Supplementary Submission to the Financial System Inquiry

Super fund governance and policy stability

4 August 2014

Superannuation Consumers' Centre
ABN 34 163 636 566
Contact: jennimack2@gmail.com or 0429 300 458

Table of Contents

Superannuation Consumers' Centre
ABN 34 163 636 566
Contact: jennimack2@gmail.com or 0429 300 458

About the Superannuation Consumers' Centre

In early 2012 the consumer organisation CHOICE convened an establishment committee for a Superannuation Consumers' Centre. The committee included former Macquarie Bank CEO Allan Moss, Former Vanguard CEO and Financial Services Council Chairman Jeremy Duffield, and former ASX and ASIC Chairman Tony D'Aloisio amongst others. In August 2012 the committee took a proposal to Government to provide a one off contribution to an investment fund to provide an endowment to fund the Centre for 20 years. The Government agreed to make a $10million contribution, provided the industry matched that contribution. While a number of major funds agreed to contribute the committee did not raise the matching $10million prior to the 2013 election.

Nonetheless the Superannuation Consumers' Centre has established itself as a legal entity, has received ACNC endorsement and is operating on a limited voluntary basis. The Centre aims to make a positive contribution to restoring trust and confidence in the superannuation industry. It will work to improve the operation of the superannuation and retirement income system so that it delivers the best possible retirement income for Australian consumers.

Given that the Centre is operating without funding, it is only able to provide limited input to Government policy processes, including this review.

The business case for the Centre remains relevant. Trust and confidence in the industry is lower than it should be. This is producing suboptimal outcomes for consumers, government and industry. No one policy response will solve this problem but **the establishment of a dedicated Superannuation Consumers' Centre is an important part of a suite of measures discussed in this submission**.

We urge the committee to support development of the Superannuation Consumers Centre via recommending that it receive:

- **specific listing in the Tax Act to enable the Centre to receive deductible gifts** from those in the community who support it; and/or
- **a tiny portion of the superannuation levy to support it,** and/or
- **Government seed funding**.

Superannuation Consumers' Centre
ABN 34 163 636 566
Contact: jennimack2@gmail.com or 0429 300 458

Summary

We support reform of super fund governance and support the broad approach in the ASX's Corporate Governance Principles, with the exception of the majority independent director approach.

We have a long history of experience with stakeholder Boards in other sectors and they have proven their value, as they have in the super sector. However we do think there is room for improvement on a number of dimensions.

This includes on:

1. Reducing board size
2. Periodic internal and external reviews
3. Greater transparency around board processes
4. Transparent nomination and appointment processes.

On composition we support the one third; one third; on third approach for industry funds set out by the Cooper review. It is our assessment that the stakeholder model has delivered value for members to date and we are not aware of evidence to the contrary.

By contrast recent research[1] reflecting on the impact of the 2003 ASX rules requiring listed companies to have a majority of independent directors suggests independent directors have tended to lack relevant industry experience and understanding and have driven dramatic pay increases. The research summary notes:

"The ASX's rule change is the most costly and disastrous regulatory change ever implemented in Australia by a private regulator".

For retail funds we do not think the inclusion of executive directors is consistent with the duty directors owe to members. Executives are more likely to be focused on the short term interests of the business rather than the longer term interests of the members. We also think retail fund boards should include directors with proven expertise in consumer/member issues.

[1] Does Board Independence Improve Firm Performance? Outcome of a Quasi-Natural Experiment*
Marc-Oliver Fischer† Peter L. Swan‡
Australian School of Business, University of New South Wales
November 18, 2013 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2312325

Superannuation Consumers' Centre
ABN 34 163 636 566
Contact: jennimack2@gmail.com or 0429 300 458

1. Trustee governance

There are two divergent models for superannuation Boards. In general, industry super funds have adopted a stakeholder Board model. In addition some have one or more independent directors. They do not have executive directors on their boards. There is some transparency, particularly amongst the major funds, with information about Board members, their date of appointment, committee memberships, governance policies, remuneration and conflict registers available on line[2].

