reported performance as Custodian data is cross-checked to independent Investment Manager data.
- Under the Custodian's service level agreement, there are extensive reporting requirements to the Guardians about the accuracy, completeness, and recoverability of data. The Custodian undertakes disaster recovery exercises for its multiple sites to provide assurance that they can be relied upon.
- An independent review is carried out of the performance system used by the Custodian.
- The Guardians perform some consistency checks on the performance results reported by the Custodian by checking portfolio movements relative to benchmarks.

6.9 Reporting capability was one of the important considerations in the Guardians' appointment of a new Custodian. We examined the detailed level of analysis in reporting provided by the new Custodian.

Use of reporting information

6.10 At the time of our performance audit, the Guardians were still developing reporting requirements with the new Custodian.[1] Although we did not specifically review the transition project in detail, it did appear to be a well-managed project with relatively few issues arising.

6.11 Given the timing of our performance audit, it would have been unreasonable for us to expect the Guardians to have fully determined their information requirements for the new Custodian and how the information was to be used.

Aggregation of information

6.12 All asset information relating to Investment Managers and asset classes are aggregated by the Custodian and forms part of the periodic reporting under the service level agreement between the Guardians and the Custodian.

6.13 There are a number of data validation checks performed by Investment Managers and the Guardians that provide reasonable assurance over the accuracy of reported investment data. These checks are performed above and beyond the data checks that the Custodian is required to perform under the service level agreement.

6.14 The Guardians report against their Statement of Intent in the annual report, and are continuously refining the objectives and measures that form the basis of this reporting.

Reporting of measures to manage major risks

6.15 The Guardians are yet to review monitoring of investment information against their recently approved Risk Management Framework (see paragraphs 3.24-3.33). However, we reviewed the information reported to the Guardians, and concluded that typical transaction processing risks are recorded and monitored:

- The Guardians' service level agreement with the Custodian focuses on major investment transaction processing risks, such as trading cut-off, asset valuation, asset classification, and performance attribution analysis.[2]
- The use of independent benchmarks applied to Investment Manager portfolios allows independent objective analysis.

1 The new Custodian was appointed with effect from 1 July 2007.

2 Performance attribution analysis attempts to explain portfolio performance in terms of the active investment management decisions for "selection" and "allocation". It aims to determine which elements of the strategy, such as market timing or security selection, were responsible for the results and why.

- The high degree of focus applied by the Guardians to Private Markets assets recognises the increasing issues of information reliability that come with investments not subject to regulatory disclosure requirements.

6.16 In our review of Investment Manager public market investment mandates, we noted that the scope of the investment mandates allows the Investment Manager to invest in unlisted securities. The purpose of holding such securities is to allow the Investment Manager to take advantage of entities expected to list on a public stock exchange.

6.17 In these instances, the Guardians continue to treat such investments as publicly traded securities for their Strategic Asset Allocation analysis. Typically, this would distort the true nature of the securities held in the portfolio as some securities would not be publicly traded. In making this observation we also note that:

- the total value of such securities cannot ever be material because of the limits allowed within the respective investment mandates and therefore also the Fund;
- the unlisted securities are subject to strict rules relating to timeframe to list;
- these rules are closely monitored by the Custodian as part of the overall investment mandate compliance process; and
- the Strategic Asset Allocation does not distinguish between listed and unlisted entities.

6.18 If the Guardians do not apply clear definitions of asset categories, the assessment of portfolio compliance relative to the Strategic Asset Allocation will be incorrect. If this difference was material, it could lead to an incorrect assessment of investment risk. All public investment mandates that we reviewed limited this risk by restricting the amount of private securities and the period of time that the investments could remain private.

Recommendation 15

We recommend that the Guardians of New Zealand Superannuation either:

- change the definition of listed securities in the Strategic Asset Allocation so that it also includes unlisted securities where they are held as part of the largely listed security investment mandate; or
- require that unlisted securities, regardless of their investment mandate, be classified as Private Markets assets.

Once this treatment is clarified, the compliance management process should be changed accordingly.

Oversight by the Board and the Minister

6.19 The Board receives and reviews monthly performance reports from management. Fund financial performance is also reported monthly to the Treasury. The Guardians, the Custodian, and Investment Managers use several methods to validate reported data. In our view, these validation checks and controls are appropriate.

6.20 The Guardians perform detailed checking and validation procedures before information is released to the Office of the Minister of Finance. The Custodian prepares the Performance Report and the Investment Operations team reviews the report.

6.21 The Guardians' internal auditor has reviewed the performance reporting processes performed by the previous Custodian. As agreed in the service level agreement with the new Custodian, the Guardians' internal auditor will also review performance processes and reporting once the reporting arrangements are agreed and delivered. In our view, these controls are adequate and should ensure that reporting is accurate.

Performance benchmarking

6.22 Apart from investment performance monitoring and benchmarking, the Guardians also compare their cost-effectiveness to that of peer organisations. This benchmarking is performed annually by a North American-based organisation specialising in the funds management and superannuation sectors. The benchmarking information is used to assess the cost-effectiveness of the Guardians' operations and was a catalyst for changing the Custodian, introducing remuneration programmes, and reorganising internal costs.

6.23 Our review of the analysis of international benchmarks of cost-effectiveness found that some aspects of the Guardians' costs are higher than peers in the benchmark survey. This is a result of:

- the Fund holding a large number of small Investment Manager investment mandates;
- significant costs for an external Custodian;[3]
- the need to invest in the development of internal control infrastructure and supervision to accommodate the Fund's rapid growth;
- costs associated with the Crown's requirements such as responsible investment activities; and
- investment advisory fees associated with development and assessment of the Strategic Asset Allocation.

3 The former Custodian attracted higher costs, and the total costs were higher in 2007 because of the transition to a new Custodian.

