Better regulation and governance, enhanced transparency and improved competition in superannuation

Discussion Paper
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BETTER REGULATION AND GOVERNANCE, ENHANCED TRANSPARENCY AND IMPROVED COMPETITION IN SUPERANNUATION—FOCUS QUESTIONS

Cbus is a public offer fund that provides superannuation services to construction, building, and allied industry workers, retirees, their families and their employers.

Cbus was established in 1984, and is one of Australia's oldest industry funds.

The fund has some 700,000 members and some 90,000 employers. Cbus manages assets valued at over $25 billion.

Cbus is conducted on a not for profit basis. All returns are used for the advantage of fund members and there are no dividends paid to stakeholders.

The constitution provides for equal representation as between employer and employee, and the appointment of a non-voting Chair. The Board has discretion to appoint an additional director who is independent of the nominating bodies.

Master Builders Australia nominates employer representatives including those from other employer associations.

The ACTU and the major unions representing the construction industry workforce nominate employee representatives.

Part 2: Better Governance

What should 'independent' mean for superannuation fund trustees and directors?

2. **What is the most appropriate definition of independence for directors in the context of superannuation boards?**

Overview

Cbus supports sensible regulation to strengthen the governance of superannuation funds, where there is evidence that the regulation will be in the best interests of fund members.

Consistent with our member-only focus, we support efforts to ensure that directors are free from influence from outside bodies when performing their fund role. We also support efforts to encourage critical-thinking in our superannuation fund boardrooms.

That said it is unusual for a government to interfere in the affairs of a corporation and to limit shareholders' rights without a compelling overriding public interest. Cbus does not believe that the overriding public interest has been identified.

Cbus does not accept the view that director independence is a panacea for improved fund performance, particularly where there is no consensus about the meaning of independence.

We reject the suggestion that directors who have a relationship with the fund's shareholders or its nominating bodies are more or less incapable of bringing independent thought to the boardroom.

The current debate has been conducted with little reference to evidence, and has ignored the body of evidence that suggests that the appointment of a significant number of independent directors on funds may be counterproductive. Elevating so called independence (or non-affiliation) above industry-knowledge, the ability to devote time to the task and a capacity for critical thinking is not right.

We would also point out that there has been a myriad of recent changes to fund governance with the introduction of Prudential Standards and guidance for Superannuation Funds and increased regulatory powers. There needs to be time allowed for these changes to be fully integrated into funds and for the regulator to complete its round of prudential consultations and reviews before making any further changes. No further change is warranted at this time.

Is there a case for "independent" directors?

Cbus is not convinced that there is sufficient evidence to warrant intervention into the affairs of trustee corporations so as to require the appointment of a minimum number of 'independent' directors onto superannuation boards. Advocates for change have failed to identify a compelling argument that would warrant the government restricting the class of persons available to shareholders to appoint to the boards of the trustee.

Much has been made of the fact that independent director obligations apply to corporate Australia. This ignores the fundamental difference between the obligations of a trustee to beneficiaries. It also ignores the fact that the ASX Listing rules were a response to a rash of spectacular corporate failures that were blamed in large part on the lack of oversight by Boards that were dominated by executive directors and where CEOs routinely acted as the Chairman of the Board. This is not the situation amongst APRA regulated funds.

The current debate about independent directors in superannuation has been dominated by assertions and speculation rather than analysis of the evidence about the efficacy of such a change.

This is not surprising given the lack of clarity about the harm that the appointment of "independent directors" is designed to address. "Independent" is variously seen as independent of management, independent of sponsoring organisations, and, in some cases, refers to people who possess particular subject matter expertise.

In 2012 the Productivity Commission reviewed all of the arguments that have been advanced in favour requiring a minimum number of independent directors on fund boards.[1] The Commission did note that there are potential benefits from independent directors "where appropriate"[2], it ultimately supported the APRA approach of not mandating any particular structure for superannuation fund boards.

In reaching this conclusion the Productivity Commission systematically reviewed each of the arguments advanced by the advocates of change. These included: the need for directors with particular expertise; the need for directors who can approach their role without fear or favour; and the need for a workable mechanism to remove under-performing directors.

Having reviewed the evidence the Productivity Commission concluded that there was no compelling evidence to support one model of governance over another. It said:

The Commission considers that issues relating to board structure are important. However, overall, there is a lack of compelling evidence to suggest that any one model of board structure should be viewed as clearly preferable in all cases. Therefore, the Commission does not consider it appropriate at this time for a particular structure to be mandated. Further, the Commission would not want to see restrictions placed on board structures without such restrictions having a sufficient evidentiary basis….[3]

The Evidence Against Mandating a Minimum Number of Independent Directors

1 Productivity Commission 2012, Default Superannuation Funds in Modern Awards, Report No. 60, Final Inquiry Report, Canberra.

2 Ibid at page 88.

3 Page 104.

The current debate has also failed to acknowledge a growing body of literature suggesting that the introduction of independent directors into corporate boardrooms has failed to improve critical thinking and effective governance and has been detrimental to firm performance.

Firm Performance

A recent study[4] of almost 1000 firms found that those firms that introduced majority independent directors in response to the 2003 ASX listing Rules have experienced large falls in company performance and a loss of shareholder value compared with other firms.[5]

The authors estimate the losses over the period 2003-2011 conservatively at A$69 billion.

