Background to the 1988 amendments to the rules of the Reserve Bank of New Zealand Staff Superannuation and Provident Fund

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The story begins around 1985. The Fund was founded in 1934 and its rules etc evolved over the following decades – often it appears (and certainly over time) more or less in step with what became the Government Superannuation Fund main scheme.

The issues under review here began with a set of rule changes made in 1988, which were developed, debated, contested etc over several years from about 1985 (including extensive discussions with the staff union, the trade union to which all non-managerial staff - compulsorily - belonged). At the time, the trustees were chaired by the Governor and included one Executive Adviser/Assistant Governor (Dick Lang) with HR responsibilities (who technically had to carry the old "Chief Cashier" title), one non-executive Reserve Bank Board member, and one trustee elected by members[1].

One of the most important of the changes was a shift towards vesting employer contributions (previously people leaving the Fund before retirement received back only their own past contributions - and any returns on those – which was (obviously) quite a deterrent to leaving the Bank for anyone who had been employed for more than a few years). But there were a variety of other changes, some more material than others. The changes made provision for a second member-elected trustee. The wind-up provisions were changed, with the key feature being a provision requiring the purchase of annuities[2] in the event of a wind-up (rather than simply totting up the assets and divided them among members in proportion to their claims, as had largely been the case until then[3]). The Bank agreed to underwrite the purchase of annuities, and presumably as a counterpart to that was that any surplus after the purchase of annuities could revert to the Bank.

And, it appears, by fairly late in the piece the Bank's conception of appropriate remuneration structures was changing. The Bank had long had a variety of fringe benefits (by far the most important of which were residential mortgages at concessional interest rates), with take-up at the discretion of employees (subject to overall eligibility rules), the market value of which (a) fluctuated widely with market interest rates, which had increased sharply in the wake of the 1984 liberalisations, and (b) had not previously been taxed, but was now being taxed under the new Fringe Benefits Tax. With finance now readily available on market and benefits from fringe benefits fully taxed as income, the Bank was considering moving to a system of total remuneration, in which the employer decided how much it wished to pay the employee, with the employee free to take that remuneration either in cash or in the form of (approved) fringe benefits. Absent such a shift all sorts of anomalies existed, including younger people (taking a mortgage) typically being better paid than older people doing similar jobs, and anyone who for personal reasons did not wish for the time being to buy a house being paid much less than colleagues who did wish to own their home[4].

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[1] Who, as it happens, had to be an employee rather than a pensioner.

[2] These amendments were being put through just prior to the big changes to the savings tax regime, which dramatically altered the attractiveness of various private superannuation and life insurance products.

[3] A halfway house had been added in 1986 (in a series of mostly technical amendments) providing for pensions to be paid in respect of Bank contributions to those members who were over 50 at the time of windup (it is not clear to me who was to pay these pensions - the Bank presumably).

[4] My own experience was illustrative. In 1987/88 I was a manager in the economics department and was seriously exploring the possibility of a career change, such that I had no interest in buying a house. My total

It was never really clear how much weight the Bank had put on fringe benefits in thinking about remuneration policy and pay levels. In years past, access to mortgages had been more of a benefit of availability than in terms of interest rate, although the concessional content increased as inflation became more prevalent and market interest rates fitfully adjusted to reflect that new norm. At a personal level, when I was applying for graduate economist jobs just a few years earlier, Reserve Bank starting salaries (absent fringe benefits) were already at least as high as those on offer at The Treasury (which offered no fringe benefits). There was little sense the Bank had ever revised down cash salary bands to take account of the increased value of fringe benefits (generally available, but benefits specific to those who chose to take them up), although in the couple of years before the 1988 rule changes Bank cash salaries were slow to adjust (upwards) in the face of (a) high inflation, and (b) rocketing private demand for (eg) economists. Note here that the Bank was the agent implementing government policy designed to reduce inflation, initially to something like "low single figures" so that it was never likely that the value of concessional mortgages would long remain as large as it had become over 1985 to 1987.

What did all this mean for the superannuation scheme?