Cost allocation

6.24 Recently, the Guardians reviewed central costs to get an objective basis for allocating costs between the Guardians and the Fund. There are opportunities to use this information further so that support costs can be fully allocated back to asset categories (or investment mandates). However, we note that Fund administration costs currently constitute a small portion of the total costs. The likely effect on the Fund's net reported returns is unlikely to be significant.

Recommendation 16

We recommend that the Guardians of New Zealand Superannuation initiate a formal process to allocate the operating and administrative costs of the Fund to the respective individual investment classes for which those costs have been incurred.

Our conclusions

6.25 The Custodian provides high quality information from which a wide range of reporting can be prepared in a timely manner. The requirements placed on the Custodian and Investment Managers as well as procedures performed by the Guardians provide effective controls to ensure that reported information is accurate. The reporting infrastructure helps to ensure that high quality and accurate information is reported to stakeholders.

6.26 From a cost perspective, the Fund is well managed, with adequate justification for expenditure. There is an opportunity for the Guardians to improve management of costs by allocating operating costs back to individual asset classes. This will improve accountability of the expenditure of the Guardians by correlating activity with investment returns.

Part 7
Information systems

Key messages

- The Guardians' information technology infrastructure is well managed.
- The most significant information technology risks faced by the Guardians have been outsourced to the Custodian, and are managed through the Custodian's infrastructure and controls, and confirmed through reporting processes.
- The internally retained information technology risks to the Guardians are minimal. Even so, the Guardians have followed good practice in implementing the Control Objectives for Information and related Technology control framework, although they are still to finalise their information technology strategy.

7.1 In this Part, we report on the Guardians' management of information systems. We set out our findings in relation to the Guardians':

- information technology function and strategies;
- management of risks relating to outsourced information technology; and
- business continuity management.

Our findings

7.2 Information systems refer to the information infrastructure necessary for the Guardians to operate the Fund. Information technology infrastructure is maintained by the Custodian, and hardware, software, and information infrastructure is maintained by the Guardians in their Auckland and Wellington offices.

7.3 The Custodian plays a vital role in all aspects of the Fund's reporting. It manages the Fund's transaction processing infrastructure, which provides all monitoring and reporting of Fund performance.

7.4 The Guardians' internal information technology systems meet business requirements. The systems include an "off the shelf" operating system and software packages for accounting[1] and financial forecasting, and the data warehouse (see paragraph 4.49). The data warehouse, a system developed in-house, has historically been the source for compliance reporting as well as investment policy research. In our view, the information infrastructure is appropriate for how the operations of the Fund are currently structured.

7.5 The Guardians also have direct daily access to all Fund transactional information provided by the Custodian. The outsourcing agreement allows the Guardians to access this information whenever required through a secure web-link to the Custodian's databases.

1 These systems are used to manage accounting for the Guardians. Accounting for the Fund is done by the Custodian.

Information technology function and strategies

7.6 The Guardians' Information Technology team consists of one staff member supported by a business analyst and third party contractors when additional resources are required. The Guardians have outsourced management of information technology infrastructure to a third party who provides a fortnightly report on the system status and maintenance activities performed. The Guardians are assessing current provisions to support projected growth of the Fund.

7.7 The relatively small and simple nature of the Guardians' information technology systems means that security and change control processes are limited and informal, based on international COBIT standards. Back-up and disaster recovery processes are more formalised through outsourcing arrangements.

7.8 Originally, the data warehouse development was driven by the need to verify certain information provided by the Custodian. However, the need for increased capability was part of the business case for the switch to a new Custodian. In our view, the value of maintaining the data warehouse facility should be reviewed. The Guardians' view is that the data warehouse is an important part of the intellectual property of the Guardians. The Guardians are committed to retaining investment data in-house. Currently, this is achieved through the data warehouse.

7.9 The Guardians are improving the alignment of the information technology function activities, including projects, to the needs of the business. This will ensure that information technology development precedes the functionality needs of the business.

7.10 The Guardians are yet to set up formal processes to strategically align information technology with the changing needs of the business. Completion of the information technology strategy depends on the development of a broader operational strategy. In the current environment, the significance of the information technology strategy is low given that the main information technology infrastructure assets are owned and managed by the Custodian. However, the remaining information technology infrastructure of the business should be developed subject to a formal plan that is integrated with the broader business plan.

Recommendation 17

We recommend that the Guardians of New Zealand Superannuation develop a long-term information technology strategy and align it with an overall operational strategy.

Management of risks relating to outsourced information technology

7.11 The Custodian owns and manages most of the outsourced information technology. Investment Managers pass all transactions to the Custodian daily, and the Custodian processes and settles the transactions. This approach limits the risk of relying on the information technology of Investment Managers.

7.12 The Guardians have a comprehensive Master Custody Agreement and service level agreement in place to govern their relationship with the Custodian. The agreement requires the Custodian to provide data securely and confidentially through its internal systems, with sufficient availability to not impede business as usual. It also commits the Custodian to a high level of processing integrity.

7.13 As part of these arrangements, the Custodian is also subject to an independent SAS 70 report that the Guardians receive annually. The SAS 70 report is completed by the Custodian's auditor and looks at generic funds management processes for the Fund's transactions. Therefore, the SAS 70 report does not specifically focus on transactions occurring under the Fund's investment mandates. To address this, the Custodian's service level agreement allows the Guardians' internal auditors to review transaction processing.

7.14 The Guardians' internal auditors have not done a review in relation to the SAS 70 report since the new Custodian was appointed. From discussions with management, we understand that a review is expected to be completed in 2008.

7.15 We reviewed the information technology component of the SAS 70 report for the year ended 31 March 2007. We did not see any issues for information technology general controls that might affect administration of transactions or reporting for the Fund. In our view, the information technology general controls applied by the Custodian are sound and reliable.