By contrast little is known about retail fund boards. Few can be found online. Where information is available it is patchy[3]. While it is understood they have in recent times moved to include independent directors little is known about these boards or how they operate, although we understand most have a number of executive directors.

There is a question whether it is appropriate to have any executive directors on a super fund Board given the conflict in interests which can arise between the interests of an executive, which tend to be narrower and favour short term performance, and the stewardship duties of trustees and directors, which tend to be focused on the whole fund and longer term in nature.

Where we can "see into" the boards of super funds we note that many have large boards. In our experience large boards tend to be a feature of stakeholder boards reflecting a desire to accommodate as broad a spread of stakeholders as possible. However there are a number of problems with large Boards:

- Beyond a certain size it is difficult for all members to contribute and so some members become "passengers"
- It is easy for directors to miss meetings and hide under-preparation when boards are large
- Large boards are expensive to run
- There is no evidence that beyond a certain size, generally around seven to 11 that more members add any additional value.

Governance practitioners tend to agree that beyond 11 or 12 directors the above problems tend to emerge. Therefore we think there is an opportunity for some boards to reduce in size, with a generally accepted maximum of 11 or 12.

[2] See Who runs CBUS, Board, Committees, Governance, Significant event notices, remuneration http://www.cbussuper.com.au/about-cbus/fund-governance
[3] http://www.bt.com.au/about-us/trustee-board/

1.1 Alignment with ASX principles: except for majority independents

Overall we think there is an opportunity to bring super fund board practices into line with contemporary best practice corporate governance. We support reform that aligns with the ASX good corporate governance principles[4], with the exception of recommendation 2.1 majority independent directors. Otherwise we support the recommended processes for director appointment, Board review and disclosure processes.

Use of the ASX definition has become widespread in Australian governance generally, including in the not- for-profit sector. It is a simple, clear standard that has proven itself.

1.2 Composition of boards

The Cooper review examined this issue and recommended a one third, one third, one third structure for funds that currently have equal representation. Nothing has changed our view in the three years since the Cooper Report was delivered to suggest an alternative approach.

We are not aware of any evidence to suggest that stakeholder boards are ineffective. With rare exceptions it has been our experience across a range of sectors that stake holders boards in fact work very well. When comparing performance of super funds there is no evidence that stakeholder board have been detrimental for members, rather funds with stakeholder boards have in fact performed very well.[5]

By contrast recent research[6] reflecting on the impact of the 2003 ASX rules requiring listed companies to have a majority of independent directors without links to shareholders suggests independent directors have tended to lack relevant industry experience and understanding and have driven dramatic pay increases. The research summary notes:

"The ASX's rule change is the most costly and disastrous regulatory change ever implemented in Australia by a private regulator.

Pursuit of private interests seems particularly likely for independent directors as, almost by definition, they have small or negligible shareholding or 'skin in the game' that diminishes any intrinsic incentive to monitor that the independent director may possess."

We are strongly supportive of an independent chair, which is a long standing and proven practice amongst a variety of stakeholder boards – see Financial Ombudsman, Food Standards Australia and

---

[4] http://www.asx.com.au/documents/asx-compliance/cg_principles_recommendations_with_2010_amendments.pdf

[5] There was widespread media coverage of the SuperRatings December 2013 super fund performance review which found at the median the industry fund sector outperformed the median of the retail fund sector over 1, 3, 7 and 10 year

[6] Does Board Independence Improve Firm Performance? Outcome of a Quasi-Natural Experiment*
Marc-Oliver Fischer† Peter L. Swan‡
Australian School of Business, University of New South Wales
November 18, 2013 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2312325

New Zealand. It is critical that the Chair has the support of all directors and is not aligned to any particular stakeholder group given the role of the Board Chair. We strongly support the concept of an independent Chair.

Given the available evidence, and that superannuation is a mandatory product, we do not support extension of independent directors beyond one third of any board.

