Submission to Treasury

Independent Directors

Executive summary

This submission is made by:

- Independent Fund Administrators & Advisers Pty Ltd (IFAA), a Brisbane based administrator of industry superannuation funds and managed investment schemes;
- QIEC Super
- Club Super

IFAA, QIEC Super and Club Super are unequivocally supportive of strong governance arrangements applying in the superannuation industry to protect the interests of members.

It is considered that the existing legislated governance arrangements in the 'not for profit' industry fund sector, including the equal representation Trustee model, have served members very well. As organisations such as Industry Super Australia have highlighted, this sector has been extraordinarily successful in delivering strong returns to members over two decades, without being the subject of scandal and fraud.

Additionally, this governance model also specifically requires Directors:

- to act honestly;
- to exercise the same degree of care, skill and diligence as a prudent superannuation trustee;
- to ensure all decisions are made in the best interests of beneficiaries,
- where a conflict exists, to give priority to the interests of the beneficiaries, and to ensure duties to the beneficiaries are met, and to comply with Prudential Standard requirements.

In the case of QIEC Super and Club Super, decisions are made in the best interests of members, and conflicts (if any) are appropriately managed in accordance with regulatory expectations.

As the existing governance model is working as intended and subject to oversight by regulators who have not indicated widespread concern, we consider that the proposal to mandate one third independent Directors to the Trustee Boards of APRA regulated funds, represents a solution to a problem which doesn't exist. There is no market failure to correct, which raises the question as to whether other political motives are driving this proposal.

It should be highlighted that QIEC Super and Club Super are not opposed to the appointment of independent Directors to Trustee Boards. However, it is considered that each Board should be able to consider their particular need for one or more independent Directors, based on their circumstances, and their need for particular skills and/or experience, rather than have a mandated quota of independent Directors imposed upon them.

It is acknowledged that some other profit focused sectors of the financial services industry are required to have a majority of independent Directors on their Boards. However, we consider it does not automatically follow that independent Directors should also be mandated in the 'not for profit' sector, given the greater alignment of interest in this sector (refer section 3b).

Most importantly, as outlined below, actual experience across various industries, including superannuation, as well as various academic studies, do not provide compelling evidence that the existence of independent Directors will actually deliver superior outcomes, either in terms of improved governance, or improved performance.

1. Do independent Directors deliver superior outcomes?

Examples of failures in the superannuation industry have been very limited, with the most notorious failure (Trio), a result of orchestrated fraud. Notably, this occurred in relation to a Trustee who actually had a majority of independent Directors on the Board. Independent Directors were also in place in other prominent organisational failures, such as HIH. Clearly the independent Director model did not prevent governance failures in those cases. It is considered that in seeking to protect the interests of members and entrenching best practice governance arrangements, the honesty, diligence, experience and aptitude of Directors, along with Board culture, are more important factors than a model which relies on an arbitrary definition of Director independence.

Also, the existence of a majority of independent Directors on the Boards of bank owned retail superannuation funds has not delivered superior performance compared to 'not for profit' industry superannuation funds. This has been confirmed in recent SuperRatings independent analysis (to 31 May 2015), which outlines that industry superannuation funds have outperformed bank owned superannuation funds over rolling 1, 3, 5, 7 and 10 years.

http://www.industrysuperaustralia.com/media/media-releases/superratings-figures-continue-to-show-australias-retirement-savings-weakened-by-underperformance-of-for-profit-bank-super-funds/

There is broad consensus that diversity and independent thinking are important in effective decision making. It is fashionable in the corporate governance sphere to promote the appointment of independent Directors as being best practice, and indeed the explanatory guide to the draft legislation quotes the Cooper review in making that observation. However, there are diverging views which indicate that imposition of structural rules around required numbers of independent Directors does not necessarily produce superior outcomes. This was highlighted in an article by Professor Sally Wheeler of the University of Belfast, who was engaged by Australian stakeholders (including ASFA) in 2013 to study the topic of independence and accountability in superannuation.

http://www.clmr.unsw.edu.au/article/accountability/corporate-governance/do-we-really-need-independent-directors-super-boards

Broader analysis of whether independent Directors deliver superior outcomes in the corporate sector also provides equivocal results. For example, the following article by Hardji Koerniadi and Alizera Tourani-Rad from the Auckland University of Technology examines the New Zealand experience, which is a comparable country with comparable corporate structures. The study concludes that independent Directors have not added value in the New Zealand corporate sector, except in the scenario when they are in the minority on Boards. This is considered to be at least partially due to the fact independent Directors generally have much less knowledge of the company than non-independent Directors, which can impact their effectiveness. The article acknowledges that studies in other jurisdictions have found both positive and negative correlations between independent Directors and corporate performance, which serves only to highlight that the benefits of independent Directors is inconclusive.

http://ro.uow.edu.au/cgi/viewcontent.cgi?article=1334&context=aabfj

Ever increasing regulatory obligations should be considered from a cost-benefit perspective, and based on the varied considerations outlined above, we consider that the 'benefit to members' test has not been sufficiently established to warrant the mandating of independent Directors in the 'not for profit' superannuation sector.