The study also found that Boards dominated by independent directors were less likely to replace an under-performing CEO, paid poorly-performing CEOs significantly more than other Boards and paid significantly higher director fees. The authors conclude that the introduction of majority independent directors has destroyed considerable shareholder wealth "with no discernible benefit other than to executives and fellow board members".

In a damning conclusion they call the introduction of majority independent directors "one of the most costly and disastrous regulatory changes ever implemented in Australia by a private regulator."

Boardroom Dynamics

There is also a body of literature that examines the impact of independent directors within the boardroom. This literature questions the assumption that so-called "independent" directors produce more critical thinking and informed discussion, leading to higher quality decision- making[6].

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4 Fischer, Marc-Oliver and Swan, Peter L., Does Board Independence Improve Firm Performance? Outcome of a Quasi-Natural Experiment (November 18, 2013). 26th Australasian Finance and Banking Conference 2013. Available at SSRN: http://ssrn.com/abstract=2312325 or http://dx.doi.org/10.2139/ssrn.2312325

5 The study found majority board independence reduces firm performance regardless of whether the criterion is shareholder value in terms of the Tobin's Q or Market-to-Book ratios, or accounting performance as measured by the industry-adjusted ROA

6 Wheeler, Sally, Independent directors and corporate governance, (2012) 27 Australian Journal of Corporate Law 168, see also Suzanne Le Mire and George Gilligan, (2012) Developing a More Complete Understanding of the Independence of Corporate Directors Working paper Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2180671.

This, it is argued, is because regulators have applied a structural solution to a behavioural problem, focusing on the relationship of the director to the firm, rather than the capacity of the director to influence change, to resist inappropriate external influences and so forth.

This formal or structural independence – which focuses of the director's relationship with the firm – does not take account of the complexities of the boardroom.

Three arguments are made:

(a) First, structural independence does not ensure diversity of cognitive ability. Boards tend to appoint people with similar training and experience to themselves, and strong social ties between directors that reduce the independent directors' capacity to be effective;

(b) Second, group dynamics will either mean that the outsiders disturb and compromise the environment of trust and shared values necessary for robust debate and questioning, or the outsiders quickly adopt the norms of the group and lose their capacity for independence[7]; and

(c) Third, those independent directors who are unfamiliar with the firm are susceptible to co-option by the CEO and executives and quickly lose their capacity for independence of mind.

What these findings tell us is that the quest for independence will not be met by simply ruling directors in or out based on their relationship with the fund, its shareholders or its sponsors, and that a much more sophisticated understanding of independence is required.

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[7] On the one hand psychologists who are expert in small group dynamics suggest that the optimal environment in which individuals feel able to raise different opinions, debate policies and question facts is one of trust and shared values. Given this, "outsiders" will not be effective, and may be counter-productive. As Sally Wheeler says

> *Indeed structural rules that force together individuals with disparate values and beliefs can be counter-productive. Those disparate values and beliefs introduce unproductive friction that gets in the way of the trust required to permit the sorts of robust analysis and debate that underpin constructive decision-making processes.*[7]

On the other hand, group dynamics suggest any outsider will quickly move to become an insider.

> *… group-think kicks in as new members of the board seek to address their lack of social capital in this new environment by 'building bridges' with the processes and personalities already present in the board. Only thereby do they gain the social efficacy to justify their presence at the board table. So within a few meetings the new members have assumed the social identity of the board they have joined and are as likely to be as over-confident about their joint capabilities, and as blind to their failures, as the directors of longer tenure.*

Let the New Regime Settle Before Introducing More Change

Finally, Cbus believes that the recent amendments to APRA's prudential supervision of superannuation governance should be monitored before further regulation is considered.

Over recent years there has been significant focus on the governance arrangements that apply to Australia's superannuation funds. Initially industry bodies such as ASFA and AIST developing best practice guidance material, which saw many funds review their practices.

This was followed by the Stronger Super regime, which saw APRA awarded powers to set enforceable Standards.

The full Prudential Standards came into effect only 8 months ago. The Standards and guidance cover governance issues such as: board composition, skills, board renewal and director tenure, board assessment and appraisal of individual directors and managing conflicts.

Given the comprehensive process that underpinned the development of these standards Cbus strongly urges the government to let the new regime settle before introducing further regulation.

3. What is the most appropriate definition of independence for directors in the context of superannuation boards?

Clearly, if the government is determined, despite the lack of supporting evidence, to require a minimum presence of "independent" directors in a fund boardroom, the government should avoid a definition that rests on the relationship between the director and the fund, or its associated entities.

Instead, Boards or nominating bodies could be required to consider the director's capacity for independent decision-making, having regard to the director's capacity for critical thinking, the director's capacity to influence within the boardroom, and the director's capacity to resist inappropriate external pressure.

APRA prudential guidance which was finalised only in July 2013 contains a list of criteria that a Board may have regard to when assessing whether a director is non-affiliated. In recruiting an independent director Cbus has already experienced difficulty associated with accessing a limited pool of eligible candidates. Further eligibility limits and increased competition will make this task more difficult and expensive.

Proportion and Role of Independent Directors

Cbus believes that all directors should possess the capacity for independent thinking, free of inappropriate external influence. We believe that our current governance structures support this outcome.

However, should the government decide to restrict the class of people eligible for appointment by proscribing certain relationships as prima face inappropriate (or at least inappropriate to dominate the Board) such intervention should be minimal.

