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23 July 2015

Manager
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The Treasury
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By email:
superannuationgovernance@treasury.gov.au

Dear Sir/Madam

Subject: Consultation: Reforms to superannuation governance

We are pleased to provide this submission in response to draft legislation to improve governance arrangements in superannuation released by Treasury on 26 June 2015 (“the draft legislation”).

Towers Watson is a leading global professional services company that helps organisations improve performance through effective people, risk and financial management. With 16,000 associates around the world, we offer consulting, technology and solutions in the areas of benefits, talent management, rewards, and risk and capital management. In Australia, we provide consulting, actuarial and investment services to a broad range of defined benefit and accumulation superannuation funds including standalone corporate funds, industry funds, master trusts and master trust sub-funds, and a wholly owned subsidiary of ours acts as trustee to a number of corporate funds.

Towers Watson supports reforms which will open up the equal representation requirements to enable and encourage the broadening of trustee board skill sets. However, we, and the superannuation funds we advise, have significant concerns regarding several areas covered by the draft legislation, including:

- the unexpected application of these changes to non-public offer employer-sponsored funds;
- the proposed definition of “independent”; and
- the requirement for the chair of a non-public offer fund to be “independent”.

The haste with which this change is being introduced is also surprising, and is also discussed further below.

Non-public offer employer sponsored funds and independent directors

The application of the independent director requirements to non-public offer employer sponsored funds is unexpected and is likely to be a significant change for many such funds. While it is welcome that boards of such funds will not need to have a majority of independent directors, the impact of this rapid and material change on the running of the fund could be substantial, and result in negative outcomes for members of these funds.

The decision to include non-public offer employer sponsored funds is in contrast to the FSI report, which noted at page 135 that:

> *…in defined benefit schemes sponsored by a single employer, equal representation of employees and employers is appropriate and consistent with the governance models of defined benefit pension funds internationally. These funds would continue to operate using the structure for which equal representation was designed, with the employer bearing the financial risk from the board's decisions.*

The FSI report recommended (in recommendation 13) that non-public offer funds be excluded from the independent director requirements.

Non-public offer employer sponsored funds have a number of differences to public offer funds, which are not recognised under the blanket approach of these new requirements. They do not compete for membership of the public, most retain defined benefit sections, albeit usually closed, and they may provide other benefits such as fee subsidies to employee members that are not provided outside the fund. Member representative directors are typically appointed via a direct election process by the fund's members. This direct election equal representation model has delivered engaged member representatives who have a vital, and welcome, interest in the fortunes of their fellow members. Member elected and employer appointed directors in these funds already hold each other accountable for decisions and act in the best interests of all members. Any skill gaps can be met by training, sourcing assistance from professional advisers, or voluntarily appointing independent directors. This model has operated successfully for many years and directly addresses the government's objectives, and hence a change that discourages non-public offer employer sponsored funds will be a negative outcome for members of these funds.

It is important to note that under the equal representation model, directors of non-public offer employer sponsored funds are generally not remunerated for their services to the fund – although they may be allowed time from their regular duties to prepare for and attend trustee and committee meetings. We are aware that APRA has recently suggested to some funds that they should record this time as remuneration on the fund's website, but this is actually misleading as the directors do not receive any additional remuneration when they commence on the board and do not suffer any reduction in remuneration when they cease to be directors.

The additional costs that will be incurred in appointing independent directors are likely to be substantial. Estimates of the potential cost increases will vary by the size of fund, but increases in operational costs of the order of 10% - 30% are possible. For some funds, the extra cost burden imposed by these requirements, which will be financed from members' retirement accounts to the extent the sponsoring employer is not willing to meet them, will not be matched by any material benefits to members.

Further, discussions with non-public offer employer sponsored funds indicate that they are concerned with the potential impact of this change on the relationship between the fund and the sponsoring employer. Imposition of an independent chair with no experience of the fund, and who will not be permitted to have any recent relationship with the employer, is likely to distance the relationship from the employer's perspective and potentially disengage the employer. It would not be to the benefit of the members if, as a result of these proposed changes, the employer decided to withdraw its support for the fund. Indeed, where the employer currently meets part or all of the fund's costs, the result is likely to be to the considerable detriment of the members, as such subsidies will not be provided outside the non-public offer employer sponsored fund.

It is quite feasible that imposing this change on non-public offer employer sponsored funds will lead to the closure of some of these funds, which will produce a worse retirement outcome for their members.

We therefore strongly recommend that the government reconsider the inclusion of non-public offer employer sponsored funds in this new regime.

