In members' best interests

ISA SUBMISSION TO GOVERNMENT DISCUSSION PAPER

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EXECUTIVE SUMMARY

Industry Super Australia welcomes the opportunity to respond to the Government's discussion paper *Better regulation and governance, enhanced transparency and improved competition in superannuation*.

The Government's discussion paper seems to reflect a view that regulation is an obstacle to efficiency. In some markets this may be the case. But the issues need to be thoughtfully considered in superannuation, because of its compulsory nature, public and economic policy objectives and low levels of consumer engagement.

Superannuation is not just a financial product, it is an integral part of Australia's retirement incomes system. All Australians have a right to a dignified retirement, the decisions this and future Governments make regarding superannuation will directly impact the retirement incomes of millions of working Australians and their families.

ISA agrees with the Assistant Treasurer's statement that 'good governance in superannuation is critical to securing trust and integrity'[1]. We strongly supports the Government's commitment to a detailed consultation process to ensure the best interests of consumers are protected and we look forward to discussing these matters further.

The past four years have seen unprecedented change in the superannuation industry. Many reforms have either just been implemented or are still in the process of implementation, and the industry as a whole has invested significant resources into the implementation process, including systems changes. ISA urges the Government to act with caution and consideration to ensure consumer confidence is not undermined and to provide ample opportunity for new arrangements to provide their promised benefits to consumers.

A better approach to regulation

ISA supports the removal of unnecessary regulation; however, the removal of regulation can often lead to direct or indirect costs being transferred to others and introduce inefficiencies. Reforms which address the costs of fund underperformance will also improve competitive pressures in the industry to the benefit of beneficiaries. ISA opposes the removal of regulations which place downward pressure on costs.

The benefits and costs of regulation must be actively considered prior to change being implemented. The uncertainty caused by constant regulatory change can ultimately impact member returns.

ISA estimates that changes to default fund arrangements that will require an employer to undertake the most basic of investigations to enable them to select a default fund for their employees outside of the guidance provided by a modern award will cost employers in excess of $160 million per year Underperformance by retail funds of 1.6% in 2012-13 cost retail fund members around $7 billion in that year alone.

Underperformance is a compounding cost, as assets not accumulated each year are unavailable for reinvestment in subsequent years. Over the 17 years to June 2013, underperformance has resulted in retail fund assets being $97 billion[2] lower than what they could have otherwise been, had retail funds earned industry fund returns over that period. Regulation should ensure that these significant direct costs borne by members are avoided.

[1] Media Release Senator The Hon Arthur Sinodinos AO Assistant Treasurer 28 November 2013.
[2] *Source:* APRA (2004) *Supertrends,* APRA (2013) *Quarterly Superannuation Performance.*

Better Governance

ISA concurs with the statement in the discussion paper that “Strong governance arrangements are needed to ensure fund members’ interests are paramount in the minds of trustees.”[3] These submissions argue that the existing governance arrangements that provide for equal representation have proved to be superior when considering the interests of fund members. Unlike other sections of the industry, equal representative trustee boards have not been the subject of serious governance failures resulting in collapse and significant losses to beneficiaries.

Over the past 20 years equal representation trustee boards have developed organically to best suit the needs of the particular demographic of each fund. This has included introducing independent trustees or chairs in instances where the board has considered this will add value to the skills matrix and board dynamics. Many boards have developed processes which allow for independent and expert input into key decision making bodies such as investment committees. These changes have resulted in a healthy diversity of board models within the industry which best suit the needs of the relevant membership.

In the context of superannuation, good governance is about enhancing the quality of decision making of the trustee such that it produces superior risk-adjusted net returns to members (and otherwise supports good retirement outcomes). Eliminating the conflicts of interest that undermine performance and undercut the ability of the fund to maximise retirement outcomes is a critical part of accomplishing this goal. The representative trustee model is a direct response to this conflict and has produced superior retirement outcomes for members.

ISA proposes changes that will continue to facilitate and encourage the organic process of governance change in a manner that ensures that governance structures adopted are consistent with a trustees’ obligation to make decisions, including governance decisions, which are in the best interests of beneficiaries.

The representative trustee system is common across pension systems in all OECD countries with trustees aligned only to the interests of members. They face no conflict between the interests of members and shareholders of parent companies.

ISA recognises the Government’s preference to gain more alignment between governance structures relevant to ASX listed companies and superannuation funds, in particular by increasing the number of independent directors. However, the public debate has not benefited by any clarity as to who such directors would be independent of, nor by a universally agreed definition of ‘independent’. In the context of listed companies and retail super funds it is clearly independent of management.

For the purposes of this submission it is assumed that the Government is seeking greater independence from both management and sponsoring organisations: unions and employer groups. ISA notes that representative trustees are already independent of the fund’s management.

It is recognised that the Government has consistently advocated for the introduction of the “third/third/third” model of board composition as advocated by the Cooper Review. More recently the Government has indicated consideration of a requirement that all superannuation funds appoint a majority of independent trustee directors.

We do not accept there is evidence to justify mandating change to board composition. If the Government is intent on taking action to improve fund governance, in addition to those measures already being implemented as a result of the Stronger Super process, there are more appropriate measures that could be considered.

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[3] Better regulation and governance, enhanced transparency and improved competition in superannuation: Discussion paper, Australian Government the Treasury, 28 November 2013 Page 9

ISA believes the Government should seek to retain the strengths of the representative trustee system and work with the superannuation industry to continue to enhance governance arrangements to ensure the industry keeps up with, or is ahead of community expectations. This submission proposes a process to achieve this outcome:

Key proposals

ISA proposes:

- the adoption of the ASX's Corporate Governance Principle defining director independence;
- the strengthening of the existing obligation on boards to annually review their skill, performance and procedures for renewal. This could be strengthened by placing a positive obligation on boards to consider if appointing an independent chair and/or independent directors (up to one-third of total board membership) may be in the best interests of fund members. The outcome of this review of board composition, supported by an account of the reasoning that led to the outcome, would be reported to APRA.
- the removal from the SIS Act of any restrictions on the ability to appoint independent directors and the removal of any restrictions on a trustee director being a member of a fund they oversee; and
- that a rigorous regime of disclosure throughout the superannuation industry is adopted, as proposed by ISA in its 2012 Governance and Disclosure Proposal.

These changes would retain the benefits of the representative trustee system whilst introducing further dynamics to superannuation boards which could add value. The adoption of an arrangement that would require or encourage a majority of independent directors is not supported as it would, in our view, ultimately have a negative impact on fund members as it would remove the driver of outperformance in the industry.

We believe it is appropriate that these changes apply to all APRA-regulated funds. Our view on the appropriate means of implementing a revised definition of independent director will be influenced by the final policy position adopted by the Government. Prudential standards or guides, regulation, legislation or the adoption by self-regulatory code are all possibilities. We note that there are existing annual obligations imposed on boards to consider their composition, skills and independence of mind within existing prudential standards.

It should not be assumed that the imposition of independent directors or chairs will add value in all instances. As our submissions show, the majority of evidence provided by international and Australian based research shows that the introduction of majority independent arrangements on boards either adds limited or negative value to boards. There is a stronger, but not conclusive, argument for the introduction of a level of independent representation on boards. Detrimental outcomes can include a tendency to homogeneous thinking and a transfer of power to company executives. Given the important public policy objective of superannuation, too much is at stake for superficial or theoretical approaches to governance. Governance requirements should rest upon clear empirical evidence; the case for change has not been made.

It is the equal representation governance model and the associated trustee motivations and loyalties that have delivered superior returns to members. The evidence is that not-for-profit representative trustee funds have negotiated better outcomes with service providers (such as investment managers and administrators) because they are working in the best interests of members not related-party service providers and shareholders.

Should the Government form the view that it will impose change upon the industry, in doing so it should not undermine the key driver of superior performance, the representative trustee model.

Arising from the Stronger Super reforms there have been significant changes to superannuation governance arrangements. It is suggested that the Stronger Super regime recognises the governance issues for listed operating companies differ from those facing superannuation funds operating within a trustee environment. For example, the needs of superannuation fund beneficiaries are markedly different from the needs of listed company shareholders and the conflicts of interest that that affect fund performance and retirement outcomes are different.

Many Stronger Super changes have just been, or are soon to be, implemented. Significant enhancements to the duties of superannuation trustees (including strict liability provisions, the introduction of a best interest duty, and new governance prudential standards) have greatly enhanced the governance arrangements within the superannuation industry and should be provided with an opportunity to impact the governance arrangements within the industry. The new arrangements are supported by APRA's general powers to intervene should it consider it necessary.

ISA argues that the governance arrangements of funds should ultimately be left to the funds themselves, provided the governance arrangements comply with all regulatory requirements, are open and transparent and can be shown to be in the best interests of fund members.

The processes for the appointment and appraisal of directors are the subject of new APRA prudential standards which provide a sound and flexible processes, including fit and proper requirements and board renewal policies. These new arrangements are important protections that should not be ignored in the Governments' consideration of these matters.

Enhanced transparency

Good governance involves putting structures in place to provide adequate protections for consumers. Elements of good governance include how funds are controlled, how they are regulated and ensuring adequate disclosure of relevant information to enable consumers, advisers and to compare superannuation performance.

ISA has been a leading advocate in the disclosure of information to consumers to allow them to make an informed choice regarding their superannuation. A product dashboard should be a concise means by which consumers, employers and analysts gain information about all relevant products. There is no need to carve out classes of products, to do so would be a disservice to consumers. It is no coincidence that those who argue for disclosure carve outs represent the most poorly performing funds. A light must be shone on all the industry. We also support full transparency in superannuation through the introduction of portfolio holdings disclosure.

We argue that the publication of a simplistic quantitative measure of liquidity based only on asset allocation could have adverse consequences, including potentially discouraging socially-advantageous investment in illiquid assets and potentially cause a shift to conservative investment options by members and trustees.

Improved competition in the default superannuation market

ISA applauds the government's aspiration for all Australians to take an active interest in their super and other financial affairs. In the context of a compulsory super system, low member and employer engagement, it is necessary for regulatory settings to stimulate competition through an open and transparent process.

Adequate competition for engaged consumers is provided by the 'Choice of fund' legislation and enables members who wish to select their own super fund to do so. In addition it is open to an employer and employees to reach agreement on workplace superannuation arrangements.

However, the vast majority of working Australians do not select their own super fund, instead relying on the workplace default. Policy and regulatory settings must therefore accommodate this market failure, to protect individual interests and national savings as lower aggregate savings will increase the burden on future taxpayers.

Employers and their associations have, almost unanimously, argued that they have neither the time nor expertise to select the workplace default fund for their employees. It is worth noting that there are now over 100 MySuper funds. Their preference is for a shortlist to be determined and included in awards.

The incentive for employers to give due consideration to choice of fund is weak. It is employees who bear the costs and benefits of default fund choice, and those workers will often, by definition, be relatively disengaged.

Consistent with the Productivity Commission's findings, ISA does not believe that the MySuper regime provides sufficient protection for members and an additional quality filter should be applied. The current arrangements though the Fair Work Commission apply that quality filter and are transparent and merit-based, enabling all superannuation funds to publicly tender for nomination in modern awards.

The processes for the selection of default funds in modern awards have proven to be effective with those funds named in awards consistently outperforming funds that are not named. Critics of the system have argued that the small number of retail funds named in awards is evidence of the lack of competition. We suggest by contrast that the prevalence of the best performing funds found within modern awards is clear evidence that the system is acting effectively. Those retail funds that are nominated in modern awards on average outperform their retail sector counterparts. The outperformance of default funds named in awards is a function of the representative trustee system under which they operate, and the fact that those funds are operated in the best interests of fund members, as opposed to the shareholders of profit-oriented funds.

The funds that have delivered effective defaults through the delivery of superior net returns over the long term are the not-for-profit funds with representative trustees. The inclusion in modern awards of super funds with historical underperformance would be a perverse public policy outcome. ISA notes that both Chant West and SuperRatings have concluded that industry super funds are likely, on average, to be lower cost than retail alternatives and deliver superior net returns and that this differential is likely to continue into the future.

ISA welcomes a competitive approach that ensures only the best and most relevant funds are named in modern awards for use by employers, whatever sector of the industry those funds derive from. It is entirely appropriate that the selection of default funds within awards be subject to an open and transparent process against a set of fair criteria that includes the benefit provided to fund members. This process should at all stages have the interests of the employees subject to the relevant awards as the primary consideration. It is unclear how a more efficient industry would be achieved by lowering the bar and encouraging poorly performing funds to be used as default funds.

We suggest that the new arrangements for the selection of default funds in awards which commenced on 1 January 2014 do meet the objectives for a fully transparent and contestable default superannuation fund system in awards.

ISA considers superannuation payments to take the form of deferred wages and supports the two stage process involved in the selection of default funds. The staged process ensures a quality filter is applied to MySuper products by an expert panel and as part of the award modernisation process, the industrial parties to modern awards are involved in the selection between two and 15 default funds to be named within a modern award.

The new process should be provided with an opportunity to demonstrate in an open and transparent manner that it will deliver the best results to employees and employers the subject of modern awards.

1. Part 1: A Better Approach to Regulation

1.The Government has committed to identifying (in dollar terms) measures that offset the cost impost to business of any new regulation. What suggestions do you have for how the regulatory compliance burden can be reduced?

The cost of administration of the $1.75 trillion super industry is around $17 billion per annum. The costs to industry and ultimately beneficiaries have risen as a result of changes to APRA reporting requirements and new systems investments to support Superstream. These very significant reforms alone are expected to cost the industry in the order of $200 million or approximately $1 million per APRA-regulated fund. In addition, the development of new MySuper products and other reforms flowing from the Stronger Super reforms are estimated to cost the industry a further $50 million.

However, these are predominantly one-off investments and should be considered in context.

Underperformance by retail funds of 1.6% in 2012-13 cost retail fund members around $7 billion in that year alone. Underperformance is a compounding cost, as assets are not accumulated each year, and are unavailable for reinvestment in subsequent years. Over the 17 years to June 2013, underperformance has resulted in retail fund assets being $97 billion[4] lower than what it could have otherwise been, had retail funds earned industry fund returns over that period. This underperformance has been largely driven by conflicted advice driving member selection in favour of poor products and a lack of transparency.

Reform which addresses the causes of this underperformance, and in so doing introduces further competitive pressure on all product providers is ultimately in the best interest of members, the taxpayer, and future generations.

The cost impact of regulatory change can be both negative as well as positive. It should be recognised that any reduction in business compliance costs does not reduce consumer protections, erode public confidence in the superannuation system which could result in lower member retirement incomes than would otherwise be the case.

We are of the view that it is often not possible to properly cost regulatory reform and equally importantly, the benefit or cost of existing regulation, with any level of precision. We can say that the existing regulatory framework in the financial services sector served Australia well during the Global Financial Crisis; the benefit derived is no doubt real, but difficult to quantify.

Funds have a legitimate interest in the cost of the regulatory regime as their members bear the cost of inappropriate regulation, (too much or too little), and because funds and their members fund the regulators via a levy system. No industry is willing to first, fund, and second, pay the cost of inappropriate or unnecessary regulation.

Stewart and Yermo have observed that:

> "Good governance can have many positive side effects such as creating trust amongst all stakeholders, reducing the need for prescriptive regulation, and facilitating supervision. Good pension fund governance can also be conducive to more effective corporate governance of the companies that they invest in, as well-managed pension funds are more likely to seek value for their investments via a more active shareholder policy.
>
> Good governance goes beyond [the] basic goal of [of minimizing conflicts of interest] and aims at delivering high pension fund performance while keeping costs low for all stakeholders."[5]

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[4] *Source:* APRA (2004) *Supertrends,* APRA (2013) *Quarterly Superannuation Performance.*

[5] Fiona Stewart and Juan Yermo, 2008, *Pension Fund Governance: Challenges and Potential Solutions*, OECD Working Paper on Insurance and Private Pensions No. 18, p. 5

1.1 The profit orientation of funds affects the funds views on regulation

For those funds which are obliged to deliver profits to shareholders, regulation can impose a cost which could negatively impact distributions to shareholders with the benefits flowing primarily to consumers, the members of funds. The inherent conflict of interests within for-profit funds results in a predisposition to oppose regulation which reduces shareholder value. Not-for-profit funds, whilst also concerned about the cost impact of regulation, are primarily concerned that the imposition of additional regulatory cost may negatively impact members of their funds. Accordingly not-for-profit funds are much more likely to fully consider both the cost and benefit of regulatory change and are more likely to support regulation that is likely to have a net positive result upon fund members.

The removal of existing regulation can transfer costs to others. For example, if the Government decided to change existing laws which limit the choice of default funds from which an employer may choose the burden of choice would fall upon individual employers. This would impose direct and indirect costs upon employers.

In its final report into the selection process for default funds in modern awards the Productivity Commission found that it:

> ".. was unable to design an appropriate test that would not place an undue burden on employers, while at the same time safeguarding the best interests of employees who derive their default superannuation product in accordance with modern awards."[6]

The Productivity Commission received a considerable number of submissions from employers stating that they did not have the resources, (including relevant skills and time), to choose a default superannuation product from the many MySuper products available on the market. The comments contained in the submissions of the South Australian Wine Industry Association Incorporated were reflective of the submissions of employers:

> "With the limited resources of businesses in the current economic climate, it cannot solely be the responsibility of the employer to determine which superannuation fund contributions are paid into for employees. This places employers in the role of Financial Planners. Imposing these additional requirements onto employers, further removes the responsibility from employees, which may in turn make employees more apathetic about their choice of superannuation fund.
>
> SAWIA employer members state they do not have the knowledge to be able to compare superannuation funds and measure the 'bells and whistles' against other funds when they lack the expertise to do so."[7]

In his submissions to the inquiry restaurateur Mr Peter Doyle OAM stated:

> " In selecting a default superannuation fund it is important to me that I don't get bogged down with any administrative burdens and that the fund meets the basic requirements set out of a business on a legislative basis.
>
> The restaurant industry is extremely busy and it is hard to find the time to look for relevant funds and ensure my staffs are happy with their choices.
>
> Industry funds and those set out in the award system such as HOST**PLUS** make it very easy for me to run my business and let me get on with the everyday challenges I face to remain profitable.
>
> The thought of looking at a long list of funds and being across them all is a daunting one when it comes to selecting one as my default option.

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[6] Productivity Commission 2012, *Default Superannuation Funds in Modern Awards*, Report No. 60, Final Inquiry Report, Canberra Page 13

[7] South Australian Wine Industry Association Incorporated; Submissions to Productivity Commission inquiry into Default Superannuation Funds in Modern Awards, 3 August 2012 Page2.