7.16 The transition to the new Custodian was governed by a formal project structure, including representation from the Guardians, the previous Custodian, and the new Custodian. The Guardians participated primarily in an overseeing and validation role. Information technology risks were considered during the transition, and deliverables were assessed according to how well they filled the gaps identified during the vendor selection process.

7.17 In our view, the risks for outsourced information technology processes are significant. However, they are adequately controlled through the provisions of the Custodian service level agreement and procedures performed by the Guardians to validate the reliability of the Custodian's processes.

Access to external provider information

7.18 The Guardians have direct access to real-time Fund-specific data through the Passport Web Portal provided by the Custodian. This portal also provides the reporting tools necessary to rapidly analyse information from Investment Managers to ensure that risks and opportunities are addressed in a timely manner.

7.19 External data is obtained from Overlay Asset Management, Bloomberg, Morningstar, and WM/Reuters. This data is uploaded to the data warehouse primarily for the purpose of validation and reconciliation of the Custodian data.

7.20 The Guardians are committed to implementing a way to collect institutional knowledge, and have started working on a knowledge management framework. The core of the framework will be an intranet[2] linking all institutional data from a single reference point. A knowledge management project team has been formed from representatives throughout the business to ensure that all knowledge is identified and collected.

7.21 In our view, the knowledge management framework is appropriate, given the outsourcing of Fund operations and the overseeing and strategy development role of the Guardians.

Business continuity management

7.22 The Guardians have a framework of high level policies for information technology continuity to support enterprise-wide business continuity management.

7.23 The Guardians have a cold site[3] for the purposes of disaster recovery, as well as back-up tape management, and server testing and recovery services. The Guardians can transfer operations to the cold site if they cannot access their regular offices. This agreement is the primary way for the Guardians to recover their internal information technology systems. If there is a disaster, the Guardians' external information technology provider will support operations during server recovery.

7.24 The Custodian has an extensive business continuity management structure including a hot site[4], three global operating locations with capacity to support the loss of one site, and a detailed Business Continuity Plan.

7.25 The Guardians' main business continuity risk is in relation to the Custodian. A failure of the Guardians' information technology systems would not have

2 An intranet is a private computer network that uses Internet protocols and network connectivity to securely share part of an organisation's information or operations with its employees.

3 A non-dedicated computer site available in the event of a disaster.

4 A dedicated computer site available in the event of a disaster.

a fundamental effect on performance of the Fund or the Guardians' ability to manage investment risk. However, a failure of the Custodian's information technology systems would present a much greater risk.

7.26 One of the benefits of outsourcing for the Guardians is gaining access to a larger and more sophisticated information technology infrastructure. Further, the physical spread of the Custodian's operations in three geographically separate locations provides assurance that business continuity risks are adequately managed.

Our conclusions

7.27 The Guardians' information technology infrastructure is well managed. The most significant risks relate to the Custodian. Largely, the Custodian's infrastructure and controls mitigate those risks. This is confirmed through the Custodian's reporting under its service level agreement with the Guardians, the annual SAS 70 report on the Custodian by its auditors, and specific procedures performed by the Guardians.

7.28 The information technology risks to the Fund from the Guardians' information technology infrastructure are minimal. Notwithstanding this, the Guardians have followed good practice in implementing the Control Objectives for Information and related Technology control framework, although they are still to finalise an information technology strategy.

Part 8
Management practices and controls

Key messages

- The work programme carried out as part of the 2007 Statement of Intent has strengthened the internal control environment of the Fund and the Guardians.
- While the Guardians have established and formalised a considerable number of operational processes, there is not yet a long-term operational strategy detailing the overall purpose of the policy framework and organisation structure.
- The ability to attract and retain staff with the appropriate skills will remain an ongoing challenge.

8.1 In this Part, we report on the Guardians' internal management practices and controls. We set out our findings in relation to the Guardians':

- internal controls;
- human resources practices; and
- business operations.

Our findings

8.2 Internal management practices and controls refer to the business operations performed by the Guardians to meet strategic and legislative objectives. This includes policies, procedures, and established processes.

8.3 The internal control framework includes:

- the type of policies and procedures adopted;
- the nature of delegations and to whom;
- the structure of banking arrangements;
- the formalisation of contracting processes;
- the necessary management skills; and
- the scope of assurance activities.

8.4 The importance of operational processes performed by the Custodian has required the Guardians to set up clear and measurable operational risk processes to monitor service performance. The relationship between the Custodian and the Investment Managers is equally important. Investment Managers are required to follow consistent protocols when reporting transactions and in resolving any compliance issues related to those transactions.

8.5 The Guardians' current internal control structure includes the following strengths:

- The separation of responsibility for trading from the related transaction processing, which is an inherent risk of any investment operation. In most advanced regulatory jurisdictions, there are requirements for physical and system-based separation of these two areas. Regulators seek to manage any influence being placed by traders on how transactions are processed and reported. Outsourced custodial responsibilities enforce strict segregation of duties between transacting and settlement of investment decisions. Investing decisions are initiated by Investment Managers and processed by the Custodian.
- Outsourced investment management provides the Guardians with access to the systems and controls of major Investment Managers. Those systems and controls provide controls throughout the investment process, such as pre-trade compliance controls.
- Funds are dispersed to about 30 Investment Managers with a diverse range of knowledge and capability. In many asset classes there is more than one Investment Manager, which allows benchmarking (that is, analysing the performance of Investment Managers within an asset class).
- Risks related to business continuity planning and disaster recovery are not centralised within the Guardians. Critical functions of the Fund could continue to operate if a disaster occurred. In such an event, the Guardians would temporarily lose the ability to oversee the operations of Investment Managers. However, investment activity and transaction settlement would continue to operate. The Guardians can restore their overseeing ability by gaining access to the Custodian's website from another location.