2. Comments on draft legislation

In relation to the draft legislation, the following issues are raised for consideration:

- The proposed definition of 'independent Director' includes reference to the concept of a 'material relationship' with the Trustee, and excludes people who have such a relationship from being independent. The APRA letter to RSE licensees on the proposals sets out some examples of what are likely to be included in this definition, including relationships with organisations that have the right to nominate Directors. However, until the updated Prudential Standards are released, it is difficult to assess the exact scope of this exclusion, but it appears that it will be broad, ruling out many potential Directors from being considered independent.

- The draft legislation sets out the proposed definition of 'independent Director', but also goes further in indicating that despite a person apparently meeting this definition, APRA may apply discretion to determine that the Director is not independent. It is understood that any such APRA determination would be a reviewable decision.

  The draft legislation outlines that APRA may make such a decision based on an assessment of whether they consider the person will be able to apply independent judgement. The industry needs to clearly understand how, and on what basis, APRA would make such an assessment. It would be considered a backward step in industry regulation if APRA were permitted to make arbitrary decisions in the absence of guidance.

- The draft legislation indicates it is not an offence if a Trustee does not comply with the proposed independent Director requirements. However, it goes on to say, that in that event, APRA may direct the Trustee not to accept any further employer contributions under s63 of the *Superannuation Industry (Supervision) Act 1993*. As per that provision, it is understood such a direction may be issued by APRA, depending on the frequency or seriousness of breaches of the requirement. Exactly what the requisite frequency or seriousness of such breaches would need to be to receive such a notice, requires clarification.

- The draft legislation indicates that APRA will also have the ability to direct a Trustee to comply with the independent Director requirements if it considers the frequency or seriousness of breaches, warrant the issuing of the direction. Failure to comply with such a direction may incur a penalty of $18,000. The industry needs to gain a greater understanding as to the circumstances in which this is likely to occur.

- The draft regulation requires Trustees to include in their annual report from 1 July 2019 whether a majority (not one third) of independent Directors are in place, and if not, explain why not. This requirement assumes that a majority of independent Directors is somehow the gold standard of governance, but as outlined in section 1, we do not consider that experience across multiple industries supports the mandating of independent Directors as guaranteeing superior outcomes, either in terms of governance or performance. As a result, we consider that this proposed reporting requirement is misconceived.

3. Other factors to consider

a) *Potential cost impacts*

It is anticipated that independent Directors will expect market remuneration to be paid. If that were to occur, there will be a consequential impact on the remuneration of existing Directors, to obtain parity. This would be appropriate given all Directors are subject to the same level of responsibility. In this way, Government policy will be directly contributing to increasing costs in the industry, which may ultimately detract from member returns. This would also seem to run counter to the Government's stated objective for costs in the industry to be reduced.

In the current environment, QIEC Super and Club Super Directors do not seek market rates of remuneration, cognisant of the impact on the membership.

b) *Alignment of interests in the 'not for profit' sector*

It is noted that banks, insurers and retail superannuation funds are subject to a governance framework that requires a majority of independent Directors, as well as an independent Chairperson. However, given the profit imperative of these players compared to the 'not for profit' member focus of industry funds, we consider there are valid arguments as to why independent Directors should not be mandated in the 'not for profit' superannuation sector. Specifically, an alignment of interests exists in this sector, whereby Directors exclusively act in the best interests of members, whereas in the profit making banking and insurance sectors, the best interests of members competes with the profit imperative.

c) *Level of engagement*

Employer and member representative Directors have a direct line of accountability to Fund members, and thus in addition to acting in the best interests of members, they have an interest borne of their representative background to achieve optimal outcomes for the Fund members. While independent Directors may bring specific experience and/or expertise, they may not have the same level of member engagement. Non-independent Directors bring industry and Fund experience to the table; new independent Directors may not, which could impact on their level of member engagement.

d) *Potential operational impacts*

The proposed changes to Prudential Standards will require Trustee Boards to ensure they have appropriate skills to effectively manage the Fund during any transition period. However, mandating an independent Chair along with other independent Directors who will likely have little or no experience in the Fund, presents a significant challenge to good governance.

Furthermore, the proposal may result in a reduction in collective knowledge, at least in the short term, which could have a negative impact on the on-going requirement to ensure the collective 'fitness' of the Board.

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