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Governance and Administration Committee
Parliament Buildings
Wellington

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Submission on the State Sector and Crown Entities Reform Bill

The Institute of Directors (IoD) appreciates the opportunity to comment on the State Sector and Crown Entities Reform Bill (the Bill) which amends the State Sector Act 1988 and the Crown Entities Act 2004.

The explanatory note to the Bill provides that "the single broad policy of the Bill is to provide for greater integrity and accountability in the management of the state services by providing for strengthened and more consistent regulation of conduct and remuneration of employees at the most senior level and a more consistent approach to the State Services Commissioner's investigatory and inquiry powers when dealing with agencies in the state services outside the public service".

About the Institute of Directors

The IoD is a non-partisan voluntary membership organisation committed to driving excellence in governance. We represent a diverse membership of over 8,600 members drawn from listed issuers, large private organisations, small and medium enterprises, state sector organisations, not-for-profits and charities.

Our Chartered Membership pathway aims to raise the bar for director professionalism in New Zealand, including through continuing professional development to support good corporate governance.

Summary

We are concerned that changes proposed in the Bill diminish the Crown entity governance model, including undermining the role of boards and their relationship with Ministers. In summary:

- we recognise the Crown's role, as shareholder, to provide guidance on CEO remuneration as is currently done by the State Services Commissioner (the Commissioner) for Crown entity boards when they consult the Commissioner before finalising the terms and conditions of employment of CEOs (including remuneration at appointment and annual reviews). This *consultation* requirement still allows boards to carry out their core function of appointing and managing the CEO. Changing this requirement to one of *consent* will undermine the core role of the board. We do not support the proposed change.
- we also do not support the introduction of a fixed (five-year) term of appointment for statutory Crown entity CEOs. A fixed term for CEOs for Crown entities would be inconsistent with other sectors, including CEOs of private entities. We think that introducing fixed terms would have a negative effect, including restricting the board's role in appointing and managing the CEO and increasing potential costs.
- we support a requirement for the Commissioner to set standards of integrity and conduct by applying a code of conduct to boards and board members of Crown entities that are currently subject to a code of conduct (currently employees, contractors and secondees are covered). It is however important that there is clarity around:

    - the interplay of board members' duties under the Crown Entities Act 2004 and their obligations under a code of conduct
    - how the proposal will not compromise the statutory independence of independent Crown entities
    - how the Commissioner will require compliance with any code of conduct and monitor adherence.

  There should also be alignment with other codes such as the FMA's Corporate Governance Handbook (which has guidelines on ethical standards) and meaningful consultation with affected boards and wider stakeholders.
- we do not support an extension of the Commissioner's role in investigations in the state services as there are already a number of agencies with powers to inquire, in particular the Auditor-General. Costs associated with extending the Commissioner's role could be significant whilst adding complexity and duplication to the system. It is important that boards and others in the state sector understand accountability and oversight arrangements and what different agencies may investigate. This is a complex area and we encourage the Committee to take a broader look at the investigative regimes across government.

The reforms in the Bill give the Commissioner increased powers and shift a level of control away from Crown entity boards to the Commissioner. This shift diminishes the Crown entity governance model, the fundamental role of the board to manage CEOs and hold them to account, and the board's relationship with the Minister. It will also deter skilled and experienced directors from putting themselves forward to serve on Crown entity boards.

The role and value of the board is described in the IoD's *Four Pillars of Governance Best Practice for New Zealand Directors* (2017):

- an effective board adds value by holding management to account for their accurate pursuit of the organisation's purpose and the successful execution of its strategy
- boards who are skilled in corporate governance focus on excellence and best practice to maximise organisational value and performance.

Diminishing the role of the board will severely restrict its effectiveness.

Overview of the State Sector Act 1988 and the Crown Entities Act 2004

The State Sector Act 1988 is one of the principal statutes (with the Crown Entities Act 2004) governing the management of the state sector. The state sector is the broad range of organisations (including Crown entities) that serve as instruments of the Crown in respect of the Government of New Zealand. The State Sector Act sets out, among other things, the powers and functions of the State Services Commissioner (the Commissioner) including setting minimum standards of integrity and conduct for Crown entities.

The Crown Entities Act 2004 provides a framework for the establishment, governance and operation of Crown entities. It also sets out accountability relationships between Crown entities, their board members, their responsible ministers and the House of Representatives. Employment of CEOs is covered under the Act.