8.6 The work programme outlined in the 2007 Statement of Intent has allowed the Guardians to formalise routine processes and strengthen internal controls.

8.7 Twenty-six out of 28 of the Guardians' policies were prepared between March and August 2007. These policies are likely to be further refined as they are implemented and need to be linked to the major risks in the Risk Management Framework. This will allow management and internal audit to focus on the Guardians' major risks.

Internal controls

Corporate policies and procedures

8.8 The 2007 Statement of Intent sets out a work programme to develop and improve the governance infrastructure of the Guardians. The changes include adoption of executive committee terms of reference, and policies and procedures.

8.9 One reason that corporate policies were not developed before 2007 was that the Guardians were focused on preparing and implementing their investment strategy. The Guardians did not have a large staff and management team, reducing the need for complex and detailed corporate policies. During this period, the Board carried out detailed analysis, along with expert advice, for all material decisions (such as the appointment of Investment Managers).

8.10 The absence of formal policies before 2007 did not mean that the Guardians applied poor processes within their operations. Indeed, the current policies document the processes historically operated by the Guardians.

8.11 The risk normally associated with limited policies and procedures has been mitigated by the involvement of the Board and the use of outsourcing. Initiatives taken since February 2007 have ensured that there are adequate policies in place as the Board becomes less involved in day-to-day management decision-making. In our view, this is an appropriate approach by the Board at this stage of the Fund's development.

8.12 The Guardians have the following strategic and operational internal control guidance:

- Annual Plan, including budgets;
- Statement of Intent (available at www.nzsuperfund.co.nz);
- Annual Report (available at www.nzsuperfund.co.nz);
- an internal "roadmap" for the Statement of Intent; and
- 28 policies approved or pending approval by the Board (see Appendix 2).

8.13 When we compared the Fund's current policies to similar organisations, we found that they were consistent in all material respects. Therefore, we conclude that the processes applied by the Guardians before 2007 were also consistent in all material respects to similar organisations. For example, we observed that sound project management, project governance, and overseeing practices had been applied during the process to change from one Custodian to another.

8.14 The work programme completed under the 2007 Statement of Intent has established and formalised a considerable number of operational processes within the Guardians. However, there is not yet a long-term operational strategy detailing the overall purpose of the policy framework and organisation structure.

8.15 The Guardians have not defined the role and purpose of each operational area and linked these to job descriptions. This makes it difficult to identify the specific contribution of individual business units to the overall objectives of the Fund.

Recommendation 18

We recommend that the Guardians of New Zealand Superannuation prepare a long-term operational strategy detailing how the Fund will be administered in the future. The purpose of the strategy is to set out the long-term operational objectives of the Guardians. This could include external provider management, overseeing of fund administration, alternative asset research, investment strategy development, and responsible investor guidance.

8.16 This is a high-priority recommendation because it sets out how operational objectives link to the long-term strategy for the Guardians. This has a flow-on effect on strategies relating to human resources, information technology, and other business processes.

Lack of policies in some areas

8.17 We found that the Guardians do not have current policies in relation to aspects of:

- risk management;
- staff training;
- external provider management; or
- legal compliance.

8.18 Although a detailed Risk Management Framework was approved in October 2007, the Guardians do not have policies covering:

- the purpose or objectives of the Risk Management Framework;
- roles and responsibilities in relation to setting and changing the measurement criteria for likelihood and effect, and the overall risk assessment (representing the combination of these two points);
- reporting content and frequency to the Board and executive management; and
- escalation of risks to the Chief Executive Officer and the Board (based on overall risk assessment).

8.19 The Guardians do not have a policy for staff training relating to business strategy, systems, corporate policies and procedures, and specialist skills and capability.

8.20 Although the Guardians have policies covering issues such as selecting external providers, there are no policies covering the following areas of external provider management (more detailed information is in Appendix 3):

- role of the Relationship Manager;
- periodic performance assessment of the external provider;
- definition of outsourcing versus contracting;

- responsibilities in relation to receipt and review of external provider reporting (as set out in the service level agreements with each external provider);
- conflict management and management of service level agreement breaches;
- changing and updating performance measures and arrangements for service level agreements; and
- receipt and review of external provider assurance (for example, comfort letters[1] and SAS 70 reports).

8.21 The Guardians also lack a policy with a process to measure and report how the Guardians address legislative compliance.

8.22 While the areas mentioned in paragraphs 8.17-8.21 are not covered by the Guardians' policies, this does not present a high risk to the Guardians' activities. A lack of policies does not mean that good practice processes have not been applied. However, it does mean that those good practices depend more on the skills and attitudes of the particular staff currently performing these roles.

8.23 Should staff or responsibilities change, the Guardians cannot be certain that good practice will continue to be applied. Further, the absence of a formal policy framework reduces the ability of the Guardians to set and measure expectations. Policies and procedures, once integrated with job descriptions, create an accountability framework and tone within the organisation that allows the business to be independently measured and reported against. Documentation of an acceptable standard will help to ensure that good practices are consistently applied.

Recommendation 19

We recommend that the Guardians of New Zealand Superannuation prepare policies in relation to risk management, training and development, external provider management processes, and legal compliance.

8.24 We reviewed the governance disclosures in the Annual Report and concluded that they are extensive and cover all material elements. However, the governance programme is not linked to the nine principles of corporate governance promulgated by the New Zealand Securities Commission (or similarly recognised global governance standards). While compliance with the Commission's standard is not compulsory, it is widely used as a benchmark by a number of leading New Zealand entities. Compliance would ensure that there is specific consideration of how the Guardians apply each element of the requirements and that there is broad disclosure to the public.