We reject any argument in favour of a majority of independent directors. This formula was adopted for corporate Australia to balance the dominance of executive directors. This is not a relevant consideration for APRA regulated funds.

Similarly we reject the call for a third of directors to be so called independent or non-aligned. The argument that a "critical mass[8]" is needed to balance against the dominance of the representative trustees assumes a commonality of views amongst that group which is not evident in practice. Many funds already have independent representation on their boards and Cbus is unaware of any anecdotal evidence or concerns raised by either independent directors or the regulator that independent directors have difficulty being heard in Boardrooms.

At a practical level, the introduction of a requirement that a third, or a majority of independent directors would cause significant disruption to existing Boards.

Trustees would have to either add to the size of their Board, or dismiss existing directors.[9] There would also be a need for Constitutions and Trust Deeds of funds to be amended to accommodate such a change shortly after these documents were amended to accommodate changes required by the Stronger Super reforms.

The removal of Board members with direct connections to employers and members compromises the rights of shareholders and reduces their accessibility to the fund and its responsiveness to the needs and aspirations of its members and employers.

4. **Both the ASX Principles for listed companies and APRA's requirements for banking and insurance entities either suggest or require an independent chair. Should superannuation trustee boards have independent chairs?**

There is no compelling reason to further limit the class of people who can be appointed to Chair a superannuation fund board.

The rationale for the ASX Principles was to split the roles of CEO and Chair to reduce the power of the executive and enhancing the power of the non-executive board members. If this is the harm government wishes to guard against, it can be accommodated with a specific prohibition on the appointment of executive Chairs.

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[8] Super System Review Final report Chapter 2, Part 2 at page 55, June 2010, accessed at http://www.supersystemreview.gov.au/content/content.aspx?doc=html/final_report.htm.

[9] The Cbus Board is currently 16 Directors. To satisfy a requirement for majority non-aligned directors whilst maintaining the existing shareholder rights would require the appointment of 13 more directors, bringing the Board to 29.

The Chair's role is to maintain a constructively critical environment, to encourage the informed contribution of the directors and promote effective communication between the executive and the Board. The Chair should be responsible for ensuring that the directors receive accurate and timely information.

These skills can be found in "affiliated" directors.

Indeed, some industry funds rotate Chair between employer and employee representatives, drawing on more experienced trustees to take on the Chair role. It may prove counter-productive to remove the ability of a board to appoint the Chair from amongst the existing Directors.

The APRA prudential guidance to funds[10] states that a prudent trustee would consider whether the appointment of a non-affiliated Chair is appropriate. Presumably, funds will be asked during their prudential review to advise APRA of the outcome of this consideration, and explain the reasoning of the Board and the shareholders. Given this guidance is relatively new, Cbus suggests the government monitor its impact before considering further regulation.

Process for appointing directors on superannuation trustee boards

5. **Given the way that directors are currently appointed varies across funds, does it matter how independent directors are appointed?**

No. Should the government decide to introduce a requirement for non-affiliated or "independent" directors, funds and their shareholders are the most appropriate bodies to consider the appointment process.

Instead, Boards and shareholders should be free, if the requirement to appoint new directors is imposed, to identify the appropriate nomination and appointment mechanism.

6. **Should the process adopted for appointing independent directors be aligned for all board appointments?**

No case has been made to interfere with the appointment processes for ordinary (or by implication non-independent) directors.

While the discussion paper refers to complexity, it's unclear who bears the burden of that complexity (Trustees? members? the regulator?). That said, the best way to avoid introducing complexity or additional compliance costs is to avoid the pursuit of alignment for its own sake.

10 APRA SPG 510

Management of conflicts of interest

7. Are there any other measures that would strengthen the conflict of interest regime?

APRA's recently developed Prudential Standards[11] reflect the need for Boards to identify, avoid and manage conflicts of interest and duty. Given this regulatory regime has been operative for less than 12 months Cbus suggests the government monitor its impact before considering further regulation.

Ongoing effectiveness of superannuation trustee boards

8. In relation to board renewal, should there be maximum appointment terms for directors? If so, what length of term is appropriate?

Cbus does not support a maximum tenure for directors, but instead supports regular consideration by the Board as to whether it has a good mix of fresh eyes with experience and continuity.

APRA's recently developed Prudential Standards[12] reflect the need for Boards to have a formal renewal policy, to ensure it remains open to new ideas and gives consideration to whether a director has served for too long.

The Productivity Commission reviewed the case for maximum tenure for directors, and concluded that the APRA policy struck an appropriate balance.

"The Commission considers that there are important trade-offs between the benefits of renewal and the benefits of having experienced board members. On balance, it supports APRA's policy, in that the policy allows for sufficient flexibility, while recognising that the status quo has seen some very long board appointments that might not have always been in the best interests of members[13]".

Cbus has adopted a 'rolling average' approach to Director tenure

"The Trustee places importance on the continuity of Trustee and Fund knowledge and the improved Board dynamics that result from a having an average Board tenure in excess of 5 years.

- The Trustee targets a measure of collective Board experience expressed as a range of average tenure for the Board. This range of average tenure is a *minimum of 5 years and a maximum of 9 years*.
- Independent Directors are generally limited to a period of service of nine (9) years[14]."

Cbus would not advocate the adoption of its policy as an industry standard but would support an approach which gives primacy to a 'principle – prudential' approach that

11 APRA SPG 521

12 APRA SPS 510

13 Productivity Commission page 104

14 See 'Fund Governance Policies and Procedure Manuals", July 2013 at www.cbussuper.com.au/__data/.../Fund-Governance-Policy-2013-07.pdf

focusses on outcomes rather than an approach to regulation that adopts a one size fits all approach.