The system in place has served me well to here and has met both the needs of my business and my employees."[8]

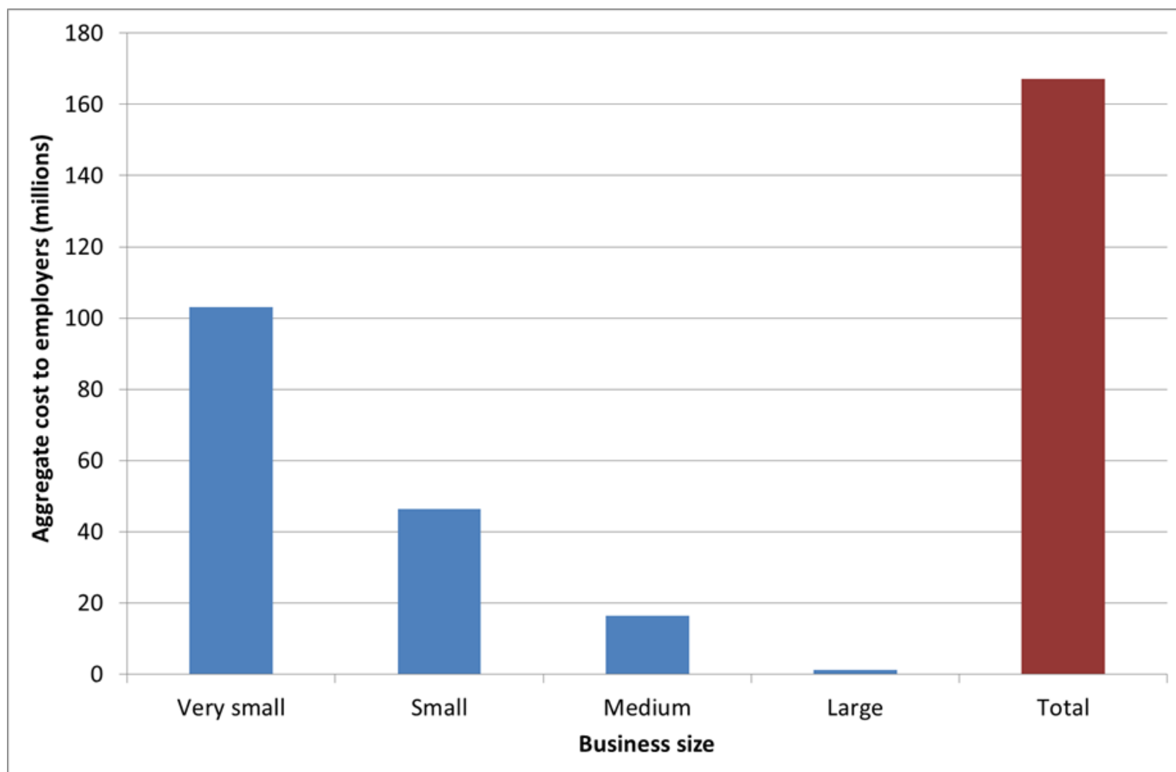
ISA supports the removal of regulatory compliance that is proven to not add value to the public good. The efficiency of the superannuation system is properly measured by the net benefit received by beneficiaries of the system. We do not support the removal of compliance measures which are likely to reduce these benefits.

1.2 Cost of employers selecting any MySuper product

ISA estimates that the additional cost imposed on employers, should they be required to select a MySuper default fund unaided by named list within a modern award, would be in excess of $160 million[9].

This is a conservative estimate, as it assumes that an employer takes only four hours to undertake due diligence and select an appropriate workplace default fund from authorised MySuper products. A conservative maximum cost of $50 per hour is allocated to cover the employers search costs. This cost includes direct and indirect costs such as an allocation for the employer's time and opportunity cost. Small to very small businesses will bear the bulk of the cost.

Figure 1: Estimated cost to employers to select MySuper default funds



Source: ABS (2012) Counts of Australian Business Cat. 8165 ISA analysis (2014)

[8] Submissions of Mr Peter Doyle OAM to Productivity Commission Inquiry into Default Superannuation Funds in Modern Awards, 23 March 2012

[9] As at June 2012, there were 835,187 employing businesses in Australia - ABS (2012) Counts of Australian Businesses, including Entries and Exits, Jun 2008 to Jun 2012, Category 8165. Accessed 17 January 2014 available at http://www.abs.gov.au
Assumes hourly cost of $50, and 4 hours search time. Business size: Very small 1-4 employees, Small 5-19, Medium 20-199, Large 200+

1.3 Orderly and limited change key to confidence

In the context of recent significant change to the superannuation industry, any future change should be limited and introduced in a manner that does not undermine confidence in the industry. This includes consumer confidence and the confidence required within the sector that there will a reasonable period of stability allowing for future change planning, including newly introduced governance changes. Continual reviews add to sectorial instability and risk and reduce the likelihood of positive change in the industry. The cost of this lack of confidence is ultimately borne by fund members and the public as a whole.

2. Part 2: Better Governance

The stated reason for the Government's proposal to introduce change to allow for the 'appropriate' provision of independent directors on superannuation trustee boards is the belief that:

> "Independent directors provide an external, dispassionate perspective, enabling boards to benefit from a diversity of views and provide a check on management recommendations. By being free from relationships that could materially interfere with their judgement they can provide an objective assessment of issues."[10]

ISA does not oppose the appointment of independent chairs or directors where it can be shown to add value to boards and ultimately fund members. Representative trustee boards recognise that the compulsory nature of superannuation requires high governance standards and ISA has been a strong supporter of improved governance standards in the superannuation industry.

2.1 ISA proposes change

ISA proposes the adoption of the definition of independent director found in the ASX Corporate Governance Guidelines with amendments to reflect the trust system that superannuation funds operate in.

Over the past 20 years equal representation trustee boards have developed organically to best suit the needs of the particular demographic of each fund. This has included introducing independent trustees or chairs in instances where the board has considered this will add value to the skills matrix and board dynamics. Many boards have developed processes which allow for independent and expert input into key decision making bodies such as investment committees. These changes have resulted in a healthy diversity of board models within the industry which best suit the needs of the relevant membership.

ISA's proposals will remove obstacles to change, and encourage further change. We suggest that a positive obligation be placed on boards to consider their composition with a view to adopting a governance structure that includes an enhanced role for independents, including an independent chair and a board composition of up to one third independent directors. Where a board considers it would be best served by a board composition that differs from a one third independent director and independent chair arrangement, the reasoning and consideration process adopted would be transparent and available to APRA.

This change would retain the benefits of the representative trustee system whilst introducing further dynamics to superannuation boards which could add value. The adoption of an arrangement that would require or encourage a majority of independent directors is not supported as it would, in our view, ultimately have a negative impact on fund members as it would remove the driver of outperformance in the industry.

2.2 Government's pre-election position

We note that in September 2013 just prior to the Federal election the Coalition Government, then in opposition, released its superannuation election policy. The policy dealt with governance issues at point 4 as follows:

> "**4. Improving Governance in Superannuation**
>
> To improve standards and better manage conflicts of interest, the Coalition will align corporate governance in superannuation more closely with the corporate governance principles applicable to ASX listed companies.

[10] Discussion paper Page 10

The Coalition is committed to improving superannuation governance by ensuring that there is:

- appropriate provision for independent directors on superannuation fund boards;
- mandatory disclosure of conflicts of interest ; and
- a requirement for specific advice to APRA by those who intend to sit on multiple superannuation fund boards that there is no potential for conflicts of interest.

The Cooper Review into the governance, efficiency, structure and operation of Australia's superannuation system questioned the financial expertise and professionalism of union and employer trustees who are appointed to superannuation boards through the 'equal representation model.'

Labor has either opposed or ignored many sensible recommendations made by the Cooper Review to improve governance arrangements without providing an acceptable explanation.

The Coalition will work with all relevant stakeholders to ensure Australia's superannuation system has appropriately high standards of corporate governance."[11]

In the preceding two years the Coalition opposition was strongly advocating the adoption of the one third independent director ratio recommended by the Cooper Review Panel[12]. The Coalition's stated position is consistent with the stated election policy that there be an "appropriate provision for independent directors on superannuation boards," and that the detailed positioning and the election statement should be read together to ascertain the extent of the Coalition's mandate on these matters.

It is suggested that there are no grounds established that would facilitate a cogent argument that the Government has a mandate from voters for governance change which would require a superannuation funds to appoint a majority of independent directors.

2.3 Cooper Review Panel

Given the importance attached to the Cooper Review Panel's findings, there is merit in briefly reviewing the evidence put to the panel on the issue of the superannuation board governance structure. It is recognised that the final recommendation of the Cooper Review Panel was for the introduction of a one third independent director ratio to superannuation boards. Whilst ISA does not have any fundamental objection to the recommendation of the Cooper Review Panel, it does not concur with some of the views expressed by the panel and we would suggest that they are not supported by any evidence put to the Panel. At Attachment B we provide a brief analysis of the views and recommendations made by the Panel and compare these views to the actual evidence put to the Panel.

2.4 Role of independent directors

The concept of "independent director" as it arises in the listed company context is focussed on addressing the separation between ownership of the corporation (by shareholders) and control of the corporation (by management). In the listed company context, directors who also are part of management (as opposed to directors who are independent of management) are under significant risk of divided loyalties and a principal-agent conflict; they have interests in their capacity as management while at the same time are expected to serve the interests of shareholders. Given this background, the ASX Corporate Governance Principles define an independent director as "a non-executive director who is not a member of

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[11] Our Plan: Real Solutions for all Australians: the direction, values and policy priorities of the next Coalition Government: The Coalition's Policy for Superannuation , September 2014. Accessed 29 January 2014, http://www.liberal.org.au/our-policies

[12] Review in to the Governance, Efficiency, Structure and Operation of Australia's Superannuation System (the Cooper Review)

management and who is free of any business or other relationship that could materially interfere with – or could reasonably be perceived to materially interfere with – the independent exercise of their judgment."[13]

ISA does not question the important and valuable role that independent directors may have within boards. While the composition of boards will be necessity or design vary, many superannuation fund boards have opted to include an independent chair and/or a set number of independent appointments to their board. A number of representative trustee funds have opted for this approach.

2.5 Independent directors in industry super funds

Representative trustee boards have evolved over the past twenty years and we now see a diversity of board structures. In the not-for-profit sector representative trustee boards reflect the demographic of the industries the funds operate in. This evolution has included an increased use of independent directors and chairs where the board has formed the view that this would improve the skills matrix of the board and or improve board dynamics whilst maintaining the positives flowing from the representative trustee character of the board.

A study of 26 industry super funds[14] (representing over 60 per cent of assets in the industry fund sector) shows that almost 62 per cent (16) of the funds already have at least one independent director on their board. Of these, the majority of funds (11) had one independent director and of these, four funds had the independent director appointed as the chairperson.

Those funds that have introduced independents onto their boards have done so in the context of a representative trustee system where there continues to be representation from employee and employer sponsors. The introduction of independent board representatives within an equal representation system can in this context add value without undermining the driver of superior performance i.e. the representative trustee system itself.

Some boards have had to deal with restrictions within their trust deeds which limit their ability to appoint independent directors, or even pay remuneration to directors.[15]

Since the introduction of APRA licensing requirements in June 2006, trustees of APRA regulated funds have been required to regularly review their governance arrangements. The introduction of licensing resulted in the merger of some funds, namely corporate funds, which were not in a position to, or were unable to commit the necessary resources to adopt the higher governance standards. Boards have continued this process with a regular assessment of their needs and capabilities. Part of this consideration involves the composition and skills of the existing board. APRA's prudential standards, in particular SPS 520 which deals with Fit and Proper requirements and SPS 510 the Governance prudential standard have extended these obligations.

2.6 Differing governance consideration between for-profit and not-for-profit funds

There are two distinct models of superannuation fund governance in Australia, for-profit and not-for-profit. The governance considerations under the two different models differ. Under a not-for-profit representative trustee model there is no requirement for the trustees to reconcile the requirement to deliver a profit to shareholders and the fiduciary duty to act in the fund member's best interests.

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[13] *ASX Corporate Governance Principles and Recommendations*, 2nd edition.

[14] 26 funds include the 16 member funds of the Industry SuperFunds campaign, and the remaining top 10

[15] In *Re Retail Employees Superannuation Trust Pty Ltd* [2013] NSWSC 1681 (14 November 2013) The Retail Employees Superannuation Trust Pty Ltd (REST) recently applied for orders from the New South Wales Supreme Court that it would be justified in altering its trust deed to entitle the trustee and its directors to be paid a fee and permit the appointment of independent directors. The 'judicial advice' provided accepted that it would be increasingly difficult for the trustee to attract suitable directors due to the significant time required to be devoted to the performance of their obligations.

In the for-profit sector the existence of this structural conflict gives rise to agency risk and different roles played by trustees. It is recognised that in recent times financial service providers that offer superannuation products have worked to address these structural conflicts. The adoption of the Financial Service Council's (FSC) 'Governance Policy'[16] by the larger bank owned superannuation funds is encouraging. The FSC policy calls for the appointment of an independent chair and a majority of independent directors.

The FSC policy is designed to some extent to address the inherent structural conflict faced by trustees of retail superannuation funds owned by listed corporations. The policy is not designed, nor can it be meaningfully applied, to the not-for-profit sectors within the superannuation industry.

In the context of superannuation, good governance is about enhancing the quality of decision making of the trustee such that it produces superior risk-adjusted net returns to members (and otherwise supports good retirement outcomes).[17] Eliminating the conflicts of interest that undermine performance and undercut the ability of the fund to maximise retirement outcomes is a critical part of accomplishing this goal.[18] The representative trustee model is a direct response to this conflict and has produced superior retirement outcomes for members.

The principles of trust law impose an obligation on trustees to act in the best interests of beneficiaries. All decisions of the trustees should be unfettered and made in the interests of beneficiaries before all others. Funds cannot be governed by the membership as a whole and potential conflicts of interest are difficult to avoid entirely. The pertinent issue is how they are managed.

APRA has sufficient powers to ensure regulated superannuation entities apply the highest standards of governance to ensure the Board and individual directors fulfil their fiduciary and regulatory obligations.

The governance of superannuation funds is important to delivering the retirement outcomes that the superannuation system is expected to provide. ISA submits that governance principles to be applied to superannuation funds should (i) be designed to address the conflicts of interest that are likely to affect the ability of the trustee to act in the best interests of members, particularly in delivering retirement outcomes, and (ii) be based on the best available empirical information about what structures produce good outcomes for members, and what structures do not.

Given the important public policy objective of superannuation, too much is at stake for superficial approaches to governance that are based on theory and imported from the listed company context. Instead, governance requirements should rest upon clear empirical evidence.

The for-profit structure generates conflicts of interest that have adversely affected performance: retail fund boards are populated by persons who have interests aligned with the financial conglomerate that is affiliated with the fund. An APRA working paper finds that "In the case of a retail fund ... the trustee (or the corporate group to which it belongs) has the strong expectation of profiting from its superannuation business. That retail trustees must reconcile their (group's) profit motives with their fiduciary duty to act in the members' best interest gives rise to agency risk."[19]

Further survey work by Wilson Sy on behalf of APRA in 2008 found that retail directors are more often placed in situations of conflict of interest:

> "Retail funds are much more likely to use service providers that are related parties, because up to about 66% of the funds by number and 81% by asset value operate within broader financial

[16] FSC Standard No. 20 *Superannuation Governance Policy* March 2013

[17] Fiona Stewart and Juan Yermo, Op Cit

[18] Recent revelations regarding the investment by trustees of superannuation cash deposits in lower earning but related bank entities by retail funds are a practical example of the conflict where bank profits are put before the interests of beneficiaries. Sydney Morning Herald, *Superannuation: Banks eating into savings*, Michael West, 20 December 2013 Page 1 Accessed 13 January 2014

[19] Kevin Liu and Bruce R Arnold, *Australian Superannuation Outsourcing – Fees, Related Parties and Concentrated Markets*, APRA Working Paper, 12 July 2010, Page 6.

conglomerate structures. Typically, the provider is the parent company of the trustee, or the provider and trustee have a common parent company. Such relationships are found in the survey in 39% of retail funds, 10% of corporate funds and not at all in the other funds. The existence of such relationships also increases the likelihood of associations of service providers with board directors.

> Over 60% of retail directors have one or more associations with service providers. This is more than twice as frequent as directors of corporate funds and about three times as frequent as those of public sector or industry funds. … many retail directors are primarily employed either by their current funds or by service providers to their funds and the proportions are substantially higher than those in other sectors. This suggests the retail directors are placed in situations of conflict of interest more often directors in other sectors,."[20]

In his more expansive work for the Journal of Pension Management Mr Sy concluded:

> "Unlike non-retail trustees who negotiate the best possible terms for investment management services for their funds, retail trustees with investment managers as executive directors on their Boards have impaired incentives to negotiate the best terms for investment management services."[21]

Representative fund trustees make the pertinent decisions for their fund, with the use of external consultants where necessary, while non-representative fund trustees tend to outsource this responsibility to affiliated individuals (the executive team). In his survey work for APRA, Sy also found that the representative trustee boards found in industry, corporate and public sector funds spent up to twice as many hours per board meeting and excluding executive sub-committee meetings, industry fund directors spend on average 1,364 director hours per year undertaking work themselves or reviewing the work of external consultants, compared to 559 director hours by retail fund directors who place a greater reliance on fund executives.[22]

Other APRA researchers investigated related party service provider fee arrangements to determine whether these impaired incentives/conflicts of interest on trustee boards translated into harm to members.[23] Concerns about these impaired incentives were confirmed. In comparing related-party fee arrangements to those with independent service providers across the for-profit and not-for-profit sectors, the research found that:

> [R]elatedness *per se* is not detrimental to fund members. However, when we consider whether the fund has been established on a not-for-profit basis, or as a retail commercial endeavour, we find that trustees of retail funds pay significantly higher fees to related-party service providers. In contrast, the fees paid by trustees of not-for-profit funds to related parties are not significantly different than those to independent service providers.[24]

This result prompted the researchers to note that:

> "[T]rustees of not-for-profit and retail trustees using independent service providers are generating near-identical value propositions. In contrast, some retail trustees using related-party administrators, are paying significantly higher fees, effectively almost doubling the median member's cost load. Reconciling this finding with the superannuation trustee's fiduciary duty to fund members will bear further investigation."[25]

[20] APRA Working Paper, Wilson Sy, August 2008; *Superannuation fund governance: An Interpretation* Pages 8-9

[21] Wilson Sy, *Pension Governance in Australia: An Anatomy and an Interpretation*, International Journal of Pension Management, Fall 2008, Page 36

[22] APRA Working Paper, Wilson Sy, Op cit Page 10

[23] See, Kevin Liu and Bruce R Arnold, Op cit Page 2

[24] Ibid at 2.

[25] Ibid at 6.

2.7 Representative trustee funds outperform

There appears to be no evidence that representative trustee funds have conflicts of interest that are affecting member returns. The evidence is that the opposite is the case.