We also think the one third/one third/one third principle should be extended to the retail sector and one third of the Board should be made up of nominees of organisations who have an understanding of the collective consumer experiences in superannuation, for example ageing, welfare and consumer organisations.

1.3 Appointments process

The aim of any reforms of trustee governance should be to **modernise the governance structures**. Therefore we suggest adopting c**urrent best practice which is to establish a Board nominations committee** which may include external stakeholders to conduct a merit based recruitment process. That is the Board sets criteria for directors and recruits against those criteria. This includes seeking out directors with specific skills from the relevant stakeholder groups.

Rather than having stakeholders appoint directors, **stakeholders can nominate candidates (preferably more than one candidate for each vacancy) who meet set criteria** to the Board nomination committee for **the Board to select the most suitable candidates taking into account the overall needs of the board including group dynamics.**

Whatever processes are adopted they should be transparent and merit-based.

1.4 Management of conflicts of interest

Consistent with good governance practice super fund boards should maintain a conflict of interest register on its website. Each fund should maintain processes to ensure the register is kept update: up to date should mean current as of the most recent meeting.

Boards should have processes in place for ensuring conflicts are declared and managed at every meeting. This is particularly important for retail super boards, which are attached to commercial financial institutions that offer investment products to the market.

In addition the Chair of the Board, CEO and Company Secretary should have responsibility for managing processes where conflicts arise ahead of meetings that would require papers to be withheld from a particular director.

Superannuation Consumers' Centre
ABN 34 163 636 566
Contact: jennimack2@gmail.com or 0429 300 458

1.5 Ongoing effectiveness of superannuation trustee boards

Current best practice points to maximum tenure of around nine or ten years. Three terms of three years would meet this standard, though it may be useful to provide a discretion in exceptional circumstances eg where a CEO resigns just before a long standing Chair's term is about to expire. In this situation it would be better to have the flexibility to retain the Chair for an additional year to settle a new CEO in. Any extensions beyond the agreed three terms of three years should be explained publically.

Boards should be required to periodically review their performance both internally and externally. This is part of the modernisation package and is consistent with practice in other companies in both the for-profit and not-for-profit sectors. Review can take many forms and Boards should have discretion to choose the most appropriate mode for each review. Reviews should be conducted as a minimum every three years but annually would be appropriate for the first three years after these reforms are introduced. That a review has been undertaken and any significant changes that flow from the review should be reported publically.

1.6 Implementation issues

2. Policy stability and consumer input

There is a saying in the super industry – **super is special** - and we agree with that. Government **policy settings force people to defer their wages** until retirement. While we support this policy objective we think it **creates a very high duty of care towards people's retirement savings by both government and industry.**

It requires policy settings and analytical capacity that values consumer outcomes and it requires a very high standard of stewardship by industry. Parts of the superannuation industry have been built on ticket clipping and conflicts that have subtracted and destroyed value to consumers – in some cases completely destroyed retirement savings built over a lifetime. More recently there is evidence that the vast super savings pool has become a honey pot for fringe players and fraudsters eg Trio.

This high duty of care requires **a strong regulatory and consumer protection framework and high levels of industry stewardship.** While we welcome the government commitment to no adverse changes to superannuation for this term of government, the system is still evolving as evidenced by this consultation and retirement incomes policy setting will be a large focus of the Financial System Inquiry currently on foot.

Industry voices are loud and numerous, and very well-resourced (due to the very large pool of money amassed from people's deferred wages) to provide government with research and analysis. Invariably they ask questions from their own perspective, as business operators. Even the not-for-profit funds as they have grown into large businesses, have business interests that may not always be compatible with member outcomes that a consumer organisation would focus on.

However there are times when the industry raises entirely sensible issues, but they have lacked credibility because of the clear vested interests.

Despite the marketing might of this huge and well-resourced industry, consumer trust in it is low. Drivers include volatile returns (especially poor returns), conflicts of interest, policy volatility and costs versus perceived value.

For these reasons we think a consumer-focused technically expert organisation, with capacity to undertake research and analysis and work with government and industry on behalf of consumers is necessary.