1 A general definition is that a comfort letter conveys assurance that something is or is not so, to the best of the writer's knowledge.

Recommendation 20
We recommend that the Guardians of New Zealand Superannuation link their governance processes and reporting to the principles of corporate governance promulgated by the New Zealand Securities Commission.

8.25 The development of the Guardians' governance infrastructure has largely been adequate and timely in light of the growth of the Fund and expansion of the management team. Some policy has followed, rather than preceded, the developments occurring within the Fund. For example, a number of Investment Managers were appointed before the Investment Manager Selection Policy was adopted in June 2007. While there was no formal policy until then, a formal process was consistently applied for the selection of each Investment Manager.

Delegations of authority

8.26 The Guardians have had a policy for delegation of authority since October 2002. The Delegations and Sub-Delegations Authorities Policy was reviewed in June 2007 as part of the internal management control project. We compared this policy with similar policies on delegations and noted that:

- the policy does not contain all delegations of the Guardians;
- it does not address sub-delegations;
- delegations are potentially restrictive in some areas; and
- delegations lack clarity in some areas.

8.27 The Delegations and Sub-Delegations Authorities Policy does not contain all delegations. Some delegations are not explicit and some are also included in other policies, terms of reference, legislation, or formal documents, for example:

- set-up of bank accounts for the Guardians (covered in section 39 of the Act);
- authority to release information to the media (including Official Information Act 1982 and Ministerial responses);
- authority to initiate or defend legal action;
- authority to enter into long-term agreements and contracts;
- recruitment, appointment, and employment conditions of the Chief Executive Officer;
- approval of relocation expenses on appointment;
- authorisation of employment-related benefits in addition to salary outside standard employment contract terms;
- approval of representation on external committees;

- authorisation of timesheets and overtime for staff with a direct reporting line (direct reports);
- approval of special leave for longer than three days;
- approval to travel overseas and attend conferences;
- any disciplinary procedures, including verbal and final warnings, suspension, dismissal, negotiating, and approving collective agreements; and
- the appointment of the Internal Auditor is not restricted to the Board or the Audit and Risk Committee (although this is covered in the Audit and Risk Committee charter).

8.28 As a result, there is a risk that some actions may be taken that do not fully reflect the intention behind the delegations given.

8.29 The Delegations and Sub-Delegations Authorities Policy does not contain any process to sub-delegate temporary authority from a specific level of management when a key staff member is absent. The policy refers to sub-delegation as the further delegation of powers from the Chief Executive Officer to senior management. An example is delegation from the Chief Executive Officer covering what, to whom, and to what extent the authority can be delegated. In our experience, sub-delegations are to direct reports up to 50% of the delegation limit.

8.30 The Delegations and Sub-Delegations Authorities Policy is restrictive on management delegations in certain areas, including:

- divesting securities for responsible investment purposes;
- making withdrawals from Investment Managers;
- setting or altering service level arrangements with Investment Managers; and
- direct investments and significant shareholdings.

8.31 For all of the above areas, clear parameters need to be set for management decision-making.

8.32 The Delegations and Sub-Delegations Authorities Policy structure does not allow clear distinction between what is within the authority of the Board, the Chief Executive Officer, and executive management (that is, it is not presented in a matrix format).

8.33 The Delegations and Sub-Delegations Authorities Policy does not include the following:

- approval for adoption of, or changes to, policies and operating procedures; and
- authority to invest surplus funds on interest-bearing deposits.

8.34 The above areas need to be considered in the review of the Delegations and Sub-Delegations Authorities Policy. Policy development has been subject to strict control by executive management and approved by the Board.

Recommendation 21

We recommend that the Guardians of New Zealand Superannuation update their Delegations and Sub-Delegations Authorities Policy, including consolidating delegations currently recorded in other policies and governance documents into one Delegation of Authority Policy.

Expectations of behaviour

8.35 The Guardians have an Employee Code of Conduct and a Board Code of Conduct. These documents cover all material elements that we would expect, and are fully communicated to staff through a formal induction process. A project is under way to build an intranet to improve the Guardians' internal communication capability. A feature of the intranet will be a central repository for all policies.

8.36 The tone for expectations of behaviour is set through various human resources policies, which address potentially sensitive issues, such as receiving gifts, travel allowances, and employee benefits. In our view, adequate human resources policies and processes are in place.

Separation of responsibilities

8.37 Fraud risk associated with the assets of the Fund is mitigated through the separation and custody of bank accounts. The Guardians' operating bank account is separate from the Fund's bank accounts. The Fund's bank accounts are maintained by the Custodian and transactions occur only on instruction from the Guardians. Therefore, appropriate segregation of duties is achieved.

8.38 In our view, the inherent risks over the custody of operating bank accounts should be included in the risk profile for the Guardians and subject to periodic internal audit review.

Recommendation 22

We recommend that the Guardians of New Zealand Superannuation routinely monitor and test how they segregate duties, to ensure that no one person controls two or more phases of a transaction or operation. Testing of segregation of duties should be included in the Guardians' annual internal audit plan.

Human resources practices

Long-term strategic human resources planning

8.39 A priority of the 2007 Statement of Intent is to "maximise the Guardians' ability to attract, retain, motivate and manage people". This has included development of human resources infrastructure such as position descriptions, capability matrices, and performance assessment programmes.

8.40 The Guardians have not developed a long-term human resources plan. The requirements of such a plan would be closely linked to the long-term operational strategy of the Guardians (see Recommendation 18). A long-term human resources plan would allow the Guardians to develop their long-term human capital requirements (in terms of numbers and skills). It would also allow for the development of position descriptions, training requirements, and budgets.

Recommendation 23

We recommend that the Guardians of New Zealand Superannuation prepare a long-term human resources plan consistent with their broader operational strategy.