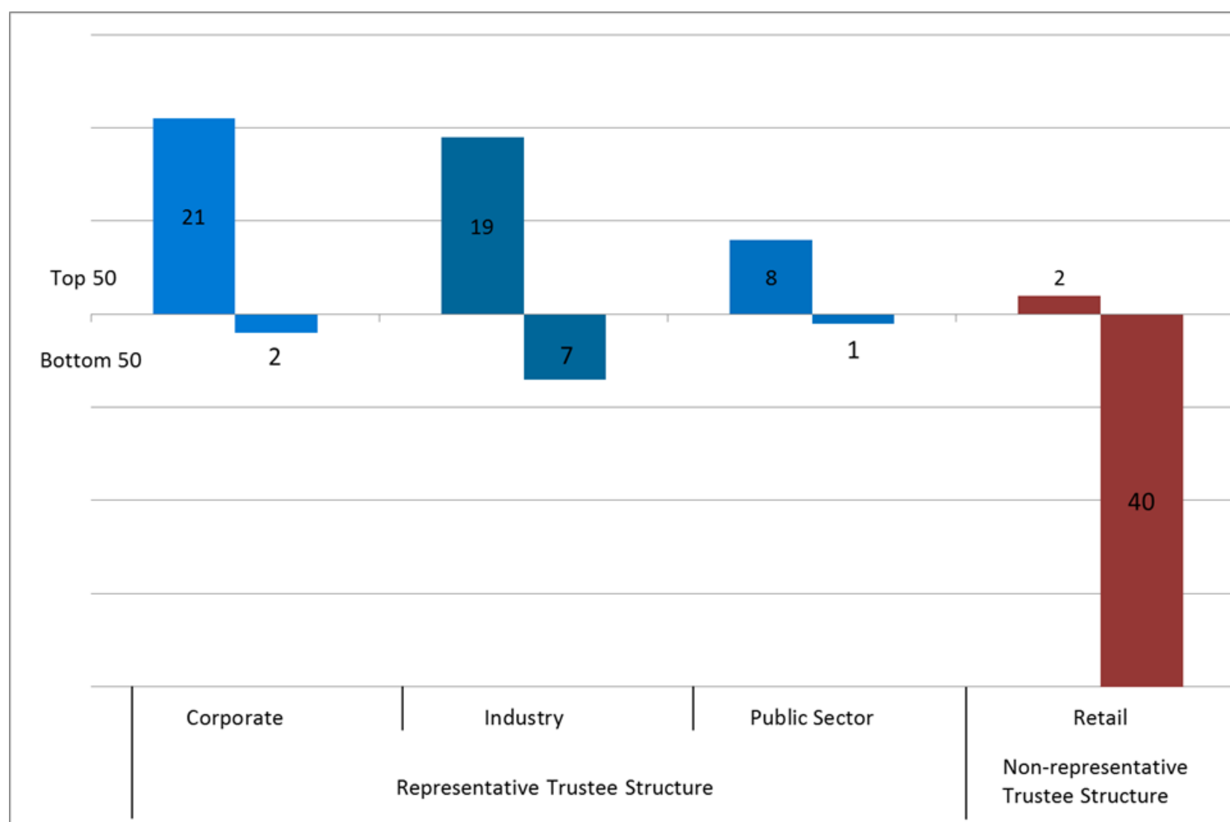
The equal representation model adopted by not-for-profit funds has been a key reason why the returns to beneficiaries of such funds have exceeded those of retail funds.

ISA's work (based on APRA data) has shown that over the 17-year period to 30 June 2013, the rate of return to investors in retail superannuation funds lagged those of the not-for-profit funds, on average by 2% per annum. Retail funds returned an average of 4.11% per annum, just above the average rate of return for cash over this period of 3.93% per annum.[26]

The APRA data also shows that retail funds do not pass on the benefits of scale to their members and that profit orientation is the prime determinant of returns. In short, it seems that the major financial institutions are resolving the conflict between their duties to members, on the one hand, and their duties to shareholders, on the other hand, by trading off member returns for shareholder distributed profit.

The overwhelming evidence is that funds operating under a representative trustee model provide better returns to members. APRA's fund-level rate of return data shows that over a 10 year period, 96 per cent of the top performing 50 funds are from the not-for-profit sector. At the other end of the scale, the majority of the lowest performing 50 funds were for-profit (80 per cent).[27]

Figure 2: 50 top performing funds vs 50 lowest performing funds based on annual 10 year ROR to June 2013, by fund classification and profit orientation



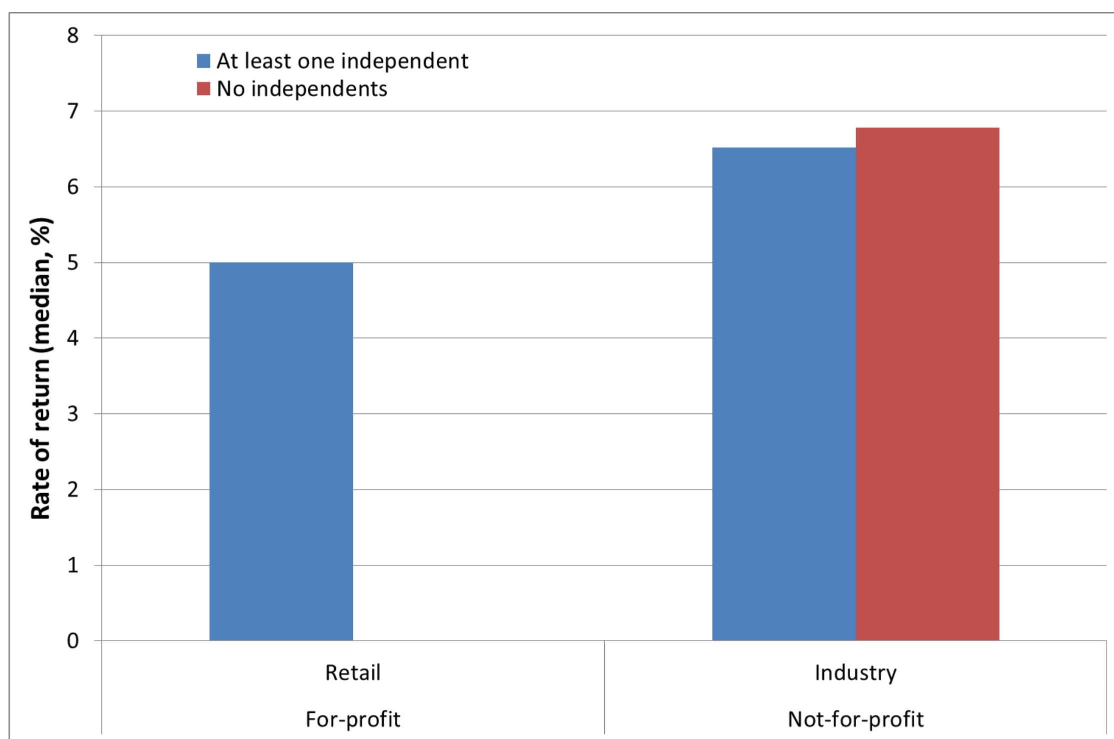
Source: APRA (2014) Fund-level Rates of Return

Some funds with a representative trustee governance model appoint up to one third of their directors as independents as they believe this best suits the interests of the fund and its members. Returns are slightly

[26] APRA (2014) *APRA Annual Statistics*; ABS (2013); ISA Analysis (2014). Returns are calculated as the geometric average.
[27] Analysis excludes ERFs

lower for representative funds with at least one independent director on their board compared to those with no independent directors; however the significant difference in returns is between representative funds and non-representative funds.

Figure 3: 10 year rate of return, to June 2013, by fund classification and board composition



Source: APRA (2014) Fund-level Rates of Return

2.7.1 Representative trustee funds have demonstrated a greater commitment to long-term investing as shown by their significantly higher asset allocation to infrastructure

APRA has found that the characteristics of not-for-profit representative trustee funds allow for a higher level of illiquid asset allocation,[28] enabling them to take advantage of scale and negotiating power when making investment decisions. Industry SuperFunds[29] allocate almost 21 per cent[30] of funds under management to alternative assets which include direct and pooled infrastructure investments and private equity.[31] Non-representative super funds allocate less than one quarter of this amount at the whole of fund level to similar assets.[32] Over the last 18 years, IFM Investor's unlisted infrastructure portfolio has delivered after tax returns averaging over 12 per cent per annum, outstripping most other asset classes, even during the turmoil of the global financial crisis.

As retail funds typically operate as platforms that allow members hundreds of choices through highly intermediated structures, this limits the opportunities for trustees to take a consolidated approach to investing,[33] resulting in transaction costs for members.

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[28] Cummings & Ellis (2011) *Risk and Return of Illiquid Investments* page 19-20 APRA Working Paper
[29] Participating funds: AustralianSuper, CBUS, HESTA, HOSTPLUS, MTAA Super, CareSuper, LUCRF Super, Media Super, NGS Super, TWUSUPER, AustSafe Super, Energy Super, First Super, legalsuper, REI Super
[30] APRA (2012) *Superannuation Fund-level Profiles and Financial Performance*
[31] Among Industry SuperFunds approximately three quarters of 'other' investments are exclusively infrastructure with most individual funds maintaining allocations between the range of 10-16 per cent.
[32] Cummings and Ellis (2011) *Risk and Return of Illiquid Investments* APRA Working Paper
[33] Cummings (2012) *Effect of fund size on the performance of Australian superannuation funds* page 24-25 APRA Working Paper

2.7.2 Representative trustee funds lead the way in director training

The Australian Institute of Superannuation Trustees (AIST) offers a range of education programs designed to enhance/develop the skills and knowledge of trustees at an individual and board collective level. These include Board Insights (the topics being selected by the Trustee), regulatory updates (facilitated by regulators such as APRA, SCT, ASIC and ATO) and most notably AIST's flagship education offering for trustees and fund executives – the Trustee Director Course. The Trustee Director Course is an in-depth education offering for new and experienced directors. It has been designed in consultation with the superannuation industry, service providers and regulators. Its focus is on the skills and knowledge required for Trustee Directorship to ensure a better retirement outcome for superannuation fund members. It is a highly practical and interactive course specialising in areas such as superannuation regulation, governance, super financial statements, investment, strategy, risk management, selection and monitoring of service providers, leadership and committee structures.

2.8 Do independent directors add value?

The clear inference to be taken from the Government's discussion paper is that the introduction of independents will add value to boards, primarily because their appointment would replace what is considered the negative impact of "relationships that could materially interfere with their (board member) judgement…". It is submitted that there is no evidence for this proposition. The benefit of the representative trustee system, (including those boards that have independent chairs and up to one third independent directors), is that the interests of the members of the funds are always front of mind. The modus operandi of not-for-profit representative trustee boards ensures that boards are both expert and loyal to their members.

The majority of academic investigations into the worth of independent directors have concluded that there is no solid empirical evidence that supports the view that independent directors add value to boards.

In their study entitled *Do Independent Directors Add Value?* Lawrence and Stapledon of the Centre for Corporate Law and Securities Regulation at the University of Melbourne undertook an analysis of Australian and overseas studies of the value added to boards following the introduction of independent board members for the period 1985 to 1995.

They found that the studies:

> "… have not proven conclusively whether or not independent directors are valuable. What the studies *have* done is fail to produce solid evidence supporting the proposition that independent directors add value (or destroy value).Thus, the upshot of the studies is that, as far as Australia's largest listed companies are concerned, independent directors do not appear to have added value over the 1985 to 1995 period." [34]

Frederick Tung of the Boston University School of Law offers the following succinct and considered view:

> "The independent director has always offered a sort of magic bullet for corporate governance, representing the idealized monitor of executives' behaviour. Yet we corporate law scholars also harbor some ambivalence about the magic of this bullet. As much as we want to trust in the promise of independent directors, no solid empirical evidence exists to suggest that independent directors add value. Moreover, we have seen spectacular failures in the face of independent boards."[35]

[34] Lawrence, Jeffrey, and Stapledon, Geof, *Do Independent Directors Add Value?,* Centre for Corporate Law and Securities Regulation Faculty of Law The University of Melbourne 1999 Page vii

[35] Tung, Frederick, *The Puzzle of Independent Directors: New Learning*, Boston University Law Review, Vol. 91, No. 3, pages 1175-1190, May 2011; Boston Univ. School of Law, Public Law Research Paper No. 11-33; Boston Univ. School of Law, Law and Economics Research Paper No. 11-33. Available at SSRN: http://ssrn.com/abstract=1882903

A recent Australian study found that the introduction of independent directors resulted in large and statistically significant falls in performance indicators. The study compared the performance of 969 Australian companies over the nine years to 2011, including 561 that changed their board structure following the introduction of the ASX's "if not why not" guidance.

The work by Fischer and Swan concluded that:

> "Using a comprehensive dataset on the Australian corporate landscape, all employed methods in this paper find that "majority board independence treatment" resulted in large and statically significant falls in two primary market performance indicators measured by the Tobin's *Q* and Market-to-Book ratio, and in accounting-based performance as measured by the Industry-adjusted ROA"[36]

The work found that the application of the five per cent rule that determines a board member not to be independent if they hold more than five per cent of the companies wealth combined with the adoption of ASX guidelines for majority independent directors has:

> "… destroyed considerable shareholder wealth of the order of $69 billion or more…. This massive loss of wealth has resulted in no discernible benefit to other than board members, both executives and non-executive directors alike."[37]

Dr Sally Wheeler of Queens University Belfast[38] has expressed the view that research into group decision-making largely confirms that diversity and independent thinking in groups is positive. "But the diversity that is valuable is not derived from imposing structural roles about the number of independent directors. Indeed structural rules that force together individuals with disparate values and beliefs can be counter-productive."[39]

Dr Wheeler is of the view that there is little direct evidence of what makes good boards work, what evidence there is suggests 'task conflict' to be a positive force, 'relationship conflict' a negative one and that 'group-think' is inevitable as board members strive for internal cohesion and new board members seek acceptance and social efficacy to justify their presence at the board table.

> "Structural rules around independence fail on all counts. It doesn't guarantee, or even promote, task conflict because boards habitually choose people with the same professional training and experience base as themselves; seldom do they choose industry outsiders. So you don't get the cognitive diversity that comes from different perspectives and experience, you just get more of the same. It doesn't address relationship conflict.
>
> All of which is to say that board governance is not something that can be engineered crudely."[40]

2.8.1 Australia's representative trustee arrangements are consistent with international governance arrangements for pension funds

Benefits of the representative trustee model are recognised internationally. Table 1 demonstrates that most OECD pension funds have adopted representative trustee arrangements as a preferred governance model. [41]

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[36] *Does Board Independence Improve Firm Performance?* Outcome of a Quasi-Natural Experiment Fischer Marc-Oliver and Swan Peter L, Australian School of Business, University of NSW 18 November 2013 Page 43
[37] Ibid Page 44
[38] Sally Wheeler is a Professor in the Faculty of Law at Queen's University, Belfast. Her research interests include socio-legal studies in the area of company law, corporate governance, contract law and legal history.
[39] Dr Sally Wheeler, Queens University Belfast; *Do we really need 'Independent' directors on super boards? http://www.clmr.unsw.edu.au/article/accountability/corporate-governance/do-we-really-need-independent-directors-super-boards*
[40] Ibid
[41] The UK Pension Regulator's governance survey of trustees (TPR (2007b)) found that having a mixed boards (member and employer nominated) was regarded of much greater importance for good governance than having an independent trustee.

Table 1 – Representation in occupational pension fund governing boards[42]

Country	Pension Fund Trustee Model
Australia	Either equal employer/employee representation, equal representation with an independent chair, or a third/third/third - employer/employee/independent.
Austria	Representation from both employer and employee groups
Belgium	Equal representation of employers and employees.
Brazil	Minimum of one third employee representation.
Canada	Multi-employer plans typically have equal representation.
Germany	Supervisory board has employee representation, with a maximum of equal representation.
Hungary	Mandatory pension funds must have member representatives in their board of directors.
Iceland	Equal representation of employers and employees.
Italy	The general assembly and the board of directors must each have equal representation of employers and employees.
Japan	Board of Representatives must have equal representation of employers and employees.
Netherlands	Equal representation of employers and employees.
Norway	The board must have at least as many employee as employer representatives.
Poland	Supervisory board needs to have no less than half employee representatives
Spain	The majority of the control commission must be selected by plan members and beneficiaries.
South Africa	At least half of trustees must be elected by plan members.

2.9 Significant governance changes introduced as part of the Stronger Super reforms

Stronger Super reforms have introduced significant enhancements to fund governance arrangements, including the introduction of a best interest obligation. These changes are part of the evolution of superannuation governance arrangements and are in addition to the general powers held by APRA to licence and intervene in fund arrangements where APRA deems it necessary.

APRA, ASIC and the Commission of Taxation are conferred extensive regulatory and investigative powers for the administration of the Superannuation Industry (Supervision) Act 1993 (SIS Act).

Amongst its many powers APRA has the power under s29A to 29JD to licence trustees, deal with operating and prudential standards under the provisions of s30 to 34; accounts, audit and reporting obligations under sections 35 and 36; deal with fund governing rules in sections 51 to 60A and matters pertaining to equal representation requirements in sections 86 to 93A.

When exercising its powers APRA is required to consider, amongst other things:

1. Whether the entity has complied with SIS prudential requirements;
2. The entity's investment strategy;
3. Security of the entity's assets; and
4. Whether records have been properly maintained.

[42] OECD Working Papers on Insurance and Private Pensions No.18 *Pension Fund Governance Challenges and Potential Solutions* (Stewart, Yermo, 2008 pages 17-18). Adapted for this submission.

If APRA deems necessary, they can require a trustee to appoint an individual or committee to investigate and report on the financial position of the entity (SISA s257), or can conduct their own investigations (SISA s 263). APRA may apply to the Federal Court of Australia to disqualify an individual from being a trustee, or a responsible officer of a body corporate that is a trustee, investment manager or custodian of a superannuation entity (SISA s126H), where:

- The person or the corporate trustee has contravened SIS Act or the *Financial Sector (Collection of Data) Act 2001*; or
- The individual is otherwise not a "fit and proper" person.

APRA will provide notice of this disqualification to the individual and publish it in the Gazette (SISA s126H). APRA may also accept and enforce an undertaking given by a regulated individual, or enforce an undertaking by applying to the court (SISA s262A).

2.9.1 APRA prudential standards

APRA has the power to make prudential standards under section 34C of the SIS Act. Following industry consultation in November 2012 APRA released revised or new operating standards as part of the Stronger Super reforms. These new prudential standards have improved the governance arrangements in the superannuation industry and are supported by the imposition of enhanced duties upon trustees in the SIS Act.

SPS 510 Governance

The prudential standard SPS 510 sets out the minimum foundations for the good governance of an RSE licensee. The key requirements found in the standard include the requirement on a board to have a policy on board renewal and procedures for assessing board performance; an obligation to establish a board remuneration committee that aligns remuneration and risk management; the establishment of a board audit committee as well as a dedicated internal audit function.

The standard requires a board, which is ultimately responsible for the sound and prudent management of the RSE licensees' business operations, to have a formal charter which sets out the roles and responsibilities of the board, including mechanisms for the monitoring of the exercise of delegated authority.

Directors collectively are required to have the necessary skills, knowledge and experience to understand the risks of the RSE licensees' business operations, including its legal and prudential obligations and to ensure the funds business operations are managed in an appropriate way that takes account of those risks.[43]

The board is required to have procedures for assessing, at least annually, the Board's performance relative to its objectives, including a process for the assessment of individual directors.[44]

The standard also requires the Board to have in place a formal policy on Board renewal to ensure the Board remain open to independent thinking. The policy requires the Board to adopt a process for the appointment and removal of directors, including factors that will determine when as existing director will be reappointed.[45]

The prudential standard also requires the RSE licensee to establish and for the Board to approve a remuneration policy that outlines the remuneration objectives and the structure of the remuneration arrangements, including a Board remuneration committee. The policy, which applies to all responsible persons that may affect the interests of beneficiaries must be designed to encourage behaviour that

[43] Clauses 8-11
[44] Clause 19
[45] Clause 20

protects the interests of beneficiaries; the long-term financial soundness of the RSE licensee or connected entities and supports the risk management framework of the RSE licensee.46

The prudential standard also requires the establishment of a Board Audit Committee,47 to have an independent and adequately resourced internal audit function48 ; requires auditor independence49. The standard also ensures that persons not be constrained from providing information to APRA.50

SPS 521 Conflicts of interest

The conflicts of interest standard requires RSE licensees to develop implement and review a conflicts management policy that is approved by the board; identify all relevant duties and interests and to develop registers of relevant duties and interests.

The conflicts management framework adopted by a fund must be one that provides a reasonable assurance that all conflicts are being clearly identified avoided or prudently managed.

The standard also imposes a positive obligation on the board to consider the duties of all relevant responsible persons which might reasonably have the potential to have a significant impact on the capacity of the RSE licensee, the associate of the RSE licensee or the responsible person with the relevant duty to act in a manner that is consistent with the best interests of beneficiaries.