Crown entities are bodies that are legally separate from the Crown but in which the Government has a controlling interest, eg through majority shareholding or having the power to appoint and replace a majority of governing members.

There are five categories of Crown entities under the Act:

- statutory entities (Crown agents, autonomous Crown entities, and independent Crown entities). Reforms in the Bill largely relate to these entities.
- Crown entity companies

- Crown entity subsidiaries
- school boards of trustees and
- tertiary education institutions.

We comment on specific aspects of the Bill below.

Boards to gain consent from the Commissioner regarding CEO's employment

Under the Crown Entities Act 2004, *statutory entity* boards are required to *consult* with the Commissioner in relation to the terms and conditions of employment of a CEO (and amendments to an agreement).

In practice, the Commissioner will provide guidance to Crown entity boards including recommendations around CEO remuneration ranges and increases. If a board makes a proposal within the scope of the Commissioner's guidance, the Commissioner will delegate the decision to the board chair. If the proposal is outside the guidance, the board must consult with the responsible Minister. We note that the Commissioner can, and does, agree with proposals that are outside the guidance in some cases.

The Supplementary Analysis Report on the Bill states that in the 2016/17 year:

- 80% of proposals (for both consults and consents) were within the Commissioner's guidance
- of the 20% outside the guidance, the Commissioner agreed with proposals for 16% of the cases
- *three* entities did not follow the recommendations of the Commissioner and relevant Minister.

The Bill will amend the Crown Entities Act 2004 to require statutory entity boards to obtain the *written consent* of the Commissioner in relation to the terms and conditions of employment of a CEO and any amendments. The Supplementary Analysis Report states that the proposal will impact 22 Crown agents, 14 autonomous Crown entities, 10 independent Crown entities, and 4 entity subsidiaries.

The amendment would align the practice of seeking the Commissioner's consent among Crown entity boards (Crown agents in the health sector are already required to obtain the Commissioner's consent and tertiary education institutions are required to obtain the Commissioner's written concurrence).

The Bill also expressly provides that the Commissioner must provide boards of statutory entities with advice and guidance on the terms and conditions of employment of CEOs (eg policy on size of remuneration and any increases).

IoD comment

Appointing and managing the CEO is one of, if not the, most important function of a board and this includes setting the CEO's terms and conditions of employment, including remuneration.

Setting appropriate levels of executive remuneration can be complex and an entity's individual context is critical.

The Commissioner currently provides guidance to statutory entity boards around CEO remuneration. This is both appropriate and useful for boards of Crown entities. If a board proposes going outside this guidance it must consult with the responsible Minister.

The current consultation requirement appears to be working well with the large majority of proposals being within the Commissioner's guidance, only three were not.

The proposal for statutory entity boards to gain consent from (rather than consult with) the Commissioner shifts a level of control from boards to the Commissioner in respect of this fundamental role of the board.

We are concerned the change will diminish the board's ability to fulfil their core role of appointing and managing a CEO. For example, it may impact on the board's ability to attract and retain the most appropriate CEOs for the role, and to hold the CEO to account for performance.

We are also concerned that the proposed change will undermine the board's relationship with the Minister.

Some experienced directors may also be deterred from serving on Crown entity boards. It is important that the state sector attracts experienced directors and that they want to serve in the sector. Good governance of state sector organisations is essential to the delivery of effective services and outcomes that benefit all New Zealanders. Boards focused on excellence in governance and high standards of professionalism can help build trust across the state, private, and not-for-profit sectors.

For the reasons above, we do not support the proposed change.

Fixed term of appointment for CEOs

The Bill proposes a fixed term of appointment for CEOs of statutory entities of not more than five years, and allows for reappointment. The Bill will apply prospectively, to appointments and reappointments after it comes into effect.

IoD comment

We do not support the introduction of fixed terms of appointments for statutory entity CEOs.

Other than CEOs of public service departments, tertiary education institutions and local government, it is not usual practice in New Zealand, including in the private sector, to have fixed terms for CEOs.

Introducing fixed terms may restrict the board's ability to manage and hold the CEO to account. Managing performance can be challenging when things are not going well with a CEO. Having a fixed term for CEOs may have unintended consequences such as deferring the removal of a CEO if the end of the term is approaching or potentially increasing severance settlements to cover the remainder of a term to remove a CEO.