For decades, contributions to the superannuation scheme had been as a set percentage of the employee's ordinary (cash) salary. Fringe benefits were not taken into account (nor was overtime, acting allowances etc).

But if the Bank was going to begin a process of moving (at least some) employees onto remuneration arrangements that involved identifying the total remuneration the Bank was willing to pay, **and** enabling employees to choose from a menu of cash or fringe benefit options, there would – for those employees - no longer be something directly akin to "ordinary cash salary". If so, some rule change might be needed to align the superannuation scheme provisions with what the new remuneration policy might look like.

The easy solution would have been to have scrapped the main fringe benefits (there were, after all, no tax benefits left on most of them[5]).

Since for most staff the mortgages they had taken out with the Bank carried an interest rate (4.5%) that could be adjusted by the Bank at its discretion, much of the issue could have been dealt with by (eg) giving notice of a schedule of adjustments bringing the concessional to a market rate within five years - as was eventually done several years later. At the point - as with their counterparts in core government departments like The Treasury – staff would have been paid only a cash salary. But this alone would not have been a comprehensive solution for two main reasons: (a) some staff had older mortgages with a 3 per cent fixed interest rates (although the real value of such loans was being rapidly deflated by inflation, and no new such loans were being made), and (b) probably more importantly, all senior managers – including Governors - had as part of their remuneration package the provision of a company car for full personal use[6], at a time when the real cost of cars was much higher than it is today. Senior managers tended to be older, in many cases approaching retirement, at which point the calculation of their pension would crystallise (based on last few years' cash salary). Since the Bank presumably did not believe its senior managers were in general overpaid, simply

remuneration was, as a result, lower than that of a young data assistant who was working for me (who had a cash salary probably roughly fit for the role, plus a newly taken-out large (for the day) mortgage.

[5] Perhaps the most valuable exceptions – car parks – were never subject to FBT but also weren't brought within the total remuneration net (ever, or at least for several decades).

[6] I am not clear when this perk was introduced, but have assumed it became more salient and probably more common as high maximum marginal tax rates became an issue in the 1970s.

scrapping the company cars and replacing them with a comparable increase in cash salary would have resulted in a non-trivial lift in the cash salary of these very senior, mostly older, officials, boosting their pensions (by design DB schemes always skew in favour of those who rise to very senior positions late in their career.) That would have been a bad look, and - without documentation we cannot know – a charitable interpretation of events in that period might include the possibility that those at the top wanted to avoid enriching themselves further that way.

But at the time, the Bank chose not to make any of these changes.

Instead, the superannuation scheme rules were amended to allow the Bank to decide (a) which employees would continue to have superannuation contributions and benefits calculated relative to ordinary salary and which relative to total remuneration, and (b) what proportion of total remuneration would represent salary for superannuation purposes for each individual employee or class of employees. Both could be varied at any time at the Bank's absolute discretion[7].

At the time, plans were for all this to affect only managerial employees, since all others were covered by the terms and remuneration structures in the binding industrial award negotiated from time to time with the union (it was not until the 1991 Employment Contracts Act that all employees were bought within the ambit of general employment law).

Remuneration structures in 1988

There is little doubt that the Reserve Bank's remuneration structures were in a mess. For these purposes I'm going to concentrate on just three components of remuneration: cash salary, access to concessional residential mortgages, and (for senior managers only) company cars for full personal use.