Key Person Risk Matrix

8.41 The Guardians have put in place a Key Person Risk Matrix to confirm that all material risks are appropriately managed. We reviewed this matrix and concluded that the Guardians are managing key person risks in a practical and reasonable manner.

8.42 The Guardians' exposure to key person risk is limited because of the extent of operational outsourcing. Most critical roles within the Guardians are committed to long-term strategic planning. A loss of a key person would not be likely to lead to an immediate operational exposure, but is more likely to affect the Guardians' successful implementation of the long-term strategy. In this regard, the steps taken by the Guardians between May and October 2007 to strengthen the senior management team have lessened this risk.

Succession planning

8.43 In organisational development, succession planning is the process of identifying and preparing suitable employees through mentoring, training, and job rotation, to replace key people – such as the Chief Executive Officer – as their terms expire.

8.44 The Key Person Risk Matrix adequately addresses succession planning. The matrix identifies roles within the Guardians that present long-term key person risk and sets out how the risk is managed by having more than one person capable of performing each role. The matrix also provides a strong basis for human capital development within the Guardians.

Attracting and retaining appropriately skilled people

8.45 The human capital needs of the Guardians are difficult to manage. Human capital is a complex area for the asset management industry. These factors mean the Guardians are exposed to opportunity cost if they cannot attract and retain suitably skilled investment analysts and strategists. Because the risk is by definition an opportunity cost, it is difficult for the Guardians to establish clear cost-benefit cases for particular roles.

8.46 The competitive nature of the asset management industry makes it difficult and costly to attract and retain experienced staff. Typically, employees hold specialist roles relating to a specific product or asset class. As a global investor, the Guardians compete for global skills in specialist areas. Generally, the investment community applies a strong correlation between a fund and its portfolio management staff. The Guardians consider the reputation of an Investment Manager's staff when appointing and continuing to use an Investment Manager.

8.47 This environment has led to premium rates being paid for high-performing employees. Risks associated with human capital management are typically managed by paying commercial salaries, providing performance-based remuneration, and using structured human capital development programmes. Not all of these methods are currently available to the Guardians.

8.48 The employment environment of a Crown entity demands a high level of transparency and draws comparison with other public sector organisations. In the context of the Guardians, this could lead to situations where certain employees are paid significantly more than in other Crown entities because of the above factors. Recognising that this situation could potentially arise, the Guardians do not have a specific process agreed with stakeholders (for example, the Crown) to deal with remuneration packages that may draw wider public scrutiny.

8.49 The Guardians have introduced the first stage of a bonus system with a uniform payment to all staff if major organisation and fund return targets are met. However, this does not address individual bonus arrangements that may be necessary to attract global human capital talent.

8.50 A further dimension to this issue for the Guardians is the long-term nature of the Fund's investment horizon. While attracting appropriate skills is an issue, as discussed above, retaining the skills throughout the duration of the Fund's investment horizon is equally challenging. Accordingly, the Guardians do not currently apply performance bonuses linked to the long-term performance of the Fund except on an aggregate basis, rather than an individual basis. To do so, the Guardians would be negotiating remuneration arrangements that are unique within the public sector and could lead to widespread debate.

8.51 The risk of not being able to attract and retain appropriately qualified staff is currently managed by the Guardians in the following ways:

- the outsourcing business operating model lessens the dependency on any one person; and
- the long-term investment horizon of the Fund eliminates the need for considerable short-term active management to meet projected returns.

8.52 Because the Guardians are susceptible to public expectations of New Zealand salaries, they may face situations where specialist skills are required but not obtained or obtained at remuneration levels not regarded as publicly acceptable. In our view, the Guardians should formalise processes for recruitment of specialists where necessary. This should include position descriptions, a process for determining adequate remuneration and benefit arrangements, and a process to have these appropriately approved and authorised.

Recommendation 24

We recommend that the Guardians of New Zealand Superannuation put in place a transparent process that they can follow if they are required to set a level of remuneration for specialist skills outside the current approved levels.

8.53 This is a high-priority recommendation. In our view, the process should assess the extent to which the skills are critical to the Guardians, and set out a process to agree remuneration levels beyond the current delegated level where appropriate. This should include setting a maximum remuneration amount. The Guardians have an agreed funding model with the Crown, which should enable the Guardians to afford market rates for senior funds specialists as needed. However, the Guardians have yet to establish any non-standard employment contracts or bonus structures.

8.54 Recognising the unique nature of the asset management industry, we consider that it would be inappropriate and a high-risk approach for the Guardians to not employ suitably qualified employees. Given the importance of the investment strategy in delivering long-term growth for the Fund, the strength of the senior management team is crucial to achieve this objective. In this regard, we agree with the approach taken by the Guardians to attract and retain specialist funds management skills.

Business operations

Cost effectiveness

8.55 The Guardians engage a specialist independent consultant to compare the Guardians to peer organisations. The process provides the Guardians with information about relative cost structures. While meaningful, the consultant's analysis cannot be considered to be totally comparable because:

- the Guardians are typically compared to more mature organisations that no longer need to invest in the corporate infrastructure and capability of a rapidly growing institution;
- the geographical location of the Guardians relative to global markets means it may not be practical to adopt the business operating model of peer organisations without taking on more risk;
- the size of the Fund relative to the New Zealand market means that the Guardians must invest a disproportionate amount in foreign markets;
- the founding legislation places certain requirements on the Guardians that may not apply to other organisations, for example, monitoring of responsible investments and the associated cost; and
- many similar funds allocate their overhead costs to specific asset classes, which makes comparison with the Fund difficult.

8.56 Overall, in our view, there is a high awareness by the Board and by management of the need to maintain cost-effective fund management services. The benchmarking process, along with other factors, was used as a catalyst for tendering the custodial and back-office services to a global group of potential providers. In our view, the early indications are that the tender has resulted in an appropriate outcome for the Guardians.