SPS 520 Fit and Proper

The fit and proper standard requires RSE licensees to implement a policy consistent with the standard. The standard requires the fitness and propriety of a responsible person to assessed prior to initial appointment and re-assessed annually. In addition there is a requirement that APRA be provided with the licensee's assessment of the fitness and propriety of responsible persons, including trustees.

Where a person is assessed not to be fit and proper for a particular appointment there is an obligation on the RSE licensee to take all prudent steps to ensure the person is not appointed or not reappointed.

The standard also imposes additional requirements on RSE auditors and actuaries.

2.10 Stronger Super

The Stronger Super reforms have as their centerpiece changes which make fund trustees and their directors more accountable and responsible in their management of superannuation funds. The changes impose a higher standard of care upon trustees and directors

2.10.1 Standard of care

A higher standard of care has been imposed on directors as a result of replacement of the "prudent person" test with the higher standard found in the "prudent superannuation trustee". The change aims to bring superannuation fund trustees in line with the standard of care for professional trustees under existing State and Territory legislation.

2.10.2 Superannuation fund trustee duties

New statutory duties for superannuation fund trustees include the duty:

> *To act fairly in dealing with classes of beneficiaries within the entity and to act fairly in dealing with beneficiaries within a class*

[46] Clauses 21 - 42
[47] Clauses 43-55
[48] Clauses 56-57
[49] Causes 58-65
[50] Clauses 68-70

This new statutory duty builds upon a trustee's existing common law duty to act fairly and equitably between classes of members.

To prepare, review and give effect to an insurance strategy and satisfy additional duties with respect to insurance

This duty recognizes the importance of insurance arrangements and the impact the costs of insurance have on final returns to members. Trustees will be subject to a new statutory duty to formulate, give effect to and regularly review an insurance strategy, having regard to the types of insurance to be offered; the level of cover; the basis of the decisions having regard to the fund demographic and the impact on members retirement incomes; the method by which the insurer is to be determined and to do all things reasonable to ensure a member's insurance claim has a reasonable prospect of success.

To manage conflicts of interest and duty

Where a conflict of interest exists the trustee has a duty to:

- give priority to the duties and interests of the beneficiaries over the duties to and interests of the trustee to other persons;
- ensure that the duties to the beneficiaries are met despite the conflict;
- ensure that the interests of the beneficiaries are not adversely affected by any conflict; and
- comply with the prudential standards in relation to the conflicts.

2.10.3 Enhanced trustee obligations for MySuper products

Trustees who provide MySuper products will have even greater responsibility to MySuper members, including a requirement to:

Promote financial interests of members of a MySuper product

This requirement focuses on returns to beneficiaries. The Explanatory Memorandum to the Trustee Obligations and Prudential Standards Act 2012 states:

> "This requires a trustee to make informed judgments regarding the MySuper product … so that it secures the best financial outcome for these beneficiaries. While this will lift the standard required of trustees, it is not a requirement that trustees generate certain level of returns ... low returns, on their own, will not necessarily involve a breach of this obligation."

Determine on an annual basis that there is sufficient scale to provide a MySuper product

There is a new obligation requiring trustees to consider annually whether the financial interests of the MySuper members are disadvantaged by comparison with other funds due to insufficiency of scale in terms of members (both MySuper and non-MySuper) or assets. The details of the trustee's method of determining these scale matters must be included in the investment strategy for the MySuper product.

Include in investment strategy an investment return target and level of risk for a MySuper product

A target investment return will need to be included in the trustee's MySuper investment strategy and must be expressed as the expected return over a rolling period of 10 years, updated each year. Trustees are also required to determine the level of investment risk that is appropriate for MySuper members, having regard to the fund demographic.

2.10.4 New covenants for directors of corporate trustees

The covenants contained in section 52 of the SIS Act apply directly to individual directors, these include a duty:

- to act honestly;
- to exercise the same degree of care, skill and diligence as a prudent superannuation entity director;
- to act in the best interests of the beneficiaries;
- where there is a conflict of duty or interest, to give priority to beneficiaries and ensure the duties to beneficiaries are met despite the conflict, to ensure the interests of beneficiaries are not adversely affected and to comply with the prudential standards;
- not to enter into a contract or do anything else which would prevent the director or the corporate trustee from properly performing or exercising their functions or powers; and
- to exercise a reasonable degree of care and diligence for the purposes of ensuring that the corporate trustee carries out the SIS Act covenants.

2.10.5 Liability of trustees

Strict liability applies to the duties upon trustees and directors who can be held liable to members for loss or damage caused as a result of a breach of their new statutory duties. A person who has suffered a loss due to a director's contravention of duties under the SIS Act is required to seek the permission of the Court before bringing an action against an individual director.

Certain defences remain available to trustees, provided they have met the relevant duties. Trustees are required to act in the best financial interests of beneficiaries and if called upon must demonstrate due diligence processes and their consideration of relevant matters in order to be able to show compliance with their SIS Act duties. This provides them with the ability to use the limited defence available under section 55(5).

These obligations have been highlighted recently by the Victorian Court of Appeal which confirmed that trustees are under a positive duty to make inquiries and to inform themselves and cannot be excused by relying upon information put before them.[51]

The combined effect of the duties imposed by common and statute law and APRA's strengthened prudential standards have created a new governance standard that is intended to heighten trustee's obligations to fund members.

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

ISA supports the definition of independent found in the ASX Corporate Governance Guidelines (the ASX definition), with minor modification to ensure it applies to a superannuation entity.

The definition has taken into account the independent director provisions articulated in the FSC Governance Standard, comments in the Cooper Review final report, and the existing SIS Act definition that applies to equal representation boards only.

The existing ASX Corporate Governance Council s' definition of independence is shown and is followed by ISA's proposed definition. All amendments are intended to do no more than ensure relevance and wide applicability within the superannuation industry.

It is proposed that the amended definition would be implemented in such a manner that it applies to all sectors of the industry. The most appropriate vehicle for the implementation of governance changes will be dependent upon the type and extent of change ultimately proposed by Government. Options include its inclusion within an APRA prudential standard or guide, regulation or an industry code. It is argued elsewhere in these submissions that a flexible principle based approach would be preferable.

The existing definition of independent found in section 10 of the SIS Act does require amendment to facilitate the appointment of independent directors and to allow directors to be members of the fund.

[51] *Alcoa of Australia Retirement Plan Pty Ltd v Frost* [2012] VSCA 238

2.11 ASX Corporate Governance Council definition of independence

An independent director is a non-executive director who is not a member of management and who is free of any business or other relationship that could materially interfere with - or could reasonably be perceived to materially interfere with - the independent exercise of their judgement.

Box 2.1: Relationships affecting independent status [12]

When determining the independent status of a director the board should consider whether the director:

1. is a substantial shareholder of the company or an officer of, or otherwise associated directly with, a substantial shareholder of the company [13]
2. is employed, or has previously been employed in an executive capacity by the company or another group member, and there has not been a period of at least three years between ceasing such employment and serving on the board
3. has within the last three years been a principal of a material professional adviser or a material consultant to the company or another group member, or an employee materially associated with the service provided
4. is a material supplier or customer of the company or other group member, or an officer of or otherwise associated directly or indirectly with a material supplier or customer
5. has a material contractual relationship with the company or another group member other than as a director.

Family ties and cross-directorships may be relevant in considering interests and relationships which may affect independence, and should be disclosed by directors to the board.

[12] The relationships affecting independent status in Box 2.1 are adapted from the definition of independence given by Corporate Governance: A Guide for Fund Managers and Corporations – Blue Book, Investment and Financial Services Association, 2004 at www.fsc.org.au.

[13] For this purpose a "substantial shareholder" is a person with a substantial holding as defined in section 9 of the Corporations Act.[52]

2.12 Proposed ISA definition of independent director

An independent director is a non-executive director who is not a member of management (of the RSE licensee or any of its related bodies corporate) and who is free of any business or other relationship that could materially interfere with – or could reasonably be perceived to materially interfere with – the independent exercise of their judgement.

When determining the independent status of a director the board should consider whether the director:

1. is a substantial shareholder[53] of the-RSE licensee or any of its related bodies corporate or an officer of, or otherwise associated directly with, a substantial shareholder of the RSE licensee or its related bodies corporate;

[52] ASX Corporate Governance Council*, Corporate Governance Principles and Recommendations with 2010 Amendments 2nd Edition* Page 17

[53] As discussed above, it is appropriate to distinguish between the conflicts facing shareholders seeking a return on investment with shareholders (member beneficiaries) operating in a not-for-profit environment or a 'non-beneficial shareholder'. The proposed definition uses the term shareholder, however it is suggested the distinction should be front of mind.

2. is employed, or has previously been employed in an executive capacity by the RSE licensee or any of its related bodies corporate, and there has not been a period of at least three years between ceasing such employment and serving on the board;
3. has within the last three years been a principal of a material professional adviser or a material consultant to the RSE licensee or any of its related bodies corporate, or an employee materially associated with the service provided;
4. is employed in an executive capacity and/or is an officer of an employer representative group or employee representative group which is a shareholder of the RSE licensee, or which under the Trust Deed may appoint directors to the board of the RSE licensee, and there has not been a period of at least three years between ceasing such employment and serving on the board;
5. is a sponsor, or an employee or an officer of a sponsor, that is a substantial shareholder of the RSE licensee;[54]
6. is a material supplier or customer of the RSE licensee or any of its related bodies corporate, or an officer of or otherwise associated directly or indirectly with a material supplier or customer;
7. has a material contractual relationship with the RSE licensee or any of its related bodies corporate other than as a director.

Family ties and cross-directorships may be relevant in considering interests and relationships which may affect independence, and should be disclosed by directors to the board.

There is no material difference between the two definitions.

ISA also accepts other aspects of the ASX Corporate Governance policy regarding independents such as the requirement that the directors who are considered independent by the board be identified as such in the annual governance statement stating reasons why the board considers the director to be independent notwithstanding the existence of relationships listed in Box 2.1. Materiality thresholds should be considered by the board. [55] ISA adopts these principles and suggested that these matters are best dealt with as part of APRA reporting requirements and should be available to the public.

3. What is an appropriate proportion of independent directors for superannuation boards?

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?

The ASX guidelines operate on a 'if not way not?' basis with disclosure about non-compliance required to be detailed in annual reporting. This process is appropriate for listed companies. Governance improvements should as a matter of principle articulate governance outcomes sought to be achieved rather than imposing rigid rules.

The benefits and diversity of the not-for-profit representative trustee system should be recognised and accommodated, it is our view that this is best achieved by providing boards with guidance and allowing them the flexibility to determine the optimal composition of their board and the role of an independent chair with the best interests of beneficiaries driving the decision making process.

It would not be appropriate to impose an inflexible set proportion of independent directors that must sit upon superannuation boards. There is no evidence that doing so would improve governance or outcomes

[54] An employee or officer of a sponsor may be eligible to be appointed as an independent director depending on the materiality of the sponsor's business or other relationship with the RSE licensee.
[55] ASX Corporate Governance Principles Page 16.

to members. It is suggested that a rigid approach will reduce governance diversity and could result in homogeneous 'group think' within the board referred to by Professor Wheeler.[56]

Some boards will be of the view that a board composition of up to one third independent directors can add value, other boards, after considering the matter, may come to the conclusion that a one third requirement would have a negative impact as it would restrict the ability of the board to include representation from key sections of the fund's demographic.

It is not unexpected that there will be a variety of views within and between boards, the key is what process is adopted to ensure the views of boards on their composition, when converted to decisions, are both reasonable and can be considered decisions that fulfil the trustee's duty to act in the best interests of beneficiaries?

2.13 Positive obligation on boards to consider role of independents

It is suggested that it is appropriate that there be a positive obligation on boards to establish and undertake a formal process that would require a board to consider their composition, including whether it is in the members' best interests to have additional independent representation at the board and chair level up to a level of one third independent director representation.

This change is a natural extension of the considerations being made by boards and is consistent with the obligations in superannuation prudential standard Governance 510. At paragraph 11 of the standard the board is required to ensure that the directors and the senior management of the RSE licensee, collectively, have the range of skills needed for the effective and prudent operation of the RSE licensee's business operations. Paragraph 11 requires an annual assessment of the performance of the board and its individual directors and paragraph 20 imposes an obligation on the board to renew itself so that it remains open to independent thinking.

The obligation on a board to consider its composition could be implemented via a variation to SPS 510 that would impose a positive obligation on the board to actively consider the possible role and number of independents[57], including an independent chair, on an annual basis. In doing so it is suggested that the board be required to consider the appropriateness of up to one third[58] of the board being appointed as independents as per the ASX guideline definition of independent director.

This process would readily interface with the existing obligations on a board to consider the collective skills held by the board and the general board efficiency and dynamics within the board. All considerations by the board would be appropriately recorded and would be made available to APRA on request. It may also be appropriate in the interests of disclosure and transparency, that funds be required as part of their annual reporting process to members to disclose what key board composition issues were considered and include a brief explanation of the outcome.

This process differs slightly from the 'if not why not' approach as it is consistent with the prudential approach taken in relevant standards which require boards to establish, implement and regularly review a decision making process for consideration of key issues, with the requirement that member's best interests

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[56] Wheeler, Op cit

[57] One consideration by boards regarding the number of independents on a board may be cost and the impact on member returns. The anecdotal evidence is that independent board members are on average, paid more.

[58] It is recognized that the Cooper Review Panel recommended the replacement of the equal representation rule with a one third independent requirement. Attachment B further explores this recommendation and is critical of the reasoning behind the recommendation. It is further acknowledged that prior to the recent federal election the Government indicated its support for the implementation of a one third independent director arrangement.

are front of mind[59]. In the event that APRA requires an explanation or further information from the fund regarding its governance arrangements, it can do so.

The above proposal imposes a clear obligation of boards whilst allowing for sufficient flexibility to ensure boards are best equipped to meet their obligations to members.

Where a board decides to facilitate the introduction of independent directors, the up to one third independent director composition introduces a significant change whilst allowing the clear benefits of the representative trustee system to be maintained.

These changes will only be effective if there be high levels of transparency and disclosure.

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

A proper interpretation of the existing prudential obligations upon RSE licensees would include a process for the nomination and appointment of board members. SPS 510 requires the board to have a formal charter that sets out the roles and responsibilities of the board, this would ordinarily include a nomination and or assessment committee. The processes for the appointment of independent directors vary between boards and will be dictated by the terms of a fund's trust deed.

Provided funds have a reasonable process which ensures all relevant matters are adequately considered the appointment process should be left to each board to determine. A principles based approach regarding appointment process provides flexibility to accommodate the different legal and structural arrangements that apply to funds.

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

Guidelines for the appointment of independent directors should be drafted on a principles based approach. ISA considers that imposing a rigid process across all boards may impose real practical, legal and other problems upon licences. Not least of which is the fact that the trust deeds of many funds will provide certain and varying appointment rights to various sponsoring organisations often with independent appointments determined to be the responsibility of the board.

It would not be a practical or desirable result to impose a rigid system which could unduly restrict the appointment of individuals who in the opinion of sponsoring organisations can add value to the board.

It should be left to the individual licensees to determine what they believe is the best process that would ensure a skilled, representative and functioning board. Whilst some licensees may be in a position to adopt a common appointment process and believe it desirable to do so, others may encounter legal and practical constraints or form the view that a well-balanced board is best achieved through multiple appointment processes.

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

A publically funded compulsory savings system should properly be the subject of clear and extensive disclosure requirements on matters that could materially affect beneficiaries. Only through adequate disclosure can conflicts be adequately dealt with and as equally important, be seen to be dealt with.

At Attachment A, ISA details its Governance and Disclosure policy. The policy includes best practice disclosure requirements and includes a requirement that:

- All trustee boards be required to disclose:
    - Identity of directors, their backgrounds and qualifications, and their attendance at board and committee meetings.

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[59] Other relevant matters will be the requirements within the trust deed as it relates to certain voting procedures. Where a 2/3rd rule applies for voting on key issues that are likely to have a material impact on members, the number of independents that would have a significant influence on the board will be significantly less.

    - Remuneration of directors, and key executive and highest paid employees, as appropriate, using listed company methodology.
- All RSE licensees should disclose fee and other significant information regarding each material professional and financial service provider it retains.
- Material professional and financial service providers should disclose their revenues from superannuation.
- All related party transactions should be disclosed and conducted on commercial 'arms-length' terms;
- Portfolio holdings should be fully and periodically disclosed to promote public accountability.
- Disclosure should be provided regarding proxy voting policies in respect of portfolio securities and how votes were cast.
- Environmental and social reporting should be consistent with listed company requirements, supplemented with industry-agreed disclosures targeted toward investment activities, including whether the entity is a signatory of the United Nations-backed Principles for Responsible Investment Initiative (PRI) and its participation in primary offerings and nation building in Australia.

Recognising that transparency is in members' interests, not-for-profit funds, and industry funds in particular, have led the way in providing detailed disclosure on the governance and operation of funds, beyond the level required in the prudential standards. Public disclosures include information about trustee directors including biographical reports, other positions held, remuneration, and meeting attendance. Increasingly disclosure is extending to executive information, including remuneration, service providers and significant portfolio holdings.

For the big retail funds, disclosure is generally limited to the minimum required by the prudential standards. There appears to be little distinction between the governance and operation of their superannuation entity, and that of the broader financial group. Often parent company employees are trustee directors of the retail fund and in some cases they are remunerated by the parent company. Further, until recently, there has been little information made publically available to members regarding trustee governance and operation of the fund. Within the last eighteen months some funds have released details including the names of trustees, and some biographical information; however no remuneration is disclosed by the major retail funds.[60]

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

As mentioned earlier, APRA's prudential standard Governance 510 imposes an obligation on funds to have in place a formal renewal process so that the board remains open to new ideas. There is a requirement that boards consider ".. whether directors have served on a board for a period that could, or could reasonably be perceived to, materially interfere with their ability to act in the best interests of beneficiaries. The policy must include the process for appointing and removing directors, including factors that will determine when an existing director will be reappointed."[61]

The new APRA prudential standard has been adopted after industry consultation and is flexible enough to allow boards to adopt renewal policies which ensure appropriate diversity, skills and experience of directors. If a maximum term was to be adopted an 'If not why not?' approach should be adopted.

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

Superannuation prudential standard 510 Governance requires board directors are subject to regular appraisals of their performance. This is appropriate. It is suggested that the trustees would not be meeting their fiduciary obligations if there was no process for the regular assessment of board performance

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[60] This is based on a periodic desktop study of the websites and annual reports (where public) of AMP Savings trust, BT Funds Management, Colonial First State Investments, The Universal Super Scheme and OnePath Custodians and related companies, and the member funds of the ISA network.
[61] SPS 510 paragraph 20.

collectively and the performance of individual members of boards. These policies often properly include board education policies.

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?

ISA supports a principles-based approach which articulates desired outcomes which relies upon a combination of industry codes and prudential standards. As mentioned earlier, the most appropriate vehicle for implementing governance changes will be dependent on the scope and nature of proposed changes. It is likely that the most appropriate vehicle for change would be changes to APRA prudential standards and/or prudential guidance.

APRA's describes its supervisory approach as one that:

> "is forward-looking, primarily risk-based, consultative, consistent and in line with international best practice. The approach also recognises that management and boards of supervised institutions are primarily responsible for financial soundness."[62]

Earlier we outlined the extensive governance changes made in recent times, including providing APRA with wide regulation making powers. The process of introducing change via APRA regulation has the advantage of including industry consultation which adds value to the process.

ISA considers that the enhanced powers available to APRA are more than sufficient to deal with governance inadequacies or potential inadequacies that it believes will impact members and the public interest.