The proposed definition of "independent"

The Explanatory Memorandum accompanying the draft legislation explains that "independent" includes, among others, persons who are not substantial shareholders of the trustee or do not have, or have not had within the last three years, a material relationship with the licensee, including through their employer.

APRA will be able to make prudential standards setting out further requirements a person must meet in order to be regarded as independent, along with powers to determine that a person is, or is not, independent. In its letter to trustees issued on 26 June 2015, APRA indicated that it proposes to include material professional advisors, consultants or suppliers as examples of material relationships. This could result in experienced professionals such as former fund actuaries and auditors, insurance company executives and executives of investment management and administration firms being excluded from the pool of independent directors for the first three years after the relationship has ended. Whether there is a sufficient pool of appropriately skilled people to enable every fund to expand or adjust its board to meet these requirements in a maximum of only three years may be problematic, and may result in the costs of such people increasing substantially from those discussed above, due to the shortage in supply.

The government has stated that the goals of this change include to "promote good governance by broadening each board's pool of experience and expertise", as well as allowing for "increased accountability of decisions made by other directors who may have conflicting interests". Boards can already broaden their experience and expertise in a variety of ways. Appointing an independent director who can fill identified skill gaps is currently one way to achieve this. In the past, fund trustees have also provided relevant training and development opportunities for their directors, as well as accessing specialist expert advice from external advisers when appropriate.

We support fund trustees being able to appoint independent directors where they consider it appropriate and relevant to their needs. However, we do not consider that compulsorily imposing a quota of independent directors is the only way to achieve these objectives. Indeed, while this remains an area of debate, there does appear to be some evidence that forcing boards to have independent directors – who by the very nature of their independence have negligible personal stakes in the performance of their fund – may actually result in inferior outcomes. For example, Swan and Forsberg[1] found that "…firm performance declines significantly as affected outside directors depart the firm to make way for 'Independents'.".

Further, simply mandating a minimum number of independent directors will not necessarily resolve the government's concerns regarding conflicts of interest. It is very difficult for a person to be completely independent and have no actual, potential or perceived conflicts of interest – it is how those conflicts are managed that is critical. In almost all non-public offer employer sponsored superannuation funds, the member representatives are directly elected by the fund membership and all decisions must be made by a two-thirds majority of all directors. In our view, the equal representation model, with direct election of member representatives, involves sufficient tension between the various stakeholder interests for the appropriate management of conflicts.

We support opening up the equal representation rules to enable and encourage the broadening of board skill sets, under the equal representation model. However, we believe that a less disruptive and more evidence-based approach would be to first remove the legislative restrictions limiting such a broader pool, and then monitor and measure developments for a period of time, before assessing whether more prescription would be beneficial.

[1] Swan, Peter L. and Forsberg, David, *Does Board "Independence" Destroy Corporate Value?* (August 15, 2014). 26th Australasian Finance and Banking Conference 2013; 27th Australasian Finance and Banking Conference 2014 Paper, p 1.

The transition

The haste with which this change is being introduced is surprising. The FSI commissioned research to assess the cost effectiveness of certain regulatory changes implemented in the last decade, and its final report stated at page 30 that:

> *…although the assessment highlighted broad agreement with the policy that led to the intervention, it also highlighted shortcomings in how policy makers and regulators approach regulatory design and implementation. These included gaps in consultation processes and optimistic time frames for implementation…*

Given these comments, it is disappointing that the only a single month has been allowed for consultation on the draft legislation, and that the transition period defined in the draft legislation means that if the final bill receives Royal Assent in the next few months, for example, then the actual transition period could be much less than three years from the commencement of the new regime on 1 July 2016. Further, APRA has indicated that drafts of the applicable prudential standards will not be issued for consultation until "later in 2015" with the final standards to be issued "before the end of 2015". Trustees must then have a transition plan in place by 1 July 2016 – only six months later. If this significant change is indeed to be applied to non-public offer employer sponsored funds, we recommend that a longer period be allowed for consideration and implementation of this very important change.

Summary

In our view there are differentiating features of non-public offer employer sponsored funds that warrant different treatment to public offer funds. These features justify continuation of the equal representation model as the means of determining the composition of the Trustee Board of non-public offer funds.

To abandon the equal representation model for non-public offer funds will reduce the retirement benefits for some members of these funds, and/or lead to the closure of the fund itself, which will be outcomes not matched by any benefits of the new regime for members of such funds.

We support allowing non-public offer funds to add independent directors, though without needing one of those independent directors to be chair, where the board decides that to do so will be beneficial to its operation.

We would be pleased to discuss this submission or provide further information if required.

Yours sincerely

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Managing Director

Brad Jeffrey
Director, Superannuation Services