8.57 However, the need to maintain cost-effective services is balanced by the need to obtain expert advice in specialist areas.

Monthly management reporting

8.58 The Guardians have an appropriately qualified Accounting and Finance team. The process for finalising financial statements for the Fund and the Guardians are subject to the necessary controls. In our discussions with management, there was no indication there were issues with the content, timeliness, or accuracy of financial information produced in relation to the Fund.

8.59 Because of the nature of the investments, the Guardians may not always be able to access accurate valuations of privately held assets in a timely manner. While acknowledging that privately held assets are a recent investment class, our analysis did not highlight that the valuation of these assets has materially affected reported Fund performance.

Our conclusions

8.60 The Guardians' internal management practices and controls have been significantly affected by the work programme carried out as part of the 2007 Statement of Intent. While some elements of the work programme were still to be completed or refined, the majority of completed work has strengthened the internal control environments of the Fund and the Guardians.

8.61 While the Guardians have established and formalised a considerable number of operational processes, there is not yet a long-term operational strategy detailing the overall purpose of the policy framework and organisation structure.

8.62 The ability to attract and retain staff with the appropriate skills will remain an ongoing challenge. To the extent practical, the Guardians need to put in place an approach for setting remuneration levels outside current approved levels.

Appendix 1
Suggested improvements to committee terms of reference and related documents

As a result of our performance audit of the Guardians of New Zealand Superannuation, we make the following suggestions to improve the terms of reference documents for Board and executive committees.

Terms of reference for Board committees

Audit and Risk Committee

The terms of reference document should include:

- the minimum number of committee members required for the committee;
- the minimum experience necessary for the Committee (as a whole) for example, Chartered Accountant, Funds Specialist, or Risk Manager;
- the frequency of reviews of risk management systems, compliance systems, delegated authorities, external/internal audit plans and the risk profile; and
- who has the responsibility to:
  - approve significant accounting policy changes;
  - evaluate the Guardians' potential exposure to fraud;
  - assess/evaluate the Guardians' adequacy and effectiveness of their internal control environment; and
  - review the annual risk profile.

Responsible Investment Committee

The terms of reference document should include the Guardians' interpretation of "responsible" and investments that "avoid prejudice to New Zealand's reputation as a responsible member of the world community".

Board Governance Statement

The document should include:

- the range of skills and experience necessary for the Board;
- the restriction that established committees cannot take action or make decisions on behalf of the Board unless specifically authorised to do so;
- the responsibility for Board members to at all times comply with the express terms and spirit of their fiduciary obligations, including acting honestly and in good faith in the best interest of the Guardians;
- the responsibility for Board members to ensure that information they hold is in strict confidence and to be used in the best interest of the Guardians;
- the responsibility for the Board to maintain and ensure compliance with internal policies and procedures;

- the responsibility for the Board to maintain an up-to-date risk profile for each of the Guardians' business operations;
- how the performance of each Board Committee is to be reviewed each year; and
- the formal induction and training procedures for new Board members.

Terms of reference for executive committees

Communications Committee

The document should state who is responsible for:

- reviewing and approving external communications;
- message development and dissemination planning;
- the stakeholder relations strategy and overseeing its implementation; and
- the media relations strategy and overseeing its implementation.

Appendix 2
Implementation of the policy framework

The following table shows the dates when the Guardians of New Zealand Superannuation implemented policies under their policy framework.

	Policy	Date of approval
1	Statement of Investment Policies, Standards and Procedures (most recently refreshed date)	May-07
2	Investment Due Diligence Policy	May-07
3	Policy Guideline	May-07
4	Internal Incident and Error Policy	May-07
5	Tax Management Policy	May-07
6	Media Policy	May-07
7	Web Content Control	May-07
8	Responsible Investment Policy Standards and Procedures	Jun-07
9	Investment Manager Selection Policy	Jun-07
10	Internal Audit Policy	Jun-07
11	Travel Policy	Jun-07
12	Adviser Selection and Appointment Policy	Jun-07
13	Delegations and Sub-Delegations Authorities Policy (most recently refreshed date – initial policy approved October 2002)	Jun-07
14	Fraud Policy	Jul-07
15	Employee Code of Conduct	Jul-07
16	Communications Policy	Jul-07
17	Events Policy	Jul-07
18	Business Continuity Management Policy	Aug-07
19	Information Management Policy	Aug-07
20	Information Technology Policy	Aug-07
21	Project Management Policy	Aug-07
22	Investment Funding Policy	Sep-07
23	Interim Counterparty Policy	Sep-07
24	Securities Lending Policy	Sep-07
25	Procurement Policy	Sep-07
26	Human Resources Policy	Sep-07
27	Investment Manager Monitoring Policy	Oct-07
28	Board Members Code of Conduct Policy (not yet approved by the Board)	-

Appendix 3
Recommended elements to include in an Outsourcing Policy

The Guardians of New Zealand Superannuation's Procurement Policy is currently being used as an Outsourcing Policy. We recommend that an Outsourcing Policy include further elements as outlined in the following table.

No.	Recommended element
1	A clear definition of the criteria to determine that an external provider relationship exists. The definition should distinguish outsourcing relationships from general contracting or procurement relationships.
2	A process and criteria for selecting an external provider that includes: • focus; • industry reputation; • experience and competence; • support of the industry; • internal controls; • information delivery; • offshore or domestic; • geographic locations; and • culture.
3	Specific operational relationship management policies that include: • risk management, recognising that the Fund retains ownership of risk although activity is transferred; • scope of services/activities that can be outsourced to external providers; • concentration of services with one external provider; • minimum requirements that must be met by an applicant to provide outsourcing services; and • a distinction between external providers for operational and support functions.
4	Performance and risk reporting elements that include performance and risk management reporting is to be agreed with external providers who are contracted to perform operational processes (that is, part of the day-to-day business operations).
5	Relationship manager responsibilities, such as: • maintaining appropriate levels of regular contact; • executing the agreed performance monitoring processes with the external provider; and • dealing with issues as they arise and elevating them to senior management when required.