Given this regulatory regime has been operative for less than 12 months Cbus suggests the government monitor its impact before considering further regulation.

9. **Should directors on boards be subject to regular appraisals of their performance?**

APRA's Prudential Standards[15] reflect the need for Boards to conduct a formal annual appraisal relative to its objectives. It also requires funds to have in place a procedure for annual assessment of each director's performance.

The Cbus Board and its directors have had a program of regular internal and external review of their performance in place for many years now and the experience has been positive.

Given this regulatory regime has been operative for less than 12 months Cbus suggests the government monitor its impact before considering further regulation.

Implementation issues

10. **Would legislation, an APRA prudential standard, industry self-regulation or a combination be most suitable for implementing changes to governance? What would the regulatory cost and compliance impacts of each option be?**
11. **What is the appropriate timeframe to implement the Government's governance policy under each option?**
12. **Given that there will be existing directors appointed under a variety of terms and conditions, what type of transitional rules are required?**

If the government is determined to implement change, it should be implemented through APRA's prudential oversight. APRA should have the flexibility to consider whether alternative methods adopted by trustees give effect to the policy objective, while avoiding a "one size fits all" prescription.

Our approach is based on the following:

(a) Cbus believes a definition that focuses upon the skills and attributes sought will deliver better outcomes than a structural test of independence.

(b) As we note above, it is unusual for government to interfere with shareholders rights without a compelling public interest. Indeed even in the face of evidence of major corporate failure, governments around the world have opted to introduce obligations regarding director independence in "soft" regulation, or "principle – prudential" regulation.

15 APRA SPS 510

This recognises the fact that while government is best placed to identify the public interest, firms are best placed to implement the policy in the interest of shareholders, (or in this case beneficiaries).

(c) This would be consistent with the way that other obligations of trustees are managed. It would limit the compliance impact in funds, as the change could be incorporated into existing internal compliance monitoring.

Costs and Timetable

The direct and indirect costs of change would be significant.

The industry is currently paying significant costs to implement the changes emanating from the Stronger Super reform program and Cbus is concerned that additional reform cost will ultimately erode members retirement savings.

Direct costs include the recruitment, appointment and induction costs associated with appointing one or more new directors and legal costs associated with amending Constitutions and Trust Deeds.

Fees paid to 'independent directors' are typically higher than that paid to Directors as the fund is not typically 'borrowing employees' (and reimbursing their substantive employers) but engaging professional Directors. This higher cost structure will be met from the retirement savings of members.

If a regulatory obligation is created to appoint more non-aligned directors it is anticipated that funds will compete amongst themselves for eligible and appropriate non-aligned candidates. This suggests a transition period of at least 3 years would be required to enable funds to phase in any obligation.

There may also be direct costs associated with the termination of directors prior to the expiry of their appointment term.

For Cbus this cost does not arise because of the terms of appointment of the current directors (does not include termination payments). Rather, the direct cost relates to the re-negotiation of shareholder rights to nominate directors.

However, more worrying is the indirect cost alluded to above, whereby a loss of shareholder involvement with the fund could diminish the funds connection to the industry it serves and the market within which it operates.

PART 3: ENHANCED TRANSPARENCY—CHOICE PRODUCT DASHBOARD AND PORTFOLIO HOLDINGS DISCLOSURE

Cbus is committed to transparency and welcomes further transparency across the superannuation industry. In particular, Cbus has long highlighted the need for increased transparency over fees that are reported to fund members, including underlying investment management fees.

PART 3A. CHOICE PRODUCT DASHBOARD

The discussion paper states that "A product dashboard is a one page document that provides core information about a superannuation product. It is displayed in a standard format, which enables easy comparison of a product's features such as fees, risk and return targets."

In considering which elements are appropriate for a choice product dashboard, it may be useful to consider that not only do product dashboards enable comparison across the same type of investment choice, but also across the spectrum of investment choice, from low to high risk/return. This comparison includes the Fund's MySuper option, which often sits within that spectrum. Cbus believes that this ability to compare across products is useful for our members.

13. Should a choice product dashboard present the same information, in the same format, as a MySuper product dashboard? In answering this question you may wish to consider, if the choice product dashboard is to present different information, what should it include and why?

Cbus believes that in the interest of comparability the choice product dashboard should include the same measures. Both the MySuper and Choice dashboard should ideally also incorporate a longer term risk measure. (We discuss this in more detail later in the submission).

Net investment return versus net return

The discussion paper focuses on the dashboard for Choice products. In relation to the return target, before moving to a discussion on the relevance for Choice products, we raise some concerns over the use of the target return methodology for MySuper.

Cbus does not believe that the investment return target is a suitable measure for a MySuper Product, as the return target is defined by APRA as the **mean** expected real (after CPI) return for the investment option over a ten year period p.a.

We believe that the return target will be interpreted by members as the outcome they can expect – all the time or most of the time - not as the outcome that will be achieved in approximately 50% of all ten year rolling periods (which is what the mean establishes).

The target return appears to be confused with the investment objective. Cbus' MySuper option's investment objective is to achieve CPI +3.5% over 75% of all ten year rolling periods, which provides a high level of confidence to members in the type of outcome they will experience. Cbus' MySuper return target, based on the same set of data but set at the mean, is CPI +5.5%. Over 29 years Cbus' MySuper option (rebadged from our existing default option) has achieved the target return in approximately half

of the 19 ten year rolling periods, as would be expected for a mean outcome.