ISA does propose legislative change to remove SIS Act restrictions on equal representation funds to allow the appointment of independent directors and to remove any restrictions on directors being a member of the fund. This will remove existing barriers to change.

The adoption of the ASX definition of independent could be either via a self-regulatory code or the amendment to the existing SPS 510 which already imposes certain governance considerations on RSE licensees. A voluntary approach to the adoption of the ASX Corporate Governance Guidelines has been strongly endorsed by Professor Swan.63

There is no evidence that the imposition of a governance structure upon the industry will do anything to improve governance efficacy or good financial performance.

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?

ISA proposes the implementation of an industry code by 1 July 2015 with transitional provisions over 3 years from 1 July 2015.

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[62] APRA; online publication; *Australian Prudential Regulation Authority: Protecting Australia's depositors, insurance policyholders and superannuation fund members*
http://www.apra.gov.au/AboutAPRA/Publications/Documents/APRA_CB_022012_ex_online.pdf

[63] *Does Board Independence Improve Firm Performance?* Outcome of a Quasi-Natural Experiment Fischer Marc-Oliver and Swan Peter L Op cit. In a recent interview Professor Swan's views were also backed by Professor Ian Ramsay, Professor of Corporate Governance at Melbourne University, See, *Shareholders suffer as independent directors pay fat cats*; Adam Creighton, The Australian, 28 August 2013 Subscription service accessed online 15/01/2014
http://www.theaustralian.com.au/business/companies/shareholders-suffer-as-independent-directors-pay-fat-cats/story-fn91v9q3-1226705307903#mm-premium

It would be appropriate to grandfather arrangements applying to existing directors whilst recognising the existing prudential obligations on funds to consider board renewal, skills and composition issues.

3. Part 3: Enhanced transparency

3.1 Product dashboard

The intention of the product dashboard is to provide a concise means of direct comparison of accumulation superannuation products – for consumers, employers and analysts. For this reason, the product dashboard should include the same standardised information for all such products. There is no need to carve-out classes of products. Exemptions should be made by way of application to the regulator on a case-by-case basis.

However, the market for accumulation superannuation products is complex. There are many providers in the market and most providers offer multiple investment options to members. Many major providers also offer similar or identical options via different channels at different prices.

Another important feature of the market is that investment options offered side-by-side by funds actually represent a very different service. For example, a number of major funds offer some combination of: (1) 'pre-mixed' options (diversified, multi-asset class options including 'MySuper' options) for which the asset allocation and asset selection is provided by the trustee; (2) single asset class options (such as 'Australian equities' options) for which the asset selection only is provided by the trustee; and (3) options in which the member directly makes their own selection of individual assets and/or managed funds. In the last category, the trustee is providing the mechanism to make a selection and a list of assets or funds to choose from.

The complex range of products available means that, in addition to the standardised information required for MySuper products, a supplementary dashboard should be developed for choice products. The implication of this approach is that all investment options or products be at least described in consistent terms, allowing direct comparison of price, expected net returns, actual historical net returns and expected volatility.

3.1.1 MySuper product dashboard

The MySuper product dashboard has already been the subject of extensive industry consultation. The only issue that requires further consideration in relation to the MySuper product dashboard is the risk measure. The current risk measure is a measure of short-term volatility. To this should be added a measure of long-term risk that provides an indication of the likelihood of failing to meet a return target over a substantial – e.g. 10 to 20 year – time-frame.

The consultation paper raises the question of a liquidity measure. Liquidity is an important aspect of superannuation fund management; however, there is no requirement for a quantitative measure of liquidity of any financial institution in any jurisdiction, and it would not be at all constructive on the product dashboard. The Government will note that a quantitative measure of liquidity is not required for banks, even though the Government itself guarantees bank liquidity.

Superannuation fund members have the right to change funds and change investment option, so liquidity must be carefully managed. Funds must, therefore, have a liquidity management plan that models cash-flow based on member decisions under both standard and stressed conditions, and manage asset allocations accordingly so that all potential liquidity demands may be met and no members disadvantaged in meeting those demands.

As has been recognised recently by the RBA[64], superannuation funds provide an asset maturity transformation role much like that of the banks, which is positive because investment in assets of significant duration provides benefit for the economy and savers. Nonetheless, bank liquidity has to be

[64] Debelle, G. (2013) *Remarks on Liquidity*, RBA. http://www.rba.gov.au/speeches/2013/sp-ag-171213.html

carefully managed. To this end, APRA has recently launched a new Prudential Practice Guide for banks on this issue: *APG 210 – Liquidity*. The principles embodied in this guide, including modelling of member customer behaviour (note quote below), could usefully be applied to superannuation fund liquidity management.

> In forecasting retail deposits, an ADI might also consider factors that influence the 'stickiness' of those retail deposits — such as size, interest-rate sensitivity and the nature of the deposit channel, e.g. direct, internet or broker.[65]

We do not believe that a measure of liquidity should be included in the choice or MySuper product dashboards. ISA concurs with the observations made on page 20 of the discussion paper that there is already a requirement for trustees to meet a 30 day portability requirement and that a liquidity measure could adversely affect members by making them more risk adverse and discourage trustees from investing in illiquid assets such as infrastructure. We would go further and argue that the suggested outcomes would be extremely likely.

In particular, the publication of a simplistic quantitative measure of liquidity based only on asset allocation could have adverse consequences. Some adverse consequences include (i) misleading members and potential members about the liquidity of the fund and their interest in the fund, (ii) encouraging socially undesirable behaviour by members (from all members seeking to withdrawing at the same time during asset allocation changes driven by pro-cyclical price movements, to some members seeking to engage in "market timing" of withdrawals), and (iii) potentially discouraging socially-advantageous investment in illiquid assets.

The Government should be well-aware of Pillar 3 disclosure for liquidity in respect of banking institutions. We do not necessarily endorse these disclosures, particularly for application to superannuation funds, even though there are similarities between the factors relevant to liquidity management of banks and of superannuation funds. Nonetheless, we note that Pillar 3 disclosures were developed with the risks of simplistic liquidity disclosures in mind, and wish to draw the Government's attention to the stark differences in sophistication between Pillar 3 disclosures and the superannuation liquidity disclosure proposals suggested to date.

3.1.2 Extra product dashboard panel for Choice products

Choice options may be available side-by-side with MySuper options within the same fund, but may have investment objectives that are different from fully diversified MySuper options. As such, it may be appropriate that additional information is required that is particularly relevant to that type of option.

We would expect that Government will receive submissions on what elements would be necessary to effectively describe and compare various Choice products in this and subsequent rounds of consultations. One example is that for single-asset class investment options an additional benchmark relevant to that asset class (such as an Australian equities index for an Australian equities investment option) would be useful additional information.

In terms of the measurement of returns on Choice products, detailed information on returns will be available via APRA's new fund level reporting. Consumers or analysts interested in gross returns, net investment returns, or detailed cost information will have that resource available to them. For the product dashboard – the most concise presentation of product information – ISA believes strongly that net returns is the appropriate formulation because it is the proportion of returns to which the member is actually entitled. Allowing additional formulations as well would potentially be confusing, without adding to direct comparability.

[65] APRA (2014), *APG 210 – Liquidity*, Prudential Practice Guides, APRA.
http://www.apra.gov.au/adi/PrudentialFramework/Documents/Prudential-Practice-Guide-APG-210-liquidity-%28January-2014%29.pdf

3.2 Portfolio holdings disclosure (PHD)

ISA supports full transparency in superannuation and supports the introduction of portfolio holdings disclosure. Funds are receiving contributions, paying and receiving rollovers and paying benefits on a daily basis, and asset holdings are effectively priced on a daily basis to facilitate those transactions. It is therefore necessary that trustees, or their service providers have complete lists of assets, and it is not unreasonable to require trustees to access those lists and consolidate them periodically for online publishing.

There are a number of implementation issues that need to be addressed in time. These include development of a consistent and exhaustive dictionary of securities, management of commercial in confidence issues of fund managers, development of systems and processes for fund managers, custodians and funds. It is likely that moving the implementation date to 1 July 2015 would assist with resolution of these issues.

Table 2 Choice Product Dashboard

Part 3A. Choice product dashboard	
13. Should a choice product dashboard present the same information, in the same format, as a MySuper product dashboard?	For direct comparability, the choice product should have same information in the same format. Additional information may also be required, such as an industry benchmark related specifically to that option.
Net investment return versus net return	
14. Is it appropriate to use a single benchmark (CPI plus percentage return) for all choice product return targets?	For direct comparability, the choice product should use a single benchmark. An additional benchmark related specifically to that type of option may also be beneficial.
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:	A single presentation of returns is appropriate for the product dashboard. The appropriate measure is the actual consumer experience i.e. the impact on the member's account balance. More detailed product information allowing other returns formulations will be available in the APRA fund level reporting.
▪ If including an additional measure for a product's investment return would add unnecessary complexity.	It would add unnecessary complexity, and likely cause confusion.
▪ 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.	There should be single common reporting requirement for both products and net return is the most appropriate measure.

Part 3A. Choice 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.	A single time horizon would aid with direct comparability. Multiple time horizons will result in an opaque and potentially confusing level of transparency.
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:	The dashboard for both MySuper and choice products should include both a short-term and long-term risk measure.
▪ Is the SRM model the best measure of short-term investment risk?	No, it only measures short-term volatility and does not consider the size of the (adverse or positive) event.
▪ What would be the most suitable measure of long-term risk to include on the product dashboard?	The measure could provide an estimate of the likelihood of meeting a given returns target (e.g. CPI + 3.5%) over 10 or 20 years.
▪ 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)?	Yes.
▪ Would including an additional risk measure add unnecessary complexity to the product dashboard?	It adds useful information that justifies the additional complexity.
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.	The dashboard should apply to all accumulation superannuation products. Relief could be offered at the discretion of the regulator on a case-by-case exception basis.
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?	No. Prudential management of liquidity risks in superannuation should be managed in a manner consistent with the principles applied in banking regulation (see APG 210, January 2014). Publication of a simplistic quantified liquidity measure would not be useful to the member, and may adversely impact asset allocation and returns.
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?	We do not believe it is in the public interest to delay the implementation of the introduction of the choice dashboard. Consumers should be in a position to compare choice products and compare choice products with MySuper products.
Part 3B. Portfolio holdings disclosure	
Presentation of portfolio holdings	

Part 3A. Choice product dashboard	
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:	ISA supports the proposal to provide detailed portfolio holdings disclosure.
▪ 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)?	The proposal is only useful if holdings are consolidated at the trustee level.
• 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.	The member or consumer experience is not enhanced by the additional reporting of collective investment vehicles. For example Pooled Superannuation Trusts (PSTs) and Wholesale Unit Trusts (WUTs) are both regulated entities which operate exclusively in the wholesale market. Imposing additional reporting costs will ultimately reduce member returns without adding additional consumer information or protections.
• Should portfolio holdings disclosure be limited to the information required to be provided to APRA under *Reporting Standard SRS 532.0 Investment Exposure Concentrations*?	No.
21. What would be the compliance costs associated with each of these models for portfolio holdings disclosure?	No comment.
22. Should portfolio holdings information be presented on an entity level or at a product (investment option) level?	The entity level is a significant first step. Option level disclosure could be considered subsequently.
Materiality threshold	
23. Is a materiality threshold an appropriate feature of portfolio holdings disclosure?	No comment.
24. What is the impact of a materiality threshold on systemic transparency in superannuation fund asset allocation?	No comment.
25. What would be the most appropriate way to implement a materiality threshold?	No comment.
Implementation issues	
26. 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?	It is recognised that a delay may be necessary given the range of parties involved in implementing such a requirement.

4. Part 4: Enhancing Competition in the Default Superannuation Market

Superannuation is not simply another financial product; it is a critically important component of Australia's unique retirement system, notwithstanding that the implementation often is left to commercial parties. As a public policy, supported by a special legal regime, regulatory oversight and tax concessions, the social objectives of superannuation must always remain prioritised above individual and private interests. At the top of any list of social objectives for superannuation, must be that the system, to the greatest extent possible, results in broadly experienced improvement to retirement outcomes.

There is imperfect competition in the superannuation market and strong default fund arrangements are required to protect the interests of the majority of employees who do not exercise choice.

It is recognised that there is a significant investment of public monies into Australia's superannuation system via the concessional tax treatment afforded to superannuation. The processes by which default funds within awards are selected is a matter of interest to all Australians.

The system for the selection of default funds should be transparent and competitive and ensure that the only most appropriate funds with better than average long-term net returns should be named in modern awards. The representative trustee not-for-profit default funds currently found in modern awards have outperformed those not named and any system change which results in the naming of inappropriate and under-performing funds will be a public policy failure which will harm beneficiaries and impose additional cost on the public taxpayer.

Modern awards apply to the most vulnerable workers in the economy; those without the qualifications, skills and bargaining power to achieve pay and conditions above basic socially accepted minimum levels. It is vital that the system ensure that compulsory superannuation contributions are made to an appropriate fund. With the origins of the compulsory superannuation system being found in the industrial relations environment, the Fair Work Commission (FWC) is ideally placed to consider facts and arguments from various interested parties related to workplace conditions, including default superannuation arrangements.

A structure for the selection of default funds that did not involve the FWC would result in minimum wage employees and their employers being unrepresented in this decision making process. This is particularly inappropriate as the employees will bear the long-term costs flowing from the selection of a poorly performing or otherwise inappropriate default fund. This would represent a fundamental misalignment of incentives and could not be relied on to deliver efficient outcomes for workers.

4.1 Rates of Return of funds named in awards

Earlier in these submissions we show that, at the fund level, not-for-profit representative trustee funds significantly outperform for-profit non-representative funds.

Table 3 below shows, at the aggregate level, the outperformance of not-for-profit representative funds over for-profit non-representative funds over 1, 3, 5, 7 and 10 years based on rate of return.

Table 3 – APRA average rate of return by fund classification, to 30 June 2013

	1 year	3 year	5 year	7 year	10 year
All entities	13.7	7.2	3.5	3.2	6.0
Corporate	12.3	7.2	4.4	3.8	6.5
Industry	14.4	8.0	3.8	4.0	6.7
Public Sector	14.2	8.1	4.0	4.1	7.0
Retail	13.1	6.2	2.9	2.3	4.9

Source: APRA (2014) Annual Superannuation Bulletin ; APRA (2007) 10 Years of Superannuation Data Collection 1996-2006, Insight Volume Two

> While the superannuation industry acknowledges that past performance is not necessarily an indicator of future performance, following APRA's recent data release, Chant West director Warren Chant commented: "There's no question that the industry funds have historically been better performers. And we don't see that really changing… If anything, the difference in performance will probably widen a bit because the retail funds have introduced quite a bit of indexing to get to their [new] price points."[66]

Table 4 is an analysis[67] of the performance of 51 funds named in modern awards and mirrors the general industry outperformance data between for-profit and not-for-profit funds shown in Table 3. Both not-for-profit and for-profit funds selected as default funds in modern awards have on average outperformed the industry and the average returns for their industry sector equivalent.

Table 4 – Comparison median rolling rate of return for the default funds

	1 year	3 year	5 year	7 year	10 year
Not-for-profit	15.40	8.19	3.97	4.30	6.96
For-profit	13.82	7.14	2.58	2.43	5.69

Source: SuperRatings fund reported returns to June 2013.

At the fund classification level, the outperformance of default funds named in modern awards is clear evidence that the existing process has served workers well. The analysis shows that funds named in default awards have higher rates of return than at the aggregate level. Even the lowest performing category of retail funds outperformed the (aggregate) retail fund average when named in a modern award (Table 5).

Table 5 – Default funds named in modern awards to 30 June 2013*

	1 year	3 year	5 year	7 year	10 year
Industry	15.35	8.21	3.95	4.22	6.98
Retail	14.43	7.08	2.69	2.43	5.50
Public Sector	13.39	8.06	4.51	4.37	6.85

Source: SuperRatings fund reported returns to June 2013.
**Sufficient comparable return data is not available for corporate funds named in modern awards.*

Some industry representatives have downplayed the importance of fund performance in the selection considerations applying to default funds. The taxpayer- funded compulsory superannuation system is an integral part of Australia's retirement system. Its success is properly measured by the long-term retirement income provided to beneficiaries and the cost borne by all Australians when the system fails to maximise returns to beneficiaries.

A small difference in the fees paid to a MySuper default fund could mean tens of thousands of dollars less in retirement. It is improper and poor public policy to downplay the importance of net returns delivered to members.

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[66] Retail/industry performance gap set to widen – InvestorDaily*23/01/2013* , http://www.investordaily.com.au/34889-retail-industry-performance-gap-set-to-widen
[67] Sample includes 85 per cent of default funds named in modern awards. SuperRatings data and fund classification from APRA. Data on the rolling rates of return is based on SuperRatings 'default' product offerings database to 30 June 2013. Of the sample, less than 10 per cent did not record a default option in the SuperRatings database, with the balanced option assumed to be the default option. Of the sample, almost 77 per cent are industry funds; 13 per cent public sector funds; and 7 per cent retail funds. There was insufficient SuperRatings data to analyse returns from corporate sector funds.

ASIC's Moneysmart website blithely, but correctly, makes the statement that:

> "Choosing a super fund is a bit like dating. Pick the right fund and you'll be set for a long, happy and comfortable life when you retire. Set your sights on the wrong one and you're in for a world of pain."[68]

4.1.1 Persistence in superannuation fund returns

Tables 3, 4 and 5 demonstrate a performance differential between not-for-profit and for-profit funds and those selected as default funds in modern awards and those not over a significant time period. APRA researchers have found clear evidence of persistence in superannuation fund returns.[69]

ISA (then ISN), commissioned an analysis of the persistence of superannuation fund returns from Deloitte Access Economics in 2012[70]. The report, which is available at Attachment C, estimated persistence (low or high) is statistically significant with a 95 per cent confidence level. Allowing an employer to choose a MySuper product with a poor performance record is therefore likely to result in ongoing future poor performance. Conversely, adopting a system which only selects the best performing funds is likely to be supported by ongoing superior performance.

4.2 New competitive system

As of 1st January 2014 a new system for the selection of default funds has been introduced. This process is open, transparent and ensures that only those funds which are of a high standard are available to be selected as a default fund within modern awards.

The new system is consistent with recommendation 7.2 of the Productivity Commission's Final Report[71] based on the following principles:

- Best interests — there is an explicit focus on meeting the best interests of employees who derive their default superannuation product in accordance with a modern award.
- Contestability and competition — all default products have an equal opportunity to be assessed for listing in awards, and competition provides the incentive for the ongoing innovation, efficiency, performance and consumer focus of superannuation funds.
- Transparency — relevant information is made publicly available and potential conflicts of interest are declared.
- Procedural fairness — all parties have the right to put forward their case for consideration by an unbiased umpire.
- Minimum regulatory burden — each party involved incurs the minimum cost and inconvenience compatible with achieving the aims of the process.
- Market stability — the superannuation market is not destabilised.
- Consistency with other policies — the process aligns with other relevant policy directions, including the Stronger Super and Future of Financial Advice.
- Regular assessment — all default products must earn their listing in an award on a regular basis.

[68] AISIC's Moneysmart web site; https://www.moneysmart.gov.au/superannuation-and-retirement/how-super-works/choosing-a-super-fund
[69] APRA (2009), Response to Submissions, Fund level disclosure from APRA superannuation statistics collection.
[70] Deloitte Access Economics, Persistence in Superannuation Fund Returns, ISN, June 2012
[71] Ibid Recommendation 7.2 Page 23

The new system will improve transparency and competition as funds alter their MySuper product offerings to ensure they pass the quality filter applied by the expert panel found in section 156F of the Fair Work Act 2009.