6	Performance management elements, such as: • a regular review of the performance measures based on changes in processing methods, issues identified throughout the review period, and any new requirements; and • reviewing and updating the service level agreement, and agreeing new performance measures for all new products.
7	External providers are to be selected through a tender process that includes short-listing bidders based on predetermined selection criteria.
8	Include key factors, based on the business case to outsource, in the outsourcing agreement.
9	Minimum reporting criteria for special outsourcing relationships (for example, for Custodian outsourcing or compliance management).
10	Requirements for outsourcing agreements, such as: • a clause allowing for periodic review of the agreement within the term of the contract and renegotiation if appropriate; • minimum performance benchmarks; • arrangements to terminate the agreements; • arrangements for any sub-contracting or outsourcing by the external provider, including specific rules or limitations to such arrangements; • application of minimum security and confidentiality of information requirements to sub-contractors; and • formal dispute resolution mechanisms.

Appendix 4
Our recommendations

High-priority recommendations

We recommend that the Guardians of New Zealand Superannuation:

- adopt a formal Board Charter, make it publicly available, incorporate the measures adopted in the Charter as part of their annual Board performance assessment process, and use the Charter to guide their external reporting. (Recommendation 2)
- update their Risk Management Framework so that relevant risk management activity is identified in important areas of the operations. This update should include preparation of risk plans, incorporating risk management measures into executive performance assessment, and linking risk to service level requirements and policy development. (Recommendation 3)
- assess the scope of the Board's current and future capability by initiating a regular independent assessment of the Board's combined capability relative to appropriate international peer organisations, and by conducting exit interviews as members retire from the Board. (Recommendation 6)
- prepare a long-term operational strategy detailing how the Fund will be administered in the future. The purpose of the strategy is to set out the long-term operational objectives of the Guardians. This could include external provider management, overseeing of fund administration, alternative asset research, investment strategy development, and responsible investor guidance. (Recommendation 18)
- put in place a transparent process that they can follow if they are required to set a level of remuneration for specialist skills outside the current approved levels. (Recommendation 24)

Other recommendations

We recommend that the Guardians of New Zealand Superannuation:

- update the terms of reference documents for their Board committees and executive committees to better reflect governance standards promulgated by global regulators. (Recommendation 1)
- in their 2008/09 internal audit plan, target high-risk processes as identified by their Risk Management Framework for assurance on a set timetable (for example, every two years). (Recommendation 4)
- further develop and refine standard reporting to support the separation of Board and management responsibilities. This should include assessing management decision-making within predefined parameters approved by the Board. (Recommendation 5)

- formalise their internal audit framework by establishing an Internal Audit Charter (consistent with the guidance of the Institute of Internal Auditors), a service level agreement with their internal audit provider, and by carrying out three-yearly peer reviews of the services provided by their internal audit provider (consistent with the Institute of Internal Auditors' peer review framework). (Recommendation 7)
- extend their screening of investments in excluded companies or entities to all security positions, including debt or fixed interest securities. (Recommendation 8)
- review how the Board approves investment activity to ensure that responsibility for investment decisions is delegated to management where appropriate. (Recommendation 9)
- formalise the periodic independent review of the Strategic Asset Allocation, and consider independence from management when selecting the investment adviser to conduct the review. The scope of work agreed with the adviser should also include validation of individual asset class benchmarks applicable to the Strategic Asset Allocation. (Recommendation 10)
- review their business operating model periodically to ensure that all aspects of their business (including whether operations are outsourced or done in-house) enable the objectives of the Fund to be met effectively and efficiently. (Recommendation 11)
- link their Investment Manager Selection Policy with their process for conducting due diligence over Investment Manager appointments. This includes linking qualifying criteria to the policy, documenting how ratings and weightings are applied, and documenting how assessment elements are set, changed, and approved. (Recommendation 12)
- amend their Investment Manager Selection Policy to include an assessment of the anti-money laundering management philosophies of prospective Investment Managers, and that this assessment becomes part of the ongoing assessment process for Investment Managers. (Recommendation 13)
- establish a policy on fees for Investment Managers that sets out the types of performance fees available and criteria for awarding a performance fee. (Recommendation 14)
- either:
  - change the definition of listed securities in the Strategic Asset Allocation so that it also includes unlisted securities where they are held as part of the largely listed security investment mandate; or
  - require that unlisted securities, regardless of their investment mandate, be classified as Private Markets assets.

Once this treatment is clarified, the compliance management process should be changed accordingly. (Recommendation 15)

- initiate a formal process to allocate the operating and administrative costs of the Fund to the respective individual investment classes for which those costs have been incurred. (Recommendation 16)
- develop a long-term information technology strategy and align it with an overall operational strategy. (Recommendation 17)
- prepare policies in relation to risk management, training and development, external provider management processes, and legal compliance. (Recommendation 19)
- link their governance processes and reporting to the principles of corporate governance promulgated by the New Zealand Securities Commission. (Recommendation 20)
- update their Delegations and Sub-Delegations Authorities Policy, including consolidating delegations currently recorded in other policies and governance documents into one Delegation of Authority Policy. (Recommendation 21)
- routinely monitor and test how they segregate duties, to ensure that no one person controls two or more phases of a transaction or operation. Testing of segregation of duties should be included in the Guardians' annual internal audit plan. (Recommendation 22)
- prepare a long-term human resources plan consistent with their broader operational strategy. (Recommendation 23)

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