There seems to be uncertainty in the industry over the methodology for the target return, compared to an investment objective. This is apparent through the target returns shown across various MySuper Dashboards (which in many cases have not changed from the investment objective, and appear to be set too low, reflecting a higher level of probability than the mean).

Using the target return, Funds could be below target for several years in a row. The target return will not enhance member trust in superannuation at these times.

14. Is it appropriate to use a single benchmark (CPI plus percentage return) for all choice product return targets?

We believe that it is appropriate for all diversified options – as this gives a higher level of transparency and comparability to members. As in the MySuper environment, in the Choice environment, funds can have investment objectives as well as the target return and they need not be the same. Including a target return to the product dashboard, on the same basis as the MySuper target return, will enable greater ability for members to look across the spectrum of choice offerings.

The discussion paper commented 'Forcing products invested in shares or an index fund to provide a return target may not be a realistic proposition for trustees, and may not be in the best interest of members'. We do not see how this is the case – particularly in the examples used, where we expect that the target return for Australian shares would be the expected return for that asset class, adjusted by an assumption of ten year CPI. This same data is used as an input in order to arrive at a MySuper target return. For an index fund, we would expect a modestly lower target return reflecting no active return component.

15. Should both net investment return (investment return net of investment costs only) and net return (investment return net of all associated costs) be used to measure a product's investment return on the choice product dashboard? In considering this question, you may wish to consider:

- **If including an additional measure for a product's investment return would add unnecessary complexity.**
- **If both net investment return and net return are used on the choice product dashboard, whether they should also be used on the MySuper product dashboard.**
- **Whether it is appropriate to use a single time horizon, for example 10 years, when calculating target net return and net return for the range of possible choice products.**

The aim of the product dashboards is for comparability, an overly complex dashboard may prove difficult for members to interpret and to compare against other investment options and other Funds.

Showing both the investment return and the net return may add to confusion over what the Dashboard is showing. It would be difficult for a member to distinguish between both measures.

The Net Return is sufficient and would enable comparability to the MySuper option. If the

decision is made to show both net investment return and net return on the Choice dashboard, it would be useful, for the sake of comparability, to show both on the MySuper product dashboard.

In the same vein, utilising one time horizon is helpful for comparative purposes. We believe a 10 or 20 year horizon is appropriate. If options can choose different timelines, the dashboard is less able to be compared against other funds. If multiple timelines are in use, we touch on the issue of whether we are unduly complicating the dashboard.

Measuring a product's investment risk

16. **Should the choice product dashboard include both a short-term (volatility) and long-term (inflation) risk measure? In considering this question, you may wish to consider:**
    - **Is the SRM model the best measure of short-term investment risk?**
    - **What would be the most suitable measure of long-term risk to include on the product dashboard?**
    - **Is it possible to present a long-term risk measure in a similar format to the short-term risk measure (that is High/Medium/Low)?**
    - **Would including an additional risk measure add unnecessary complexity to the product dashboard?**

Cbus shares the concerns of other funds over the use of the SRM as the only risk measure, and believes that a long-term measure of risk should be included in the product dashboard. Adding an additional measure would add complexity to the dashboard, but in this case, it provides members with a better guide to the risks involved. It is important to add balance to the shorter term volatility measure, by including a longer term risk measure.

The example provided by the Institute of Actuaries of Australia replaces CPI with AWOTE. We believe that AWOTE is far less understood in the broader community than the CPI (and receives less coverage by media). Using AWOTE would add a second inflation measure for members to understand, would increase complexity and possibly lead to greater member confusion.

For long term risk, a measure that takes inflation into account would be useful. Keeping a similar format (high/medium/low) would be simpler for members. The methodology could use the Institute of Actuaries model with a range, for example, an outcome between the range of 0-20% would be 'Low' etc.

The SRM model is the measure of short-term investment volatility that is currently agreed across a large component of the industry. While it is helpful in thinking about the number of years a negative return can be expected to be experienced, it lacks describing the degree of variation around returns.

Additional carve outs

17. **Are additional carve outs from the choice product dashboard obligations required? If so, why are these additional carve outs required? In considering this question, you may also wish to consider identifying where the gaps in the current carve out provisions are.**

Cbus believes that member direct investing options (for example, members investing directly

in shares, term deposits) should be carved out of the product dashboard obligations. These are a selection of single asset choices made by the member and reporting a dashboard for each of these single assets would add significant costs to the Fund. These costs would have to be borne by the direct investing members. This would greatly reduce competitiveness with the SMSF sector.

A liquidity measure

18. Should a measure of liquidity be included on the choice and/or MySuper product dashboard? If so, what would a suitable measure be?

Cbus does not recommend that a cash flow measure be added to the dashboard, as we believe this would unduly complicate the dashboard.

The liquidity measure concept is complex, particularly when it comes to a measure that can be readily interpreted by members.

The percentage of assets that can be liquidated within 30 days is usually used as the measure of liquidity for the total fund, monitored by the Trustee and APRA. This is a measure of the Fund's ability to meet member withdrawals (including pension payments) during a major liquidity crisis.