It is expected that the Fair Work Commission will soon open applications from funds to be named on the Default Fund List produced by the Expert Panel appointed to undertake this task.

The key role of the expert panel is to assess applications against an established criterion found in section 156F of the Fair Work Act:

Section 156F *Fair Work Act 2009*

(a) the appropriateness of the MySuper product's long term investment return target and risk profile;
(b) the superannuation fund's expected ability to deliver on the MySuper product's long term investment return target, given its risk profile;
(c) the appropriateness of the fees and costs associated with the MySuper product, given:
 (i) its stated long term investment return target and risk profile; and
 (ii) the quality and timeliness of services provided;
(d) the net returns on contributions invested in the MySuper product;
(e) whether the superannuation fund's governance practices are consistent with meeting the best interests of members of the fund, including whether there are mechanisms in place to deal with conflict of interest;
(f) the appropriateness of any insurance offered in relation to the MySuper product;
(g) the quality of advice given to a member of the superannuation fund relating to the member's existing interest in the fund and products offered by the fund;
(h) the administrative efficiency of the superannuation fund;
(i) any other matters the FWC considers relevant.

The above criterion introduces the 'quality filter' recommended by the Productivity Commission.

The best interests of employees who are subject to modern awards is the primary driver of the process and is reflected in the matters the Expert Panel will consider when drawing up a default fund list The considerations reflect those issues that the Productivity Commission considered material quality filters to be applied when selecting a default fund for inclusion in a modern award. These considerations include long-term investment returns; risk profile; net returns; the funds governance practices; its insurance offering; the quality of intra-fund advice; the funds administration capabilities and any other relevant matters.

4.2.1 A Competitive, open and transparent process

Any fund offering an authorised MySuper product is entitled to apply to have their product or products listed on the Default Fund List.

The application of the filters by the expert panel and the ultimate selection of a default fund to be included in a modern award is an open and transparent process. With the exception of those matters that are deemed to be commercially sensitive, applications for inclusion on the default fund list and other submissions will be publically available. The process before the Fair Work Commission includes an express requirement that conflicts be declared and all hearings are open to the public.

4.2.2 Efficient process

The use of the existing infrastructure, personnel and expertise contained within the Fair Work Commission is appropriate as it is an efficient means by which a selection of high quality default funds can be made

available to employers. The process is linked to the four yearly award modernisation exercise. Inefficiencies and duplication would be introduced if the process for the naming of default funds in modern awards was undertaken by another body.

4.3 Employers

There have been persistent calls from sections of the superannuation industry to allow employers the 'freedom' to choose a default superannuation fund for their employees, an outcome it is argued, employers' desire. Work undertaken on behalf of the ATO showed[72] that the vast majority of employers are satisfied with the existing default fund arrangements and that allowing an employer to choose any MySuper default fund will not add to competition in the industry or reduce costs to employers and employees. The MySuper and other regulatory reforms affecting default superannuation funds, whilst a step forward, do not provide a homogeneous product. Significant differences in MySuper product offerings and costs remain and are expected to remain.[73]

It is submitted that the clear evidence is that with few exceptions, employers, particularly employers who rely upon modern awards, do not have a high engagement with issues relating to the superannuation of their employees. Where employers do consider choice of default fund the determinative considerations relate to those which impact the employer directly, such as cost to the employer and ease of interface with the product provider and in a small number of cases incentive received by the employer. Employers do not see superannuation as a priority for their business. Superannuation is considered by many employers, especially those with limited human resource and payroll resources, to be an inconvenience.

In 2010 the ATO released the results of the largest quantitative and qualitative survey of the attitudes of employers to superannuation released to date. The quantitative[74] and qualitative[75] research undertaken by Colmar Brunton Social Research on behalf of the ATO was released in early 2010.

At 3.1.3 of the qualitative survey the researchers report that:

> "Superannuation is not seen as being a particularly important aspect of running a business. For most it is just another compulsory bill and more compulsory administration. Relative to other aspects of running a business, superannuation payments and the associated administration are seen as things that "just have to be done". They are not considered to be important in their own right and are lumped in with similar obligations such as WorkCover and GST. Consequently employers spend very little time dealing with superannuation unless their role is specifically relevant to its administration. Most employ book-keepers or office managers to administer contributions to superannuation funds and so spend very little time themselves in relation to superannuation. Employers estimated that they would spend between an hour and 4 hours on superannuation in a typical 3 month period.
>
> *"In terms of importance, for me superannuation is right down the bottom...you've got to make money first." (Employer, less than 20 staff)*
>
> *"There are things that are more important and more fundamental." (Employer, less than 20 staff)*
>
> *"The only time it comes up is when a new employee comes in and does not use the company fund." (Employer, 20 or more staff)*[76]

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[72] Colmar Brunton Social Research prepared for Australian Taxation Office. *Investigating Superannuation: Quantative Investigation with Employers,* 20 January 2010

[73] See comments by Warren Chant on Page 40

[74] Colmar Brunton Social Research Ibid

[75] Colmar Brunton Social Research prepared for Australian Taxation Office. *Understanding Superannuation: Preliminary Report: Qualitative Investigation with Employers, Consumers and Industry*, 25 March 2010.

[76] Colmar Brunton qualitative survey results page 20.

The qualitative survey of over 1000 employers reflects the above perspective, with employers declaring they didn't have the skills, resources or time to make key decisions relating to superannuation on behalf of their employees.

4.3.1 Employers role in nominating a default fund

The impact of an employer changing a default fund is obviously more significant than the impact of an individual employee; especially if the employer is a large one.

The Colmar Brunton qualitative survey found that the majority of employers were adamant that it is not their role to provide superannuation advice or assistance to employees and that some employers were reluctant to even provide information regarding the company's default fund[77] as they considered this financial advice that could leave them susceptible to litigation. The quantitative survey found that 56 per cent of businesses ask a new employee to nominate their superannuation fund without mentioning the default fund that applies to the business. These findings are not surprising as the survey also found that most employers have only a basic understanding of the superannuation system which is compounded by the perception of frequent change to the system.[78]

Importantly, the survey found that the smaller the business, the less likely the business is to mention the default fund to employees. Most award reliant workplaces are small to medium sized businesses.[79]

The Council of Small Business Australia80 (COSBOA), in their submission to the Productivity Commission's inquiry into the process by which default funds are named in modern awards stated:

> "The employer is forced by this legislation to choose a default fund for employees who amongst other considerations do not have the capacity or training to choose their own fund. In effect the employer is advising their employees that the default fund is suitable for their use. A superannuation fund is made up of several financial products which in any other situation are highly regulated and require advice from a Financial Adviser trained to a minimum standard and licenced under the financial services act.
>
> Yet the employer is expected to choose a fund and assess its features and benefits for their employees who cannot choose themselves. COSBOA considers it very unproductive to foist such an obligation on a small employer who in reality is often a person with little more capability of making such a choice as their employees."[81]

When dealing with the requirement to consider insurance options within default funds, COSBOA recognised that there is different insurance coverage between default funds and there could be negative ramifications for both employers and employees should the default funds' insurance coverage prove to be inadequate.

> "A small business person should not be put in the position of trying to choose between the different insurance options within competing default funds for their employees. The repercussions if a tragedy happens and they are accused of getting this wrong could have significant effects on their health, self- esteem and personal business productivity."[82]

The Colmar Brunton survey found that most employers have only a basic understanding of superannuation issues[83] and that the majority of employers (66%) did not compare the relative performance of

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[77] Colmar Brunton qualitative survey page 20.
[78] Ibid Page 21.
[79] ABS Cat. No. 6310.0 Employee Earnings, Benefits and Trade Union Membership, August 2010.
[80] COSBOA describe themselves as "the country's peak body exclusively representing the interests of small businesses" http://www.cosboa.org.au/
[81] COSBOA submission to Productivity Commission, 4 March 2012, Page 5.
[82] Ibid Page 3.
[83] Colmar Brunton qualitative survey Page 21.

superannuation funds. Other reasons given for not comparing default fund performance was that the task was too time consuming (17%), the task was thought to belong to another (14%) or that the employer simply didn't care about the fund's performance (12%).[84]

The qualitative survey found:

> "Among some there is a perception that investing time and effort into reviewing superannuation fund performance and reconsidering default funds will only end up in lost time and productivity with no conceivable gain."[85]

It is suggested that it is highly likely that a during the current period of significant regulatory change regarding an employer's superannuation obligations, the general level of employer engagement and understanding of obligations will have reduced from the low level that existed at the time of the Colmar Brunton survey.

The compelling evidence is that employers do not have the skills or inclination to focus on returns to members and other factors which are likely to have a significant influence on the retirement incomes of employees.

The evidence is that where employers have had the option of choosing a workplace default fund, they have often done so on advice from an accountant or financial adviser.[86] Disturbingly the Colmar Brunton qualitative survey found that most employers after receiving advice of choice of fund did not make any of their own investigations.

4.3.2 What employers are looking for

Ease of use and convenience appears to be the overwhelming driving force for employers. Key industry super funds have confirmed that their in-house research or experience reflects the findings of the Colmar Brunton surveys.

4.3.3 Employer conflicts

Where employers have a number of competing default fund options; either a limited number of named funds within an award or an unlimited choice of funds, there is a potential for conflicts to arise. The business environment raises these potential conflicts with large banking corporations which businesses are reliant upon dominating the retail superannuation options.

Section 68A of the SIS Act prohibits the offering of inducements from a superannuation provider to an employer regarding the employer's choice of default fund. The Act prohibits conduct by fund trustees that amounts to offering goods and services to employers as an inducement to their employees becoming members of the fund, or refusing to supply goods and services, such as banking services, because employees have not agreed to become members.

The Colmar Brunton survey found that 13% of employers admitted to receiving a direct or indirect benefit from a superannuation provider.[87] This revelation is not surprising as many employers appear to be unaware that the SIS Act prohibits the receipt of inducements. What is surprising is that such a large number of employers have admitted to the practice, including some large employers.

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[84] Colmar Brunton quantative survey Page 68-70.
[85] Colmar Brunton qualitative survey Page 30-31.
[86] This is confirmed in COSBOA's submissions to the Productivity Commission (see footnote 81)
[87] Colmar Burton quantative survey Pages 55-57.

The Colmar Brunton qualitative survey found that:

> "Employers would be more inclined to consider changing their default superannuation fund if it was clear that membership of one fund would provide financial or resource benefit to the company."[88]

The evidence is that the banks (which operate the majority of retail superannuation products) offer financial discounts as inducements, to both individuals and businesses.

In the event that the Government removes protections surrounding the selection of default funds it would be necessary to introduce strong changes to prohibit 'third line forcing'. It should not be possible to 'package up' or 'bundle' a range of financial services, including default superannuation, when the benefit is obtained by one party and the cost of an inappropriate decision, borne by another.

27. 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?

As discussed above, we believe that the existing model does offer a fully transparent and contestable system. The process is open and the selection criteria clear and applies equally to all funds. The new system was introduced following a lengthy consultation process and is entirely consistent with the principles adopted by the Productivity Commission. The existing system operates within an established process and is cost effective.

28. 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?

The existing model is consistent with the system principles proposed by the Productivity Commission, in particular the Commission's recognition of the need for an additional quality filter beyond MySuper authorisation. The existing system is a practical manifestation of the Productivity Commission's proposals as it ensures all funds have access to the system; that the system remains within the Fair Work Commission and that there is a smaller appropriate sub-set of funds chosen from a wider group of MySuper products that have also been subject to a higher level quality filter.

At recommendation 8.4 the Productivity Commission held the view that the Expert Panel should identify 'a small subset of those listed products judged as best meeting the interests of the relevant employees'. The relevant part of the recommendation reads:

> "In addition, it is highly desirable that, where possible, the panel identify in each modern award a small subset of those products found suitable for listing that it judges best meet the interests of employees who derive their default superannuation product in accordance with that modern award. Identifying a small subset of products will assist employer choice and encourage competition."[89]

The Commission recognised that the identification of the award specific subset of funds found suitable for listing should be done so in a transparent manner using publically disclosed factors.

The Productivity Commission stated that:

> "Identifying a subset of products has several advantages:
>
> - It makes it easier for new employers to choose a default product.
> - It would be broadly consistent with the size of the lists currently in awards which appears to have been manageable for employers.

[88] Colmar Brunton qualitative survey Page 28.
[89] Productivity Commission Final Report Op cit Page 25

- It will drive competition between funds to achieve the status of being one of the subset when the subset of products is determined and reviewed and could lift standards throughout the industry."[90]

The Productivity Commission also recommended that the decisions of the panel not be the subject of appeal. This is a sensible recommendation which avoids litigation by financial product providers who may have a financial interest to pursue an appeal. However, the recommendation raised real issues of law. Appeals against decisions of the Full Bench or the Expert Panel are heard by the Federal or High Court in accordance with section 75(v) of the constitution. There is a real advantage to the orderly working of the system if the Full Bench deals with the final stage of the selection process.

The recent amendments to the Fair Work Act and the general existing provisions of the Act, combined with the established processes of the Fair Work Commission ensure that the process for the selection of default funds is open and transparent. Hearings are open to the public and other interested parties; transcript is taken and the rule of law and due process is applied. The Act requires the Commission to be informed of any conflicts of interest.

The existing system has introduced a second stage to the process that allows those parties that have standing in relation to the relevant award[91] to either make application or be heard by the Full Bench of the Commission regarding the variation of the relevant clauses in modern awards. In our view it is appropriate that this established process for the variation of awards, including the award modernisation process, continue. Superannuation payments have the character of deferred wages and the representations of employers (those who pay) and employees (those who receive) should be provided with a greater weight than the interests of financial product providers. Employer and employee organisations are entrusted with special rights under the Fair Work Act and in return certain obligations are imposed, including a requirement that the organisations be registered and operate in a manner that is consistent with the Act. Removing the rights of employer and employee organisations to deal with superannuation matters within the established system will undermine the consensus that superannuation arrangements should be operated in the best interests of the relevant employees.

The involvement of employee and employer representatives via the award modernisation process is an efficient process that will also ensure a more targeted and appropriate selection of funds aimed at an award dependant demographic.

4.3.4 Allowing employers to choose any MySuper Product as a default fund

The draft report of the Productivity Commission[92] floated the option that employers should be able to choose any MySuper product. After further consideration the Commission concluded that:

> ".. the Commission is not in a position to observe the quality of the products being offered by the market. Accordingly, the Commission is not currently able to be satisfied that the legislated MySuper authorisation process will operate as a sufficient filter to ensure the best interests of employees who derive their default superannuation product in accordance with modern awards would be adequately protected simply by those employees being placed in any MySuper product."[93]

The Commission then went on to explain why it no longer supported the proposal for employer discretion.

> "The Commission does not support this discretion provision. The Commission was unable to design an appropriate test that would not place an undue burden on employers, while at the same time

[90] Productivity Commission Final Report Op cit Pages 15-16
[91] Employer and employee representative organisations and employers and employees the subject of the award.
[92] Productivity Commission 2012, *Default superannuation funds in modern awards*, Draft Inquiry Report, June 2012
[93] Productivity Commission Final Report Op cit, Page 13

safeguarding the best interests of employees who derive the default superannuation product in accordance with modern awards."[94]

It has been suggested by some, that the Commission changed its position after comments from the Workplace Relations Minister. This view is not correct and is disrespectful to the Commission which on the facts and after careful consideration was not able to design a workable solution.

The Commission also came to the view that it was important that there be a periodic process that can facilitate the removal of "non-existent or demonstrably unsuitable products"[95] from modern awards. This acknowledges that there may be unsuitable (but authorised) MySuper products and an ongoing evaluation process is necessary.

After careful consideration and extensive consultation the Productivity Commission came to the strong opinion that it is in the best interests of both employers and employees that there be a process for the selection of default funds available to employers beyond mere MySuper authorisation. Employer submissions to the Productivity Commission were in overwhelming support of this position; the submissions of COSBOA referred to earlier in these submissions are testimony that the vast majority of Australian employers don't have the time, skills or inclination to select any MySuper product and need assistance. The existing system is intended to meet this need.

29. 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?

It is appropriate that the 'quality filter' continues to be applied by an Expert Panel within the FWC. There is no better placed organisation to apply the quality filter. To introduce another body into the process would introduce inefficiency into the system with no discernible benefit. The Productivity Commission accepted this and argued that the most efficient process would be one which ultilised the Fair Work Commission's resources and expertise via an extension of the Minimum Wage Panel process that allows for the appointment of part-time external experts to assist the Fair Work Commission in the exercise of its functions. At page 15 of its final report the Commission provided reasons why it recommended the process for the selection of default funds operate within the Fair Work Commission. These include:

- The desirability of all relevant parties being heard by one decision maker as part of one process;
- There are costs involved in the setting up of a new body96; and
- There are risks that the three 'regulators' (new body, APRA and Fair Work Commission) potentially overlapping.

The Expert Panel operates within the Fair Work Commission which is in the best position to determine matters related to awards. It is appropriate to link the determination of the award superannuation provisions with the general award review processes undertaken by the Commission, including the Full Bench. The Expert Panel will be a substantial body within the Commission, comprising three part-time superannuation/finance experts and three Fair Work Commissioner/Deputy or Vice Presidents and is overseen by the President of the Commission. It should be given a chance to demonstrate its ability to make impartial and informed decisions in the best interests of employers, employees and the public.

It would not be appropriate to ask APRA the regulator and body that provides MySuper authorisations to effectively rank the quality of the products it has authorised. The legislated criterion contained in s156F of the Fair Work Act is appropriate and contains matters that are best dealt with by the FWC.

[94] Ibid, Box 3, Page 3.
[95] Ibid Page 16
[96] The management of an ongoing Secretariat, secure records, IT, HR and administration systems would be required to accommodate a function that is intended to facilitate a regular but infrequent review of the superannuation provisions in modern awards.

30. 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.

We consider that this process would neither improve competition nor retirement benefits for members. This system would be confusing as (engaged) employers would need to assess two lists of potential default funds (i.e. in the award and in the 'high quality fund' list) and for indifferent/disengaged/uncertain employers, they would be able to choose a sub-par MySuper fund without consideration of the 'high performing fund' list.

If the employee's interests are considered paramount, it would be difficult, if not impossible, for there to be any reasonable justification for an employer to choose a sub-standard default fund for employees. Notwithstanding the legal protections available for an employer that selects a product authorised by the regulator.

It is suggested that if there is a further list of authorised high quality funds beyond those which have passed the quality filter, and the employer elects not to choose the higher quality fund to the economic loss of employees, litigation is not only possible, but likely. In such circumstances, where there is evidence that an employer has received or been offered a direct or indirect benefit from a MySuper product provider, litigation is not only likely but may also involve the product provider.

The Productivity Commission recognised that the creation of an additional 'high quality' list would instil competition between those seeking naming on the list. ISA agrees, however, there appears to be no utility in the use by employers of the second list of 'better funds' being voluntary. A better approach would be to ensure only 'high quality funds' pass the 'quality filter' via the application of the criterion found in s156F of the Fair Work Act.

Generally where there is competition, parties strive to win a prize. In this case the prize is placement on a list of quality default fund products that an employer must choose from, (in the absence of their employees exercising choice or a pertinent workplace agreement).

If the players in this open and transparent competition can't demonstrate to the umpire that their product is of sufficient quality, there appears to be no public policy grounds to support that product receiving compulsory superannuation payments.