- **Salary scales**, including steps within each scale, were set (a) for staff below the level of manager/adviser in an industrial award negotiated with the (compulsory) Reserve Bank of New Zealand Industrial Union of Workers, and (b) for managerial level staff by the Bank, but in consultation with the Executive Association. Salaries for the Governor and Deputy Governor were set independently, by (I believe) the Higher Salaries Commission. Scales encompassed all staff, without a great deal of room for discretion.
- **Cars.** As I understand it, all senior managers (chief managers and above) were eligible for Bank cars for full personal use (at a time when the relative real price of cars was higher than it is today). I don't know whether all availed themselves of the option, but it seems highly likely. This was a systematic boost to total remuneration for this class of employee.
- **Residential mortgages for owner-occupied dwellings** were available quite generally (perhaps, from memory, from age 23). Eligibility had increased over the years (marriage was apparently once a prerequisite). In earlier decades, the main benefit of the facility had been (a) assured access (in a market prone to quantity rationing), and (b) longer terms than were common in the market. By 1988, access to finance in the private market was no longer an issue, there was no longer a tax advantage (FBT came in in 1986) but the pricing was extremely concessional. The floating mortgage rate in June 1988 averaged 16.6 per cent, while the rate on new Reserve Bank mortgages was 4.5 per cent. New mortgages contained a provision for the Bank to vary the rate (although to this point that scope had never been

[7] Up or down. In the extreme, for example, the Bank could increase a favoured senior employee's superable salary percentage just prior to retirement, increasing that employee's effective remuneration (a pension is just deferred remuneration) at the expense of the scheme (rather than of the Bank), and thus of other employee members more generally.

used), while older staff mortgages had been at a fixed rate of 3 per cent (the real value of these mortgages was being quickly eroded by post-1984 inflation).

Within the eligibility rules, utilisation of the mortgage facility was entirely at the discretion of staff. Some took loans, others didn't. Some traded up to keep up a large - cheap - mortgage, and others didn't. There was no attempt on a person-by-person basis to adjust cash salaries for the choice to, or not to, take a mortgage.

The thinking behind the reform approach was to move, as possible, to identifying the total remuneration the Bank was willing to pay each employee, and then to allow them to choose between cash and any fringe benefits on offer, the latter costed at the full cost to the Bank (including FBT). A few years later, there was a further (and sensible) shift to phase out all material fringe benefits, in which case people would be paid only cash. This latter approach was the way things had always worked in key public sector comparator agencies (eg The Treasury), and after it was adopted at the Bank there was never any need to change the formal remuneration of the remaining number of staff employed on the (by then) collective employment contract. Their superannuation contributions and benefits were always calculated - to this day - on the same (effective) basis as pre 1988.

There was probably no reason for the Bank to have thought that senior managers had been overpaid in total (cash plus fringe benefits). Thus, if the Bank had eliminated the company car option – as it probably should have done once FBT was put in place - it would presumably have increased the cash salaries of these people commensurately, which would – on the rules in place until 1988 - have increased their pension entitlements (and contributions) accordingly, quite late in the careers of many.

But the distribution of benefits from the mortgage scheme were all over the place, at a time when the cost (in pre-tax equivalent terms) of such mortgages had soared, and salary structures for professional staff were only sluggishly adjusting to the newly liberalised market reality. At a stylised level one could think of four classes of employee.

- Those with a cash salary that was roughly a wider market rate for a job of that sort, and a mortgage as well. The total remuneration of some of these people was materially above what a rational assessment of the person's value in the role was. (These people were often in fairly low-level clerical position or processing positions)
- Those with only a cash salary, but a salary that was probably a fair market rate for a job of that sort.
- Those people (often younger professional staff) whose combined effective total remuneration (cash + mortgage value, temporarily inflated by high market rates) meant that overall they were fairly paid for the job.
- Those with only a cash salary, having chosen not to buy a house, but where the cash salary was materially lower than market comparators for the job[8].

Some staff (first bullet) were materially overpaid, others were materially underpaid, and others may have been about right (but in the 3rd bullet case, by chance more than anything given how much the value of mortgages was swinging around).

One obvious aspect of any response would have been to have a) stopped allowing new mortgages, and (b) set in place a schedule for adjusting variable mortgage rates to market. This was the route

[8] This was my own position in 1988 (the "underpaid" bit was generally recognised by my bosses)

chosen a few years later (from 1991) and was one prompt to many people then withdrawing from the superannuation scheme (DB division) when the new DC scheme was set up. Doing so would have imposed material hardship on some employees, and presumably in 1988 the Bank was not yet up for that.

The Bank's solution - adopted by the superannuation scheme trustees in the 1988 rule changes – was to provide options (to the Bank).