However, we note that this is not an indicator to members of how quickly they can move their money out of a fund. Portability requirements are now to be met by funds within a 3 day time period for standard transfers, while a 30-day portability date applies to closed products or illiquid investments where the RSE licensee has obtained member consent that a longer redemption period may apply or where APRA has suspended or varied an RSE licensee's obligation under the portability provisions. (Refer APRA's Prudential Practice Guide SPG 280 Payment Standards.)

The practice guide states that the Fund is to be managed in such a way as to ensure 3 day portability (for standard transfers) is available. In doing so, the level of cash flows (contributions) the fund receives is a major driver of the funds ability to meet its withdrawal and transfer requirements. Without cash flow, recourse to liquid assets would be more important.

A measure that does not incorporate cash flow expectations is not a complete measure and potentially misleading, it may also lead members to make choices towards more highly liquid but, over the long term, lower returning investment options (such as Cash and Conservative options), which may not perform as well in inflationary environments.

If members simply need to understand how quickly they can withdraw their funds, one suggestion, which meets the requirement in a way that members may understand is:

Number of days to process a withdrawal request	3 days (or, 30 days, or x days)

Implementation issues

19. **Should the commencement date for the choice product dashboard be delayed beyond 1 July 2014? Is so, what date would be suitable for its commencement? What would be the benefits and costs to such a delay?**

Given the delay in final reform requirements, it would be more practicable to introduce at a later date, for example, by 31 December 2014. There are no costs to a delay, while the benefits include having sufficient time to implement the change.

PART 3B. PORTFOLIO HOLDINGS DISCLOSURE

Cbus welcomes greater disclosure to members over assets funds hold. We are also conscious that large funds, such as Cbus, invest across thousands of assets, and are concerned that reporting at this level of information could make it difficult for members to understand their material exposures. We are aware that there is an additional cost of obtaining and ensuring accuracy of data from collective investment vehicles that are second or third tier investment vehicles (or more). This cost is borne by members as we are an all profit to members fund.

Presentation of Portfolio Holdings

20. **Which model of portfolio holdings disclosure would best achieve an appropriate balance between improved transparency and compliance costs? In considering this question, you may wish to consider the various options discussed above:**

- **Should portfolio holdings disclosure be consistent with the current legislative requirements (that is, full look through to the final asset, including investments held by collective investment vehicles)?**
- **Should the managers/responsible entities of collective investment vehicles be required to disclose their assets separately? To give effect to this requirement, legislation would require all collective investment vehicles to disclose their asset holdings, regardless of whether some of its units are held by a superannuation fund.**
- **Should portfolio holdings disclosure be limited to the information required to be provided to APRA under Reporting Standard SRS 532.0 Investment Exposure Concentrations?**

The simplest, least cost solution for funds is the first alternative option, which requires managers of collective investment vehicles to disclose separately. However, this would not be in the best interest of the member as it would be much more complicated for them to calculate their exposure to a particular asset or group of assets. Members would find it difficult to obtain information from investment vehicles domiciled overseas.

This is a similar issue with the second alternative option – in that the cost is already outlaid to report to APRA, however from a member viewpoint, holdings in collective vehicles that are not associated entities are not transparent and in many cases may be substantial.

An option we prefer, suggested by Cbus' custodian, is to supply disclosure in line with what we already prepare for APRA reporting. That is, to provide detailed holdings to the first non-

associate entity level. For example, if Cbus invests in a unit trust at first non-associate entity level, that trust's asset holdings are disclosed, but any asset that is an investment vehicle holding (i.e. second tier) does not have its assets disclosed. The advantage of this approach is that it aligns with what we are already receiving from fund managers for APRA reporting, and can be readily compiled. This is our preference, as it is the most practicable option whilst still providing a high level of disclosure. The cost impact is minimised due to the fact that we are already collecting the data for APRA reporting.

All models require holding values to be listed. We believe that some assets are not as suited for listing of holding values, we discuss this further under the heading 'sensitivity', below question 25.

21. What would be the compliance costs associated with each of these models for portfolio holdings disclosure?

We believe that the compliance cost could range from around $50,000 - $80,000 for all options.

Should portfolio holdings information be presented on an entity level or at a product (investment option) level?

From a member standpoint, portfolio holdings information should ideally be shown at the product (or investment option) level. The information would provide a view to what assets they are invested in.

Cbus, like many Funds, pools assets by asset type. It would be useful to provide the total Fund allocation to an asset and then, in further columns the percentage allocated to each investment option, including MySuper. This reduces the bulk of the report substantially.

Materiality Threshold

Cbus believes that materiality and sensitivity of information are two separate issues, and may be best considered separately.

Materiality

Materiality goes to the heart of providing useful information. The number of investments we would report if reporting all assets would be well over 2,400 items. We question whether providing so much material is useful to members, particularly where some of these investments have little overall impact on the fund return. For example, if we have an investment of $1,000,000 in an asset, it represents around 0.004% of Cbus' MySuper option.

22. Is a materiality threshold an appropriate feature of portfolio holdings disclosure?

It is appropriate to have a threshold, refer to comments above.

23. What is the impact of a materiality threshold on systemic transparency in superannuation fund asset allocation?

A materiality threshold, by nature, reduces full systemic transparency. However, the trade-off is that the information provided is more useful to the member as these are the assets

that will make a perceivable difference to investment outcomes.

24. What would be the most appropriate way to implement a materiality threshold?

A threshold that is % or $ based, depending on which is greater. That is, perhaps report all assets that are at or above a specified percentage of the asset class or fund (say, 0.1%).