The evidence is that employers need and/or desire assistance in the selection of default funds. Effectively having two lists that offer different quality funds will not assist employers will not simplify the default fund selection process for employers. Further, if the lower quality funds are selected, this will have an adverse impact on the retirement balances of employees and undermine the ambitions of the Australian retirement income system. The achievement of superannuation's public policy goals must be sensitive to the relevant facts and circumstances of the persons protected by modern awards. Modern awards interlace with industrial law to form the safety-net for Australia's most vulnerable workers. The workers protected by modern awards, axiomatically, lack the bargaining power and other characteristics to receive rewards for their labour in excess of socially accepted minimums, including superannuation entitlements. Allowing retirement incomes to be paid into sub-standard default funds should form no part of a safety net.

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

The Productivity Commission held the view that corporate products, including Tailored MySuper products "should be required to apply to the default superannuation panel for approval."97 If employee's best interests are to be the primary consideration this is appropriate.

The existing arrangements for dealing with corporate super are entirely consistent with the recommendations of the Productivity Commission. Promoters of Corporate MySuper products can address the 'quality filter' criterion in s156F in an application to be named on a list of 'Employer MySuper Products'. The relevant superannuation clause in an award will not name individual 'employer MySuper products' but rather facilitate the use of the fund by the corporate employer. This process was adopted after extensive consultation and is sensible and workable.

[97] Productivity Commission Final Report Op cit Page 16

Attachment A

ISA Governance and Disclosure Policy

Background

Industry Super Australia (ISA) is advocating significant changes to the disclosure protocols of the superannuation industry, which will improve accountability across all sectors of the industry and provide greater confidence in the superannuation system.

The role of superannuation in the economy and public policy

In addition to the important role it plays in securing retirement incomes for all Australians, superannuation is a critical part of the Australian economy. Superannuation not only helps the economy to grow, it is vital to the economic and demographic imperative of reducing the tax burden in the form of pension payments to an ageing population.

These goals are supported by public policy. This support includes compulsion and tax concessions. As a result, the public has a stake in the superannuation system. To ensure accountability to members and to the public, superannuation funds and other key participants in the system should have a level of governance and transparency that at least meets that of listed companies in relevant comparisons. ISN's proposals have four core recommendations.

1. Uniform disclosure requirements that apply system-wide, including material fund managers and other professional and financial service providers to superannuation funds;
2. All related party transactions should be disclosed and conducted on commercial 'arms-length' terms;
3. Superannuation fund trustee boards and directors should be committed to achieving outcomes that are in the best interests of the beneficiaries of their funds. Should the Australian Prudential Regulation Authority (APRA) identify concerns, the trustee should be required by APRA to consider the composition of its board, which may include appointing representative or non-associated directors; and
4. Disclosure standards that enhance accountability to the public interest.

Uniform disclosure expectations throughout the super system

It is recognised that many trustee offices across all sectors are often small and most of the material activities of the fund are outsourced. Equally, many entities (including related parties) exist mainly or solely to provide services to the super industry.

Therefore to achieve system-wide transparency for public accountability, improved disclosure and governance should not be limited to super funds but include all material service providers in the superannuation system, including fund managers. System-wide disclosures are necessary to ensure effectiveness; piecemeal or voluntary adherence will only distort competition.

Recommendations

1. In light of the different business models and corporate structures, disclosure outcomes across super funds and material service providers including fund managers and related parties must be uniform.
2. This includes disclosing the:
    a. Identity of directors, their backgrounds and qualifications, and their attendance at board and committee meetings.
    b. Remuneration of directors, and key executive and highest paid employees, as appropriate, using listed company methodology.
3. Super funds should disclose fee and other significant information regarding each material professional and financial service provider it retains.
4. Material professional and financial service providers should disclose their revenues from superannuation.

Related party transactions

There is evidence that some trustees using related parties are paying significantly higher fees, effectively almost doubling the median member's cost load. Retaining confidence in the superannuation system demands integrity in all related party transactions.

Recommendations

1. All related party transactions must be disclosed.
2. All related party transactions must be conducted on terms no more favourable to the related party than would be reasonable if the fund were dealing at arm's length.

Board composition

Recognising there are different governance models (related party, representative trustee and self-managed) governance arrangements should ensure the interests of members (the beneficiaries) are the priority and the governance model is transparent.

The long-term outperformance of the representative trustee model supports the inclusion of representative directors on trustee boards over related party directors or the mandatory inclusion of independent directors. There is no empirical evidence to support an alternative policy setting.

Recommendations

1. Superannuation fund trustee boards and directors should be committed to achieving outcomes that are in the best interests of the beneficiaries of their funds. If APRA identifies concerns, the trustee should be required by APRA to consider the composition of its board, which may include appointing representative or non-associated directors.
2. Trustee boards should advise shareholders or nominating organisations of the skills and experience sought in a director nomination. In relation to directors eligible for reappointment, the shareholder or nominating organisation should be provided with an assessment of their performance by the board.
3. Boards should be able to remove directors for cause and subject to procedural safeguards, including recognition of shareholder rights.
4. The superannuation industry should seek to achieve no less than 40% representation of each gender on boards, as recommended by the Australian Institute of Superannuation Trustees (AIST).
5. Trustee directors should be required to be members of a relevant professional organisation (including but not limited to superannuation organisations), and undertake ongoing training and development.
6. Directors should be appointed for renewable fixed terms.

Disclosures in the public interest

For members and the broader community to retain confidence in the superannuation system, disclosure should, in principle, at least meet the benchmarks for listed companies on relevant comparisons.

Recommendations

1. Portfolio holdings should be fully and periodically disclosed to promote public accountability, even though very few members would be expected to use the information.
2. Disclosure should be provided regarding proxy voting policies in respect of portfolio securities and how votes were cast.
3. Environmental and social reporting should be provided consistent with listed company requirements, supplemented with industry-agreed disclosures targeted toward investment activities, including whether the entity is a signatory of the United Nations-backed Principles for Responsible Investment Initiative (PRI) and its participation in primary offerings and nation building in Australia.

Implementation

ISN recognises that the above proposals must be implemented through standards that would apply to all participants in the superannuation industry at the same time. Disclosures are most useful when they enable comparisons, which is only possible if all participants furnish comparable information. In addition, ISN acknowledges that some of the proposed disclosures may include commercially sensitive information, and it may be unreasonable to publish that information if it was not required equally of all participants. Accordingly, a voluntary approach in which some superannuation fund trustees or service providers unilaterally make all of the proposed disclosures is neither expected nor recommended.

Attachment B

What the Cooper Review Proposed

The government's discussion paper refers to the findings of the Cooper Review Panel and whilst in opposition the government was a strong supporter of the adoption of a one third independent director rule for equal representation funds.

ISA recognises that a number of representative trustee funds have introduced independents, including up to one third of directors as independents onto their boards. These funds have done to as they believe in their particular circumstances value is added to the board. It is suggested that these changes have not been adopted in acceptance of the views expressed by the Cooper Review Panel .

Given the importance attached to the Cooper Review Panel's findings, there is merit is briefly reviewing the evidence put to the panel on the issue of the superannuation board governance structure.

Although it acknowledged that there was not systemic governance issues in the industry the Cooper Review panel recommended a range of governance enhancements. The vast majority of these were adopted by the government via the Stronger Super reforms. In particular changes to the SIS Act's section 52 covenants and the adoption of new prudential standards, these changes have been actively supported by ISA.

One change that was not adopted was the proposal to abandon the mandatory equal representation or policy committee system and its replacement with a requirement that one third of directors be independent.

It is suggested that the review panel's reasoning behind the proposed change was unconvincing. Associate Professor Dr Ronald B Davis of the University of British Columbia specialises in pension governance and law has criticised the review panel's approach. Dr Davis has noted that:

> "However, instead of investigating means of enhancing member representation, the Review opted to recommend that non-representative trustees be appointed based on the assertion that having independent directors was the best practice in corporate governance."
>
> "The Review ignored an important difference between corporations and industry superannuation. In corporate governance, the problem is that shareholders face severe collective action problems in monitoring and disciplining the directors and management through the ballot. In the industry funds, these collective action problems are reduced because representative union organizations have the resources and coordination necessary to protect plan members' interests in superannuation. To the extent that there is a concern that the union members' superannuation interests are significantly different from members outside the union, some alternative organization could have been considered before determining that they, and other members are better off with trustees who are completely divorced from them and their representative organizations.
>
> The Review offered no concrete, measurable goal that its proposal for a fundamental governance shift would achieve, opting instead for the assertion that an "outside perspective" was vital for the industry funds by providing an "objective assessment of issues". No illustrations of the failure of industry boards to objectively assess issues were offered, leaving one to wonder how this missing element had manifested itself in the 20 years prior to the Review. Indeed, the fact that industry superannuation funds have consistently out-performed retail funds over a long period of time ought to have raised the question: what is so fundamentally wrong with the governance structure that requires such a large structural change in response?"[98]

[98] Dr Ronald B Davis, *Reflections on Representation in Superannuation Governance*, University of British Columbia; http://www.clmr.unsw.edu.au/article/accountability/accountability-systems/reflections-representation-superannuation-governance

It is suggested that the Copper Review Panel did not undertake a detailed analysis of the representative trustee system; the panel's final recommendations bear only a passing relationship to the panel's terms of reference, consultation questions and submissions to the review. Only six of the 100 submissions considered changes to the composition of trustee boards with respect to the independence of its directors and only one submission dealt with the issue in any detail.

The PriceWaterhouseCoopers (PWC) submission was the only submission which considered in any detail a model of trustee board which was a significant transformation of the current representative model. PWC submitted that:

"consideration should be given to a 3/3/3 system whereby each trustee Board has a third of its directors being independent directors, thus helping to ensure that *Trustees that are owned by shareholders act independently of the shareholder in ensuring members interests are protected*."[99]

> The submission is made out of concern that a trustee may place the interests of shareholders (their owners) before the interests of members, a concern re-iterated in the Review's final report.[100] However, such a concern is not relevant to superannuation funds as their shareholders are their members. The risk of trustee directors acting with the interests of shareholders as primary can only exist in the retail sector in which the funds are sponsored by corporate entities, most commonly the major banks. The PWC submission is informed by research focussing on the European fund industry in which they argue that the interests of long term investors (including pension members) need to be protected against fund managers and employees and other stakeholders.[101] While they note that the research is not 'focussed on Australia' insufficient care has been taken in translating the term/concepts of 'independence' from the European context to the Australian superannuation system. In commenting on the Review's definition of trustee independence (s5.2.5), PWC recommend that "it is in the members best interest for Trustee Directors to be members of their fund"[102] (that is *not* 'independent' in relation to s5.2.5).

The reviews final report found that: "The equal representation model appears to impose rigidity into fund governance practices and reduce accountability, without contributing materially to the representation objective on which it was predicated."[103]

Surprisingly the panel when noting the maturity of the superannuation system questioned the legitimacy of the interest employers and employees have in the operation of funds.[104]

The report then expressed the view that the lack of direct election of representative trustees and the changed industrial relations climate undermine the representative credentials of representative trustees and leave significant groups unrepresented, in particular members who are pensioners and the growing ranks of post-retirement members. [105]

While consideration of the evolution and change in the super industry is important, the significance of this is the funds that have proved to be enduring and performed the best during this evolution are

---

[99] PriceWaterhouseCoopers, submission *Super System Review: Phase One*, 16 October 2009, p 12.
[100] "For example, the present system creates ambiguity and confusion for some trustee-directors as to whom their duty of loyalty is primarily owed: to the members of the fund or to the for-profit trustee company (and hence its owners and associated parties)", *Super System Review Final Report: Part Two - Recommendation Packages*, p 45.
[101] PriceWaterhouseCoopers and Caceis, 'Ideal Fund – Reengineering the Fund Value Proposition', June 2009.
[102] PWC go on to comment that ""Having a financial interest in the outcome of the fund can only help further encourage Directors to act in the members best interest. Also, as a matter of practicality, directors will receive directors fees with associated superannuation contributions which will need to be paid to a fund and it seems perverse to not allow that to be the fund of which they are director." p 13.
[103] Review in to the Governance, Efficiency, Structure and Operation of Australia's Superannuation System (the Cooper Review) Page 54
[104] Ibid Page 53.
[105] Ibid Page 53-54.

representative trustee funds, rather than being categorised as remnants of a past age it should be acknowledged that representative trustee funds are the best performing funds over the short, medium and most importantly long-term.

The Cooper Review Panel's recommendations for the introduction of one third independent directors appears to be based less on evidence of any actual inadequacies of the representative trustee system, but rather a views on the legitimacy of employer and union involvement in fund affairs. It is surprising that the panel's response to their opinion that the representative trustee system is not as democratic as they would wish was to introduce into the system independent trustees who are of course not elected.

Attachment C

Deloitte Access Economics

Persistence in Superannuation Fund Returns

June 2012

Deloitte Access Economics

Persistence in Superannuation Fund Returns

Industry Super Network

24 June 2012

Deloitte.

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24 June 2012

Dear Sacha:

Persistence in superannuation fund returns

Please find attached the revised version of our short report on the persistence of the returns of superannuation funds. This version takes into account your comments on the ordering of the presentation of the estimates of persistence and the discussion of raw and risk-adjusted returns.

Yours sincerely,

Andrew A. Weiss
Director
Deloitte Access Economics Pty Ltd

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Executive Summary

Deloitte Access Economics was engaged by the Industry Super Network to undertake an analysis of the persistence of super fund returns, including undertaking the necessary literature review on the estimation of the degree of persistence in superannuation fund returns, formulating a simple approach to the estimation of persistence in returns and calculating those estimates.

The analysis investigates persistence by asking whether being ranked in the highest, middle or lowest third of funds in the APRA performance data in 2004-2007 is correlated with the ranking in 2008-2011. The analysis finds such a correlation, which is evidence of persistence in returns. For all 172 multi-asset class funds with complete data in the APRA league table, the estimated persistence is statistically significant with a 95% confidence level. For the 91 funds with over $1 billion in assets, the result is significant at a 99% confidence level. Profit orientation of funds is a likely source of the estimated persistence.

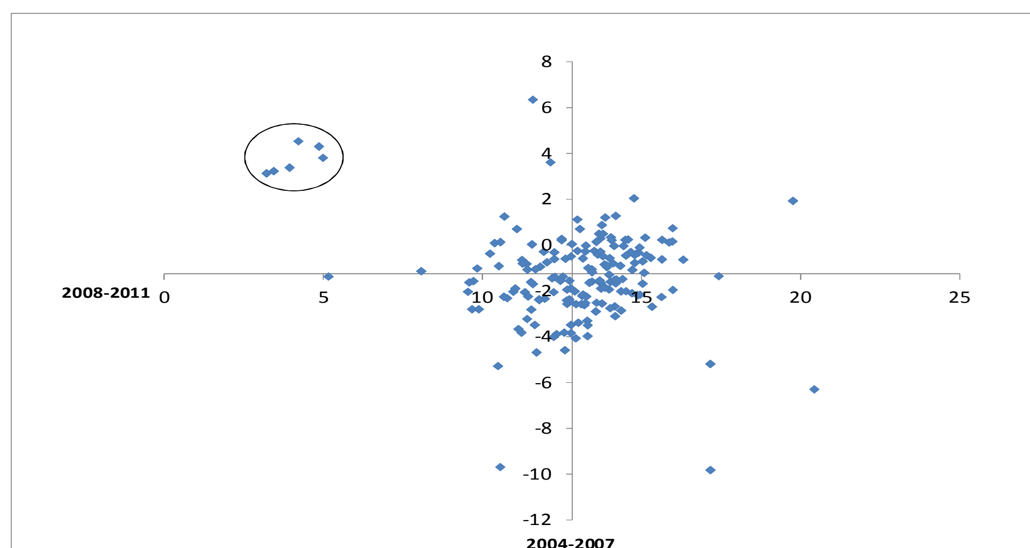
Estimates of persistence

Annual data on superannuation fund-level financial performance was obtained from the APRA web page. Data is available for eight years, 2004-2011, and the annual rate of return variable in the data is defined as net earnings after tax as a percentage of cash flow adjusted net assets.

Following APRA (2009), we apply a simple analysis of the predictability of superannuation funds returns – we compare performance based on raw returns across the two four-year periods 2004-2007 and 2008-2011.

Complete data is available for 178 funds and the following chart shows the average annual rates of return in the two periods (centred at the average returns across the funds).

Average annual rates of return, 2004-2007 versus 2008-2011



Source: Deloitte Access Economics, using APRA data.

All returns were positive in the first period, but a substantial number were negative in the second period. There are six funds with steady returns across the two four-year periods, and also within each four-year period. The funds appear to be a distinct sub-population within the 178 funds and we refer to them as 'low risk funds'. Some of the statistics below are calculated with and without those funds.

Standard measures of correlation may be influenced by the outliers – the six low risk funds as well as the other outliers. An alternative approach is to divide the funds into tertiles of returns (bottom 1/3, middle 1/3 and top 1/3), and compare rankings across the two periods. That gives the results in the following table.

Transition matrix for tertiles (2004-2007 to 2008-2011)

		2008-2011			
		T3	**T2**	**T1**	**Total**
	T3	25	21	12	58
2004-2007	**T2**	19	16	23	58
	T1	14	20	22	56
	total	58	57	57	172

Note: T1 = bottom 1/3 of funds, T2 = middle 1/3 of funds, T3 = top 1/3 of funds. Source: Deloitte Access Economics, using APRA data.

The larger values of the (T1, T1) and (T3, T3) elements and smaller values in the (T1, T3) and (T3, T1) elements suggest persistence of returns.

Kendall's τ_b (tau-b) correlation coefficient is a nonparametric measure of association based on ranks. The statistic can be used to test the hypothesis that the two quantities – the returns in the two periods in this case – are statistically independent. Independence means no persistence and non-zero correlation can be associated with persistence.

The following table shows the values of the statistic in the sample and a variety of splits of the data. In the first row, the Kendall τ_b correlation for the tertiles is given by 0.16 with a p-value of 0.02 – the statistic is significant at the 5% level. Row 2 shows the results for large funds, defined as those with net assets at the end of 2011 of over $1 billion (and which represent over 96% of the total assets). Across large funds, the τ_b correlation (0.38) is larger than for all funds and again suggests persistence in returns.

Kendall's τ_b statistics

		Kendall's τ_b	p-value	Number of funds
All funds				
1	tertiles, excl 6 low risk funds	0.16	0.02	172
Large funds (net assets > $1b)				
2	tertiles	0.38	0.00	91
For profit				
3	tertiles, excl 6 low risk funds	-0.16	0.20	60
Not for profit				
4	tertiles	0.03	0.70	112

Source: Deloitte Access Economics, using APRA data.

Rows 3 and 4 show the results by profit orientation (retail = 'for profit' and corporate /industry = 'not for profit'). The results use the tertiles defined from the entire sample. The negative τ_b correlation for the for profit funds (row 3) suggests negative persistence in returns, while the very small τ_b correlation for the not for profit funds indicates no persistence (row 4).

The overall results are not replicated when funds are first sorted by profit-orientation. This appears to be because the not for profit funds achieve higher average returns in both periods. When the two fund types are combined, the higher average returns among the not for profit funds translates into the persistence of returns.

Similar results are obtained using returns rather than the tertile rankings.

Survivorship bias is a potential issue for interpreting the results. But a comparison of the annual average rates of return for the 178 funds in the sample versus those not in the sample (and for which returns data is available) suggests that this is not the case.

Raw and risk-adjusted returns

Risk is important as investors are generally risk-averse. However, risk is hard to quantify and is often conflated with volatility in short-term returns, as in the Sharpe 'reward to variability ratio'.