Code of conduct for board members

The Commissioner has a leadership role on integrity and conduct in the state services under the State Sector Act 1988. This includes the power to issue a code of conduct and apply it to Crown entities (excluding tertiary education institutions and Crown Research Institutes and their subsidiaries). Codes apply to employees, contractors and secondees but not boards or board members.

The State Services Commission's website sets out the reasons why the code of conduct (developed for state sector agencies) doesn't apply to Crown entity board members:

> "As the Crown Entities Act 2004 specifies individual and collective duties of board members, the Commissioner has decided not to include the personal conduct of board members in the coverage of the code of conduct.
>
> Many parties can have a legitimate interest in the conduct of Crown entity board members

(eg the chairperson, other members on the board, a select committee undertaking a review, the Minister of Finance, the Auditor-General, the Ombudsmen, the State Services Commissioner, the public). However, the board's most important relationship in terms of accountability is with the responsible Minister. In the event of members' wrong-doing, the Minister may lose confidence in their ability to fulfil their responsibilities and initiate statutory processes for removing them from office. This is the same process the Minister would consider if members were included in the code coverage."

Changes proposed in the Bill expressly provide that the Commissioner may apply a code of conduct to a Crown entity's board and board members. As a result, they may be investigated by the Commissioner for breaches of the code as part of the mandate under the Act. The range of entities subject to the Commissioner's mandate has not increased.

Key reasons put forward for boards and board members to be subject to a code include:

- it is the right thing to do (including from a transparency and accountability perspective) and board members should not be treated differently to workers
- it would align with international practice (eg the *UK Code of Conduct for Board Members of Public Bodies*)
- it is necessary for reconnecting the system around a unifying spirit of service to the community.

IoD comment

Boards have a key leadership role in fostering high ethical standards and setting the tone for a healthy organisational culture. In leading from the top and displaying and encouraging high ethical standards, board members positively influence culture, behaviour and the reputation of their organisations.

Many boards and directors already adhere to a code of conduct. The IoD's *Code of Practice for Directors*, which all members sign up to, provides that directors should encourage the adoption of a code of conduct and set an example in their adherence to the values set out in the code. The Financial Markets Authority's *Corporate Governance Handbook* (2018) and *NZX Corporate Governance Code* (2017) also recommend that boards should adopt a code of ethics. The FMA's handbook applies to public sector entities.

We support the proposal as it is appropriate for board members to demonstrate, and be held accountable for, high standards of integrity and conduct. However, we emphasise the importance that:

- there is clarity around:
    - the collective and individual duties of boards and board members under the Crown Entities Act 2004 and their obligations under a code of conduct. While legislation takes precedence, there may be issues with how the Act and the code interrelate and operate.
    - how the proposal will not compromise the statutory independence of independent Crown entities
    - how the Commissioner will require compliance with any code of conduct and monitor adherence
- that there is alignment with other codes such as the FMA's handbook (with guidelines on ethical standards)
- that there is meaningful consultation with affected boards when a code is being developed (with Crown entities and wider stakeholders).

Reforming the Commissioner's inquiry and investigative powers

The Commissioner has broad inquiry and investigative powers under the State Sector Act to carry out statutory functions. The Commissioner's powers differ when exercising these functions in relation to the core public service and the wider state services.

The Bill will amend the State Services Act to put in place a single investigation package aligned with the regime in the Inquiries Act 2013 (which covers public and governmental inquiries and Royal Commissions). The amendments are described as promoting greater consistency in the manner in which inquiries and investigations are conducted across government.

IoD Comment

The landscape for inquiries and investigations into misconduct in the state sector is complex. It appears that the proposed reform is aimed at achieving consistency for the Commissioner's role in inquiries and investigations. However, there are a number of other agencies who can investigate matters in the state sector, in particular the Auditor-General.

It is important that boards and others in the state sector understand accountability and oversight arrangements and what different agencies may investigate.

Extending the Commissioner's role could add significant costs, duplication and complexity to the system.

We do not support this proposed extension of the Commissioner's role and encourage the Committee to take a broader look at the investigative regimes across government.

Conclusion

The reforms in the Bill give the Commissioner increased powers and shift a level of control away from Crown entity boards to the Commissioner. This shift diminishes the Crown entity governance model, the fundamental role of the board to manage CEOs and hold them to account, and the board's relationship with the Minister. It will also deter skilled and experienced directors from putting themselves forward to serve on Crown entity boards

We appreciate the opportunity to comment on behalf of our members.

Yours sincerely

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