Note that setting a requirement to disclose 95% of portfolio with the ability for the Trustee to determine which 5% not to disclose is problematic, and could potentially be used to hide underperforming assets or assets that are considered controversial.

Sensitivity

Cbus believes that several unlisted asset types are, by nature, more sensitive to disclosure of their market value. These include private equity, property and infrastructure investments. In effect we believe we are potentially impacting the sale price of an asset by providing our valuation price. In strong markets this is generally less of a concern, but in weaker markets, for funds that may need to sell, the discovery process is jeopardised as the buyer knows where to base their highest bid – at the disclosed price. The three month delay in providing valuation information does not adequately resolve this issue for an asset such as unlisted property where sale processes are lengthy and prices are valued less frequently.

Another issue relating to sensitivity is that disclosing a fund manager's assets individually may result in loss of IP where the manager does not have a high level of turnover. That is, the delay in reporting doesn't mean the portfolio reported is stale (although the valuations may be). Particularly for collective vehicles where their holdings are not aggregated (as is proposed under Table 2 in the draft regulations).

We also are aware that several international collective vehicles are unwilling to supply their asset listing and valuations where these are to be attributed directly to them (that is, not aggregated) as in Table 2 under the current proposal. Additionally, for some existing contracts, Cbus is legally obligated to not disclose any information. An example of this is where we invest in venture capital.

To address sensitivity, one solution would be to carve out the asset types that are considered 'sensitive' and list them separately (but aggregated by asset) without disclosing their market value. The market value could be shown for the aggregated asset group. This has the benefit of still providing disclosure to members about what the fund is invested in. The total asset class or type could include the value. We would suggest exclusions for direct and unlisted property and infrastructure and private equity.

A materiality threshold does not adequately address sensitivity – as some assets that are sensitive to disclosure may be a sizable proportion of the Fund (i.e. greater than 0.1%) or, under the other suggestion in the discussion paper, may make up (combined) greater than the 5% of assets the Trustee can choose over whether to disclose.

Without an appropriate solution for disclosure of sensitive assets, Cbus would look to seeking relief from portfolio holdings disclosure from ASIC under section 1020F of the

Corporations Act 2001, section 1017BB.

Implementation issues

25. **Should the commencement date for portfolio holdings disclosure be delayed beyond 1 July 2014? Is so, what date would be suitable for its commencement? What would be the benefits and costs to such a delay?**

We see no costs associated with a delay at present. The benefits to any delay are having more time to:

- **Establish processes for obtaining data from all investment vehicles;**
- **Improve the data cleaning processes (working with the Fund custodian) so that the information is accurate and reliable, particularly for look through reporting;**
- **Prepare web based educational material on how to interpret the asset names and types; and**
- **Resource the project (given the extensive requirements of meeting new APRA reporting introduced over 2013).**

30 June 2015 would be a suitable commencement date for full look through disclosure under the current model. If any of the other alternative options is proposed 31 December 2014 would be appropriate.

Part 4: Improved competition in the default superannuation market

26. Does the existing model (which commences on 1 January 2014) meet the objectives for a fully transparent and contestable default superannuation fund system for awards, with a minimum of red tape?

Cbus supports transparency, administrative efficiency and competition in superannuation where it enhances the net benefit to members.

<u>Context</u>

The award system allocates a worker's superannuation where that worker has not selected a fund.

In Cbus' experience many employers are either reluctant to choose, or ill equipped to choose.

The FWACs role is to fill the gap that exists where competition has failed to excite the interests of consumers. Default funds in awards ensure that, in the absence of individual choice, and in the absence of a collectively agreed fund, an employer directs the employee's retirement savings to an appropriate fund.

In exercising its powers, FWA is standing in the shoes of those employees who have failed to exercise individual or collective choice in favour of a particular fund or investment choice. As such, its role is a paternalistic role.

In this context, it is appropriate that FWA actively examine the nature of the labour market within the scope of each award, the ease with which employees can exercise individual or collective choice, the extent of award reliance, labour mobility within the industry, educational attainment and other characteristics of the industry.

It is also appropriate that FWA consider the impact of its decisions upon the employees and employers to whom the award applies.

These considerations are applied by FWA in setting other terms and conditions of employment in awards, and should equally apply when nominating default funds.

<u>Stage One</u>

Cbus made submissions to the Productivity Commission Inquiry in which we supported a process that required applicant funds to put forward a case to be considered for selection as a default fund. In our submission then, as now, we believe that the hurdle should be higher than simply holding a MySuper licence.

The Productivity Commission accepted the need for a "quality filter".

"The Stronger Super and related reforms provide an effective foundation to promote disclosure and comparability of default superannuation products and funds but, given the uncertainty surrounding the likely number, mix and quality of MySuper products,

there needs to be a 'quality filter' to distinguish among them.[16]"

The 'quality filter' adopted in S 156F of the Fair Work Act is appropriate and consistent with objectives of transparency or competition.

The administrative burden is proportionate to the commercial advantage of being successfully listed.

Stage Two

Cbus submit that Fair Work Commission (FWC) should be required to have regard to the views of the industrial parties regarding which superannuation funds should be nominated as a default fund.

The claims of funds as to their eligibility to act as default fund, and the merits of their products and services is dealt with in stage one of the process. Stage two should be about the extent to which the fund's offering is suitable to the particular circumstances of the employees and employers covered by the award.