The approach taken here utilises the geometric average of raw returns over multi-year periods. While not allowing for short-term risk, the advantages of this approach for the analysis of superannuation returns include that:

- It is not reliant on an industry benchmark, which, in the case of a multi-asset class investment such as superannuation, requires arbitrary assumptions to be made about benchmark asset allocation.
- The analysis is based on data which is available and comprehensible to consumers.

Alternative approaches involving the calculation of risk-adjusted returns are discussed in Section 3.

Deloitte Access Economics

24 June 2012

1 Introduction

Deloitte Access Economics was engaged by the Industry Super Network to undertake an analysis of the persistence of super fund returns, including:

- Undertaking the necessary literature review on the estimation of the degree of persistence in superannuation fund returns.
- Formulating an approach to the estimation of persistence in returns. That approach takes into account, *inter alia*:
  - The statistical treatment of the data
  - The treatment of outliers
  - The use of raw returns versus risk-adjusted returns
  - The treatment of survivorship bias

Section 2 of the report presents the estimates of persistence. Section 3 uses a selected review of the literature to give background and context, focussing on the use of raw and risk-adjusted returns.

2 Estimates of persistence

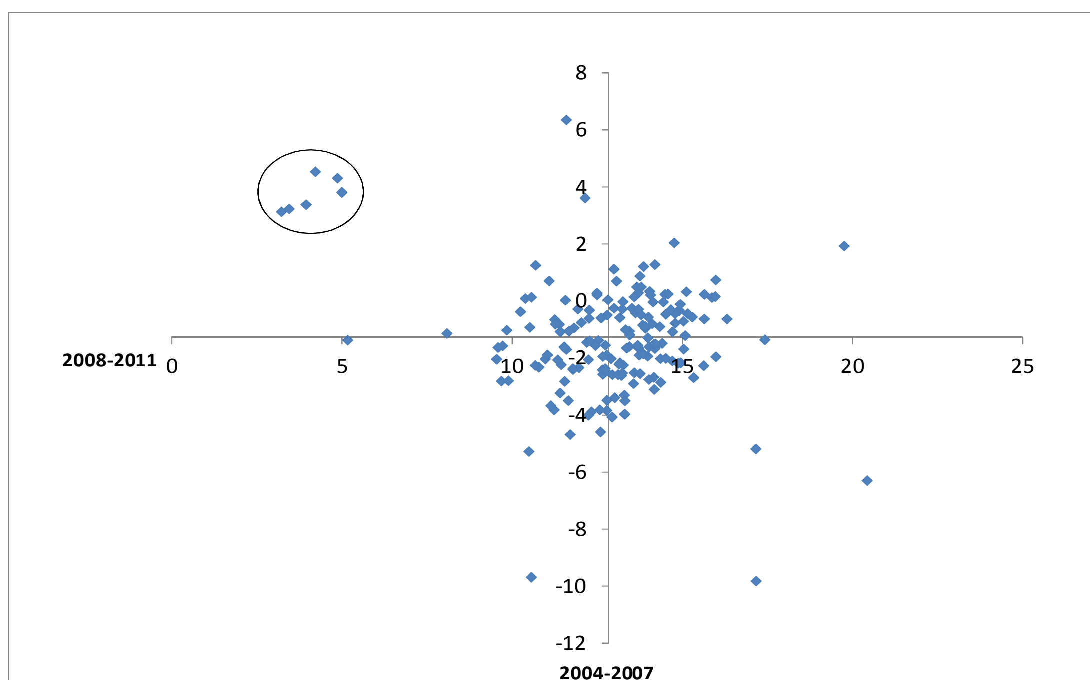
Annual data on superannuation fund-level financial performance was obtained from the APRA web page. Data is available for eight years, 2004-2011, and the rate of return variable in the data is defined as

$$\text{ROR} = \frac{\text{Net earning after tax}}{\text{Cash flow adjusted net assets}}$$

Following APRA (2009), we apply a simple analysis of the predictability of superannuation funds returns – we compare performance based on raw returns across the two four-year periods 2004-2007 and 2008-2011. Section 3 of the report discusses the use of raw and risk-adjusted returns.

Complete data is available for 178 funds (excluding eligible rollover funds), and Figure 2.1 plots the rates of return in the two periods (centred at the average returns across the funds). Multi-year returns are calculated using geometric means. All returns were positive in the first period, but a substantial number were negative in the second period.

Figure 2.1: Average annual rates of return, 2004-2007 versus 2008-2011



Source: Deloitte Access Economics, using APRA data.

There are six funds with steady returns across the two four-year periods, and also within each four-year period.[1] The funds appear to be a distinct sub-population within the 178

[1] The funds are Newcastle Permanent Superannuation Plan, Macquarie ADF Superannuation Fund, Challenger Retirement Fund, Greater Rollover and Allocated Pension Fund, BT Superannuation Savings Fund and The State Bank Supersafe Approved Deposit Fund. The standard deviations of their returns across the eight years are very

funds and we refer to them a 'low risk funds'. Some of the statistics below are calculated with and without those funds.

Standard measures of correlation using the data in Figure 2.1 may be influenced by the outliers, the six low risk funds as well as the other outliers.

An alternative approach is to divide the funds into tertiles of returns (bottom 1/3, middle 1/3 and top 1/3), and compare rankings across the two periods. That gives the results in Table 2.2. For example, the 12 in the (T3, T1) element means that 12 funds were in the top 1/3 of returns in 2004-2007 and then were in the bottom 1/3 of funds in 2008-2011.

Table 2.2: Transition matrix for tertiles (2004-2007 to 2008-2011)

		2008-2011			
		T3	**T2**	**T1**	**Total**
	T3	25	21	12	58
2004-2007	**T2**	19	16	23	58
	T1	14	20	22	56
	Total	58	57	57	172

Note: T1 = bottom 1/3 of funds, T2 = middle 1/3 of funds, T3 = top 1/3 of funds. Source: Deloitte Access Economics, using APRA data.

The larger values of the (T1, T1) and (T3, T3) elements and smaller values in the (T1, T3) and (T3, T1) elements suggests persistence of returns.

Kendall's τ_b (tau-b) correlation coefficient is a nonparametric measure of association based on the number of concordances and discordances in paired observations. Here, the pairs are each fund's returns in the two four-year periods. Concordance occurs when paired observations vary together, and discordance occurs when paired observations vary differently. Kendall's τ_b is a measure of rank correlation and is calculated from the number of interchanges of the first variable, and corrects for tied pairs.

The τ_b statistic can be used to test the hypothesis that the two quantities – the returns in the two periods in this case – are statistically independent. Independence means no persistence and as in APRA (2009) we can associate correlation with persistence.[2]

Table 2.3 shows the values of the statistic in the sample and a variety of splits of the data. In the first row, the Kendall τ_b correlation for the tertiles is given by 0.12 with a p-value of 0.06 – the statistic is significant at the 10% level. Removing the six low risk funds gives the results in the third row – the Kendall τ_b correlation for the tertiles of the 172 funds is 0.16 with a p-value of 0.02. That is, the test implies that the hypothesis of independence – no persistence – should be rejected (at the 5% level). Applying the test to the returns themselves gives similar results (rows 2 and 4).

low, less than 100 basis points. That compares with a minimum of over 400 basis points for the other funds. Presumably, their assets are mostly cash.

[2] See, for example, Agresti (1984) for details on Kendall's τ_b.

Table 2.3: Kendall's τ_b statistics

		Kendall's τ_b	p-value	Number of funds
All funds				
1	tertiles	0.12	0.06	178
2	returns	0.06	0.23	178
3	tertiles, excl 6 low risk funds	0.16	0.02	172
4	returns, excl 6 low risk funds	0.13	0.01	172
Large funds (net assets > $1b)				
5	tertiles	0.38	0.00	91
6	returns	0.24	0.00	91

Source: Deloitte Access Economics, using APRA data.

Rows 5 and 6 show the results for large funds, defined as those with net assets at the end of 2011 of over $1 billion. Ninety one of the 178 funds have assets over $1 billion, and they represent over 96% of the total assets ($652 billion out of $676 billion). By this definition of size, all six of the low risk funds are small (assets less than $1 billion).

From rows 5 and 6, across large funds, there is evidence of persistence in returns over the two periods. A possible reason for the results – not properly accounting for other factors – is discussed in the next section.

Results by fund type

Table 2.4 shows the results by fund type (retail = 'for profit' and corporate/industry = 'not for profit'). The results for the tertiles use the tertiles defined from the entire sample.[3]

Table 2.4: Kendall's τ_b statistics by fund type

		Kendall's τ_b	p-value	Number of funds
For profit				
1	tertiles, excl 6 funds	-0.16	0.20	60
2	returns, excl 6 funds	-0.16	0.07	60
Not for profit				
3	tertiles	0.03	0.70	112
4	returns	0.04	0.54	112
Large, For profit				
5	tertiles	0.02	0.90	34
6	returns	-0.13	0.27	34
Large, Not for profit				
7	tertiles	0.18	0.12	57
8	returns	0.14	0.13	57

Source: Deloitte Access Economics, using APRA data.

[3] In other words, the cut-offs for assigning tertiles are those from the entire sample.

The results indicate that:

- There is negative τ_b persistence in returns to the for profit funds (rows 1 and 2), but almost zero τ_b persistence among the not for profit funds (rows 3 and 4). None of the τ_b correlations are statistically significant (at the 5% level).
- There is no evidence of persistence in returns for the large, for profit funds (rows 5 and 6), and evidence of low positive persistence among the large, not for profit funds (rows 7 and 8).

There is an apparent discrepancy in the overall results in Table 2.3, where the correlations are positive and generally statistically significant, and the results by fund type in Table 2.4, where the correlations are negative or close to zero. One possible explanation for that is that the not for profit funds achieve higher average returns in both periods.

Table 2.5 shows the average returns by fund type across the two periods. The average annual returns are large, not for profit funds, for example, are 1.78 (= 13.98 – 12.20) percentage points higher in the first period and 1.37 (= -0.78 + 2.15) percentage points higher in the second period.

When the two fund types are combined, the higher average returns among the not for profit funds translates into the positive estimate of persistence of returns.[4]

Table 2.5: Average annual returns by fund type and size

Fund type	2004-2007	2008-2011
For profit	11.33	-1.68
For profit, excl 6 funds	12.06	-2.22
For profit, large	12.20	-2.15
Not for profit	13.73	-1.01
Not for profit, large	13.98	-0.78

Source: Deloitte Access Economics, using APRA data.

Cummings (2012) as well as other work by APRA have noted that returns over this period are higher for not for profit funds. That applies to both raw and risk-adjusted returns. Sy and Liu (2009) give tertiles of risk-adjusted returns but do not apply the test based on Kendall's τ_b.

Survivorship

Performance studies potentially face 'survivorship bias'. That bias arises because some funds disappear during the period being studied – they may close or merge, or data on them may become unavailable. To the extent that being a survivor depends on past performance, using data based on surviving funds may bias upwards the true average performance of the managed fund industry.

[4] As an experiment, we added 1.78 to the return of each large, for profit fund in the first period, and 1.37 in the second period (so that the new means are the same, by fund type). The Kendall τ_b statistic for the new returns fell to 0.03, indicating no correlation/persistence.

The potential effects on persistence are less clear. If the funds that disappear are those with consistent poor performances, then persistence may be underestimated by survivorship bias. Alternatively, if the funds that disappear are more likely to be in the subset of funds that took risks (and for which the risks failed), such that the remaining funds are the ones that 'won their bets', then persistence may be overestimated due to survivorship. The first source of bias is usually emphasised.

In the period 2004-2011, the number of funds in the APRA data falls from 1245 to 289, implying that survivorship is a potential influence on the results (as is selection bias with respect to the 178 funds with returns in all years).

As a simple test for survivorship bias, we compare the annual average rates of return for the 178 funds in the sample versus those not in the sample (and for which returns data is available). Table 2.6 below shows that there is little difference across the two groups of funds in average returns in the first four years, suggesting that survivorship bias may not be a major factor in the results.

Table 2.6: Average annual rates of return and survivorship

	2004	2005	2006	2007	2008	2009	2010	2011
Average ROR								
Not in sample	11.7	11.7	12.9	12.8	-10.5	-5.3	6.3	5.6
In sample	11.9	11.7	13.5	14.3	-7.8	-11.0	8.2	7.2
Number of funds								
Not in sample	467	340	216	181	150	126	94	39
In sample	178	178	178	178	178	178	178	178

Note: In sample means in the sample of 178 funds with rate of return data in all eight years. Values are simple averages across funds. Source: Deloitte Access Economics, using APRA data.

3 Raw and risk-adjusted returns

This section contains a short discussion of the use of raw and risk-adjusted returns, to provide additional context for the estimates in the previous section.

Adjusting for risk

Risk is important – agents are assumed to like higher expected returns but dislike risk (*i.e.*, they are risk-averse).

Most analyses of persistence in investment performance are based on risk-adjusted measures of performance. The argument is that because returns and risks are positively correlated, a manager may improve a portfolio's return simply by aggressively investing in more risky assets. But investors prefer less risk (other things being equal) and so will want to be compensated for additional risk. The measure of return should take that compensation into account.

But risk can be hard to quantify. The standard deviation of returns is one commonly used measure of risk. The Sharpe Index is a 'reward to variability ratio' given by the ratio of excess return (*i.e.*, return above a risk free investment) to the standard deviation.

The Capital Asset Pricing Model (CAPM)[5] provides a measure of risk that accounts for an asset's correlation with other assets within a larger portfolio. According to this model, the expected return on a risky asset at time t, $E[R_t]$, is equal to the risk-free rate at time t, R_{ft}, plus the asset's risk premium. The latter is equal to the product of the asset's beta (β) and the expected excess return on the market portfolio, $E[R_{mt} - R_{ft}]$:

$$E[R_t] = R_{ft} + \beta\, E[R_{mt} - R_{ft}].$$

The β is a measure of the risky asset's sensitivity to movements in the market risk premium (*i.e.*, in $E[R_{mt} - R_{ft}]$). In that sense, β is a measure of the market risk of the asset.

In this theory, assets with higher betas can expect to earn higher rates of return. The risk is that such assets will also experience more volatile returns. For example, holders of such assets can expect to lose more money whenever the market return ends up being less than the risk-free rate.

Jensen's Alpha[6] extends the CAPM and measures the deviation of a portfolio's return from the equilibrium level from the CAPM:

$$E[R_t] = \alpha + R_{ft} + \beta\, E[R_{mt} - R_{ft}].$$

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[5] See, for example, Sharpe (1964).

[6] Jensen (1969).

For ranking purposes, the higher the alpha, the better the performance. A fund beats the market, on a systematic risk adjusted basis, if Jensen's Alpha is greater than zero, and vice versa.

Benchmarking

The CAPM provides the framework for most studies of the persistence in investment performance. For stock portfolios, performance is benchmarked against the market portfolio. But superannuation funds hold assets from a variety of asset classes, making the definition of a benchmark problematic.

Researchers are left to create their own benchmark, which can be industry wide or fund-specific. A fund-specific benchmark would be calculated based on proportional index returns to each of the asset classes held within a portfolio. But a fund-specific benchmark is not possible because that requires whole of fund asset allocation, which is not available. (it was collected by APRA, but only until 2004.)

It should also be noted that this approach shrinks the role of asset allocation in the analysis, whereas that is an important component of the role of the role of the fund trustee.[7]

Benchmarking example

Cummings (2012), for example, computes two benchmarks, representing the investment opportunity sets of superannuation funds in Australia and worldwide.

In the Australian market, the Citigroup Australian Broad Investment-Grade Bond Index in local currency, the S&P ASX 200 Accumulation Index, the Mercer Unlisted Property Funds Index Pre-Tax and the Cambridge Associates Australia Private Equity and Venture Capital Index are used to represent the return on fixed income, common stock, unlisted property and other investments, respectively.

In the world market, the MSCI Total Return Net World ex-Australia Index in local currency is used to represent the return on overseas common stock (in addition to the four domestic indices).

The aggregate value of investments in each asset class by managed funds is sourced from the Australian Bureau of Statistics. The multi-asset class market portfolio indices are formed by using the return series of each asset class, weighted by the asset class's proportion of the aggregate value of all asset classes at the beginning of each quarter.

Quintile rankings based on fund size are used to calculate beta's associated with the multi-asset class market portfolios. This approach allows for the possibility that funds of different sizes have different levels of exposure to market-wide risk. All sample funds are divided into five quintiles based on their net assets of the previous period.

The beta's of these five portfolios to market-wide risk are estimated by using two multi-asset class interpretations of the CAPM:

$$R_{pt} - R_{ft} = \alpha_p + \beta_p (R_{mpt} - R_{ft}) + \text{error}.$$

[7] The trustee typically controls asset allocation more directly than asset selection.

where R_{pt} is the return on one of the five fund-size-sorted superannuation fund portfolios, R_{ft} is the 90-day bank bill interest rate and R_{mpt} is the return on the multi-asset class market portfolio index.

The risk-adjusted return for fund *i* is calculated as the difference between the realised fund return and the expected fund return:

$$\alpha_{it} = R_{it} - [R_{ft} + \beta_p (R_{mpt} - R_{ft})].$$

Cummings (2012) does not consider the sensitivity of the results to the definitions of the benchmarks, the categorisation of funds into quintiles and so on.

Consumers

Several authors have discussed the relevance of studies to the situation of consumers. For example, in reviewing managed funds, Allen *et al*. (2003) argue that the following issues will generally be relevant to some degree in selecting an asset mix, product and fund manager:

- Consumers are interested in risk, including the risk of capital loss and the volatility of investment value over time.
- Most consumers would want to hold a fund for several years at least. In the case of equity-based managed funds, they comment that the investment horizon is at least five years. Frequent swapping involves both fees and inconvenience.
- Measures of performance need to be net of transactions costs. An investor is concerned with the dollars that subsequently end up in his pocket, not hypothetical measures.

Giles *et al.* (2002), in discussing UK equity funds, argue that academic studies have often concentrated on the question of abnormal returns (because market efficiency suggests that there should be no persistence in abnormal returns). They argue for the use of raw returns. Along the same lines, Allen *et al.* (2003, p 7) note that "*The first question in any discussion of performance is "can funds add value in the sense of 'beating the market'"?*". Sy and Liu (2009) note that "*Most published research applies a variety of performance measures and regression models to publicly available return data of mostly equity mutual funds to detect any statistical regularity such as persistent correlation of returns to various factors. The general motivation appears to be to find out whether there is empirical evidence to show that professional managers possess investment skills*."

Blake and Timmermann (2003) are critical of focus in Giles *et al.* (2002) on raw returns. Similarly, Allen *et al.* (2003) conclude that returns are only meaningful if adjusted for risk/volatility or comparing "like with like". But they also conclude that "*the risk-adjusted studies involve complicated computer analyses that are only available to research houses and academics. They do not reflect the information available to retail investors via advertisements, league tables or formal offer documents. The risk-adjusted studies therefore measure the potential value of past performance information in the hands of experts, not ordinary consumers.*"

The holding period is particularly relevant for superannuation funds, where the time-frame is often reasonably long, say 20-30 years. Even over much shorter periods than this (such as three to five years), the main goal of investment may be to maximise expected returns in order to maximise retirement income, rather than to constrain short-term volatility. If that

is the case, then raw returns are crucial – over longer periods of time, risk is averaged out and average returns determine the final level of assets available. (Consumers might seek lower risk as retirement approaches.)

The GFC

The GFC falls in the middle of the 2004-2011 period covered by the Australian data on the APRA website and so provides a 'natural experiment' on the role of risk. It is predicted by the CAPM that riskier funds obtain lower returns in such a period, and returns should be less persistent than in a more stable period.

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