2.2 Regulatory impact assessment

We support the Government's desire to improve regulation and appreciate that it "is mindful that policy changes **must maximise benefits to members**, whilst minimising the compliance burden on the sector."[7]

While we support proper consideration of the costs and benefits of regulation via **regulatory impact assessment this must done within a framework that allows consideration of other factors where RIS methodology is weak.** Key weaknesses are that:

1) **Business typically overestimates costs** of regulation and
2) The **methodology does not adequately value** (rather than price) **social outcomes**.

This means costs to business tend to be inflated and costs to the community undervalued.

US research[8] "Polluted Data" found cost estimates in advance of regulation were more than twice actual costs in 11 out of 12 cases. Other research "On accuracy of regulatory cost estimates" found costs were 25% higher for 14 out of 28 cases.

Theories[9] have been put forward why this might be:

---

[7] P1 Better regulation and governance, enhanced transparency and improved competition in superannuation Discussion Paper 28 November 2013

[8] Detailed in *Priceless On Knowing the Price of Everything and the Value of Nothing*, Frank Ackerman and Lisa Heinzerling, 2004

- Technology improves over time bringing costs down
- People get more efficient at implementing new rules over time
- New rules encourage innovation

At the same time as inflating business costs the methodology fails to properly price consumer impacts or intangibles eg the cost of nervous breakdown and health problems following the loss of one's retirement income following a Storm Financial, Westpoint or Trio, and the cascading problems which follow such as marriage breakdown, spiral into mental health issues, dependency issues and in some cases homelessness. [10]

So we urge the Government to be mindful that history shows us that when it comes to assessing regulatory impacts, costs to business are typically inflated whereas costs to consumers typically undervalued, because they are hard to value and consumer behaviour does not always follow predicted pathways.

We also note that some of the most effective public policy interventions were introduced in the absence of the current RIS processes and we are not confident that they would have survived today's methodology eg would the succession of smoking reduction measures brought in since the 70s passed RIS methodology? Would section s52 (ban on misleading and deceptive conduct) of the Australian Competition and Consumer Act pass a RIS test?

We think **it is critical that the limitations of the RIS methodology are taken into account in assessing any removal of superannuation regulation because superannuation is compulsory.**

Government policy settings force people to defer their wages until retirement. While we support this policy objective it **creates a very high duty of care** towards people's retirement savings and **requires a strong regulatory and consumer protection framework**.

Removal of the requirement for "equal representation" will require legislative amendment. Beyond that we support APRA standards to set out the broad principles or framework of governance requirements and to allow companies to develop governance systems against those standards. Industry associations may wish to develop detailed guidance to assist their members develop systems and this would be appropriate.

---

[9] ibid

[10] For a discussion of the consumer's experiences post the collapse of Storm Financial see The social impact of financial loss ASIC report 240 May 2011 http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep240-published-May-2011.pdf/$file/rep240-published-May-2011.pdf

Superannuation Consumers' Centre
ABN 34 163 636 566
Contact: jennimack2@gmail.com or 0429 300 458

Implementation via APRA standards should allow for practices to flexibly evolve over time. It also allows for innovation in practice, and is least expensive to implement.

If the government opts for a one third approach to independent directors, then given trustee terms tend to be three years this would appear a reasonable maximum for implementation, from the time APRA standards are notified. A three year time framework would allow for new directors to be brought on to boards at the same time as retaining the necessary continuity and depth of understanding at Board level.

However if the government opts for a majority of independent directors then a substantially longer implementation timeframe will be required, at least one year for every director that must be replaced. This would be necessary to ensure depth of knowledge and expertise on the boards are retained but also to ensure a good supply of suitable skilled candidates are available for these roles.

We do not see that any transitional rules would be required; rather APRA standards could specify a transition period. APRA could monitor progress through their regular supervisory visits. We believe super fund boards are more than capable of working out a sensible rotation plan once the broad parameters are set.

Superannuation Consumers' Centre
ABN 34 163 636 566
Contact: jennimack2@gmail.com or 0429 300 458