Our argument recognises the industrial relations heritage of award superannuation, but is not reliant upon that.

Unions and employers, and their peak bodies, have intimate specialist knowledge of the labour force, labour mobility, the capacity of employers to manage payroll and others systems, employee financial literacy, the insurance needs of the workforce and the investment preferences of the workforce.

Furthermore, the FWCs role is to make a decision where the employees have failed to exercise a choice, either individually or through bargaining.

The FWC is essentially charged with trying to uncover the views of the workforce. Representative industrial parties, especially unions, are best placed to provide FWA with the views of the workforce as to the fund attributes and features that are valued by workers in a particular occupation or industry.

Transparency

It is generally accepted that the process of selecting a default fund should not rest with the employer, whose commercial interests may mean he or she is not well placed to stand in the shoes of an employee who does not exercise choice of fund.

That being so, FWC is ideally placed to perform the role. The FWC is a quasi-judicial body accustomed to applying the rules of natural justice, and making its decisions having regards to the substantial merits of the matter before it. Its processes are open, low cost and all the evidence before it is in the public domain. Its reasons for decision are made public, and its decisions are subject to judicial review.

[16] Page **132** DEFAULT SUPERANNUATION IN MODERN AWARDS

Contestability

Some argue that the current process denies a voice to entities with no interest in an industry covered by an award. The two-stage process is designed to ensure that industry connection is not relevant to eligibility, but is relevant to suitability. The distinction was illustrated in oral evidence to the Productivity Commission by the ACTU[17] when considering whether an entertainment company should be granted standing to vary an award to increase the number of public holidays.

Conclusion

Cbus believes the current system should be given a chance to operate before further reforms are considered.

27. If not, is the model presented by the Productivity Commission the most appropriate one for governing the selection and ongoing assessment of default superannuation funds in modern awards or should MySuper authorisation alone be sufficient?

Cbus does not accept the need for change. That said, if the government is minded to change the system, Cbus prefers the Productivity Commission approach to an arrangement where all MySuper products would be listed in an award.

Administrative Burden on Employers

To require employers to assume responsibility for selection of the default fund from a large pool adds a material administrative burden on employers.

"[Employers] want to 'get on and build' rather than be concerned with the intimate and complex issues of superannuation administration".

Providing employers with a large range of funds from which to choose undermines the purpose of the award default system, which is to ensure an employee voice in the choice of fund, and to control the risk of a poor choice.

Dr David Gruen of the Commonwealth Department of Treasury and Finance has remarked on the emergence of behavioural economics (since Wallis) and its impact on choice theory and its adoption in the approach of the Cooper Inquiry –

"…the standard theoretical result that more information and choices make people better off – and certainly no worse off – has also been questioned. Large choice sets appear, in some circumstances, to degrade the quality of the decisions people make.

The relevant literature suggests a range of behavioural responses to 'choice overload'. Choice overload increases the likelihood that people (particularly those with low levels of financial education) will choose a default option, or leads people to pick simpler options regardless of their suitability or, finally, degrades people's capacity to make

17 Melbourne 30 July 2012, ACTU Assistant Secretary Tim Lyons.

optimal decisions…"[18]

Transaction Costs

Introducing a large number of funds from which an employer can choose will fragment the provision of default superannuation services within an industry to the detriment of consumers, particularly through multiple account-holding. This is particularly relevant for the construction industry, where job turnover is high.

The original rationale for industry funds was to ensure employee's superannuation was both fully vested and portable between jobs. Employees could move from job to job without having to leave superannuation behind with their previous employer. Despite this, we now have 28 million accounts for 11 million workers. Annually, 1 million new accounts are created for a net workforce growth of around 200,000 employees. The default system should be designed to minimise the risk of multiple account holding.

Multiple account-holding not only affects administration fees, it can have an impact on the costs of insurance, particularly if new members need to be underwritten. Cbus automatic acceptance levels have been priced based on the mobile nature of the labour market.

28. **If the Productivity Commission's model is appropriate, which organisation is best placed to assess superannuation funds using a 'quality filter'? For example, should this be done by an expert panel in the Fair Work Commission or is there another more suitable process?**

Superannuation is an industrial matter and the FWC is appropriately placed and resourced to manage modern awards. The FWC regularly has complex evidence before it. The expert panel is appropriate mechanism to ensure specialist subject matter expertise is available within the Commission. The Commission is able to supplement that expertise.

29. **Would a model where modern awards allow employers to choose to make contributions to any fund offering a MySuper product, but an advisory list of high quality funds is also published to assist them in their choice, improve competition in the default superannuation market while still helping employers to make a choice? In this model, the advisory list of high quality funds could be chosen by the same organisation referred to in focus question 29.**

No. See above. Where an employer genuinely believes that the funds that are listed in the award are not appropriate, the employer can initiate bargaining, and an agreement can easily override the award, provided the majority of employees have voted to support the change.

[18] See Thinking Seriously About the Default Option, Dr David Gruen and Tim Wong on 28/9/10, http://www.treasury.gov.au/documents/1877/HTML/docshell.asp?URL=MySuper_ACE.htm.

30. If changes are made to the selection and assessment of default superannuation funds in modern awards, how should corporate funds be treated?

Cbus does not believe there is significant use of corporate funds in the building and construction industry but as a matter of principle submits that access to selection as a default superannuation in a modern award should require funds to participate in a selection process that applies the S 156F 'quality filter.'