In the 1980 deed, and for the purposes of that deed, "salary" is defined as

> shall mean the ordinary salary per annum of a member in respect of his/her service to the Bank, whether it is paid weekly, fortnightly, or otherwise.

In the 1988 deed, by contrast, "salary" is defined as follows:

a. in the case of any contributor whose ordinary salary per annum takes the form of a salary package (consisting partly of payment in cash, with the remainder being provided by way of non-cash benefits), means:
    i. the contributor's ordinary salary per annum; or
    ii. some specified proportion of the contributor's ordinary salary per annum

   as determined from time to time by the Bank and advised to the contributor.

b. In any other case, means the contributor's ordinary salary per annum

Even for those on a remuneration package (ie with non-cash benefits), it was entirely at the Bank's discretion whether or not "salary" for superannuation purposes was going to be defined as total remuneration ("ordinary salary" in this new world) or some portion of total remuneration. The Bank can alter this choice, and the choice of the "specified proportion" separately for each individual and at any time, or any direction, to any extent, it chose. There isn't really any doubt that that is what the words say. It is a very very different model than the previous one in which for all contributors' superannuation contributions and entitlements were calculated on 100 per cent of ordinary (cash) salary, with no scope for vary that proportion either across time or across individuals.

The Bank, presumably (since the documentation is now missing), believed it faced several issues that required them to do something (make some amendment to the rules). Since "ordinary salary" had not previously been defined there was probably a need to define a new base. Then there were the group of senior managers who had a systematic material lift in their total remuneration because of the company cars. If they traded those in and took cash instead their pension entitlements would otherwise rise, even though past contributions had not been based on a salary level consistent with the all-up remuneration.

And then there were the rest of the staff. In the first wave of remuneration overhaul the Bank focused only on managerial level staff. And it applied a common "superable salary percentage" (as it has become known) to all staff in that category, whether or not they had a mortgage, whether they had previously been under, over, or about fairly paid (in total remuneration terms).

Much of the mindset became focused on what was happening in the trading banks (historically seen as something like a relevant private sector comparator). Concessional mortgages was also a phenomenon at these banks (historically part as quid pro quo for the expectation branch staff would move round country relatively frequently), as were DB pension schemes which had been based on cash salaries.

With hindsight it is a puzzling comparator. Perhaps it made some sense to use trading banks as part of a comparator base in setting overall remuneration levels (in this case for managerial staff). But for a DB pension scheme, to which people contribute over (say) 40 years and then receive pensions based on the last few years' rates of pay what mattered much more was consistency within the scheme over decades (recognising, as courts long have, that a DB pension scheme is an arrangement for deferred remuneration). Someone retiring in 2000 might have joined the Bank in 1960 when - with house prices cheap and market interest rates low – pension contributions would have been based on almost the entirety of total remuneration (all the more so, since the typical recruit might have been aged 16, and not even able to get a mortgage until they got married several years later). And yet the rule change in 1988 - and the policy implemented using it in 1989 – suddenly decreed that their future contributions (for, say, their last dozen years) and future pensions would be calculated as (say) 75 per cent of total remuneration, a portion that could be cut further by the Bank at any time (including just prior to retirement).

Which nicely brings us to the question of the ability of trustees to change the rules of the scheme.

Terms under which superannuation scheme rules could be changed

The rules at the time provided that the trustees could not change rules - even with the consent of the Bank's directors, and with the Bank itself as an executing party to the amending deed – "without the consent of every member whose interest in the scheme at the date of amendment could be reduced or adversely affected by the proposed amendment". In other words, trustees and the Bank were free to make changes (with the consent of the Government Actuary) only if there was no possibility of an adverse effect.

It wasn't as if the trustees were unaware of this provision, somehow lost since 1934. In fact, the rule had been strengthened only 18 months previously when in November 1986 the deed was amended to insert "could" where "would" had previously been. In fact, in the preamble to the amending deed the trustees asserted that the rule change did not adversely affect "in any way any pension or other benefit (whether immediate or deferred) to which any person became entitled" before the new rules came into effect (they were backdated to 1 July 1985). Note, however, that there wording is much more akin to "would not" than "could not".

Again, whether due to the Bank's shocking recordkeeping (under the deed responsibility for maintaining "all papers and books" was the Bank's) or because they don't exist, we have no way of knowing now on what basis trustees in 1988 reached that conclusion. (At least 2 of the 4 trustees are still alive, as are both the senior officials who executed the document for the Bank.)

But it simply cannot have met the test in the rules even if (as it appears they did) the staff union had agreed to the changes. There are some points that may be arguable. There are other changes that clearly benefit some members but quite possibly worsen the position of those remaining (for example, vesting provisions assisted those who left, but at a cost to those remaining, given that it was clear in law that the interest in any surplus in the scheme belongs to members[9]). The courts have been pretty clear that it is up to members to determine whether a potential disadvantage in one area is outweighed by potential benefits in others (trustees cannot simply apply their own weighting scheme if there is any disadvantage in any part of a package of amendments - or potential disadvantage per the rules and Act as they stood in 1988). Nor can a (compulsory) staff union provide the consent required in the rules. Only each individual potentially adversely affected member can.

But it is around the definition of "salary" in the deed that every 1988 member was **potentially** adversely affected in respect of their interest in the scheme at the date of the amendment. Each person who belonged to the Fund had contributed for some years on one basis (100 per cent of ordinary salary), and had accrued pension rights in respect of that service. In some cases, those contributions (and accruing pension rights) will have been over decades, in other cases (my own) a very short period of time. But the rule change - as discussed above - handed power to the Bank, in respect of anyone who might be put on a package salary basis, to cut the superable salary percentage at any time, by any amount. Cutting the superable salary percentage to 10 per cent five years out from expected retirement and that member's pension entitlements will be gutted (cut by 90 per cent), including on entitlements accrued before the rule change[10]. There is simply no doubt that the Bank was handed such powers by the 1988 rule change and that the creation of such powers had the potential to make members worse off. Under the rules as they stood at the time, member consent was clearly required. But it was not sought.

(The fact that the Bank never exercised those powers to the full extent of what was legally possible may be relevant to the actual costs and damage, but not to the question of the ability of the trustees and Bank to have made a rule change of this sort. Perhaps, had they been asked, members might all have consented. But we can't know as they weren't asked.)

The whole episode is made all the more egregious by the fact that the same lawyers (from Rudd Watts and Stone) were used by both the Bank and the trustees. There is no sign that the trustees - acting as they were required to in the best interests of members, and operating under the deed and the Superannuation Schemes Act – ever sought any advice independent of that being provided to the Bank, even though the rule changes were handing large discretionary powers to the Bank.

Note, finally, that the Bank recognised some issues that it appears to have regarded as transitional. There were several employees close to retirement whose cash salaries prior to the rule amendment had been their entire remuneration. In some cases, those cash salaries may even have been higher than the total remuneration the Bank wished to pay them in future. Applying a superable salary percentage would have lowered their salary for pension purposes (and thus pension entitlements) just prior to retirement. These individuals were protected. Note that (a) this grandfathering was not part of the rule change package (where the "could be adversely affected" test needed to be applied, and b) was not applied in any way,

[9] This is no trivial point. I am trustee of another (DC) superannuation scheme in which the FMA recently insisted that we obtain member consent to amend the rules to provide for full vesting, even though (a) the amounts involved were tiny, and (b) for some years trustees had been using their discretion, already provided for in the rules, to grant full vesting on a case by case basis to withdrawing members.

[10] It was always open to trustees to reduce contribution rates etc in respect of future service. The issue here is in respect of service prior to the rule change.

shape or form for individuals retiring up to decades later (the latest DB member to retire, who was an employee in 1988, did so only last year).

The 1988 rule change was made in the term of Spencer Russell (as Governor and chair of the Board and of trustees) and with Suzanne Snively as the non-executive Board director serving as a trustee.