

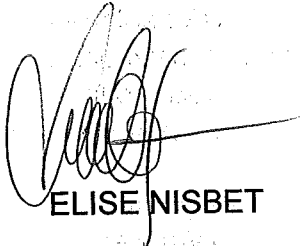
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Better Regulation and Governance, Enhanced Transparency and Improved Competition in Superannuation

I enclose my submission to the Australian Treasury, as prepared by myself, Elise Nisbet, based on the Discussion paper dated 28th November 2012 and entitled 'Better Regulation and Governance, Enhanced Transparency and improved competition in Superannuation'.

Comments are based on my Dissertation and the views in this submission are entirely my own. They do not necessarily reflect those of my Employer, University institution or Australian Regulatory bodies.

Yours Sincerely,



ELISE NISBET

**BETTER REGULATION AND
GOVERNANCE,
ENHANCED TRANSPARENCY
AND IMPROVED
COMPETITION IN
SUPERANNUATION**

SUBMISSION TO THE TREASURY

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1. Introduction

I welcome the opportunity to submit recommendations to the Australian Treasury on Better Regulation and Governance, Enhanced Transparency, and improved competition in Superannuation. This submission is based on Research contained within the Dissertation "*Influence of Board structure on the performance and governance framework of Australian Superannuation funds*". This research focussed on Operational and Investment performance with a view to link key structural characteristics of trustee boards to performance results. Areas of focus included the impact of independent directors, structural and governance differences between Retail and Industry funds and the impact of Gender Diversity. As a researcher and participant in the Finance Industry, I feel it is important to flag key issues raised by outcomes of my Dissertation and make contribute to the development of the Superannuation industry. It is a central investment vehicle and a crucial driver behind Australia's financial health, most notably as a Superannuation fund is commonly the second largest asset held by individuals. The impact of the Global Financial Crisis is a warning that research and development needs to occur in order for us as a country to adequately manage our \$1.7 Trillion industry.

Extensive debate has occurred recently on the best type of Superannuation fund, especially since the Cooper Review (2010)¹ and the MySuper reforms. Interestingly, much of the debate centres on transparency, reporting and governance, with little to no discussion on board structure. Regulation is necessary to a certain extent, in order to maintain compliance to standards and policies that promote transparency and accountability. However, it is also necessary to appreciate that the industry has been subjected to many amendments since the mandatory system was introduced under the *Superannuation Industry (Supervision) Act 1993* ('SIS Act'). With the impending Murray Inquiry, seeking to assess the sustainability of Australia's financial system, the Super industry has a critical impact on the current market. My Dissertation provides key insight into Australian trustee board structures that may assist with future policy development.

From a population of 200 of Australia's largest superannuation funds (by total asset holding), data was sourced from Retail and Industry classified funds and a series of observations were made at two identical points in 2009 and 2012. Multiple regression analysis was performed in order to draw connections between input variables and output performance results.

References contained in this submission are based on the outcomes of this particular study. Any reference to other author's work is adequately mentioned. Comment is made only on focus questions that are considered by my Dissertation, with particular emphasis placed upon;

¹ Cooper, J. (2010). Super System Review Final Report Part Two Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System. Canberra, Australia, Commonwealth of Australia

- The structure of the board (In particular Independent Directors) and performance of Australian superannuation funds;
- Board Gender Diversity;
- Differences between retail and industry funds when consulting the characteristics of the structure of the board and the performance of Australian superannuation funds

2. Objectives of Recommendations

- To achieve greater transparency in the Australian Superannuation Industry.
- To promote a fair level of competition for the Australian consumer.
- To assist with recognition and implementation of the most effective mechanisms of governance.
- Offer insight into the benefit of Independent directors.
- Highlight the impact of Gender Diversity.
- Promotion of clarity and accountability for Superannuation fund Trustees and Boards.

3. Summary of Recommendations

- Independent Directors have a significant effect on trustee board performance. As such, it is important that the definition of 'Independence' be adequately defined.
- Independent directors should comprise a substantial proportion of the trustee board, yet it is important to recognise the contribution of 'Associated' directors.
- Each type of fund has specific governance structures and as such identical regulation is not beneficial. Key structural differences (especially between For-Profit and Not-for-Profit funds) need to be carefully considered.
- Gender Diversity needs to be further explored with the link to improved board independence examined by future research.
- Sustainability and transparency needs to be the focus. Proactive achievement can only be made through ensuring that it is the beneficiaries' interest that is kept primary, and that members are educated about product options.
- Optimal board composition will be different for each fund type and as such there is no specific 'optimal' definition.
- If fair competition is to be achieved, several competitive advantages enjoyed by Industry funds needs to be made available to other superannuation fund types.

My Submission features a discussion on the following sections of the Discussion paper;

Part 2: Better Governance

Focus Questions: 2-9

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

There is criticism over the scope and value of the definition of 'Independence', despite the SIS Act² providing minor details, it only accounts for present associations. Although there is no strict requirement for Superannuation funds to appoint Independent Directors, most Trustee directors on Superannuation boards do not satisfy the legal definition of 'Independence'. This means that legislation does not account for Directors who have prior associations to the Superannuation entity. For example, a Director may have been employed by the fund in a previous capacity. However, under the SIS Act definition, they may still be classified as 'Independent'.

Hwang and Kim (2009)³ found that true independence is rare as many Directors have social ties with each other. This is alarming, as many Directors may not be able to complete the required oversight function that is generally expected. The main advantage of appointing Independent Directors is management oversight ensuring compliance with regulatory duties and detailing objectivity in their deliberations. However, this cannot be achieved when Directors have prior relationships, associations or formal ties. Most notably, only 62% of those directors classified as 'Independent' have no social or conventional ties to other board members.⁴

The Cooper Review (2010) defined that a trustee is independent;

"...[I]f the trustee director is not associated with the super fund in the past or currently, and is not associated (past or currently) with the employer sponsor or union that appoints him or her."

Whilst this may be narrow interpretation, it extends the 'arms-length' interpretation of independence under ASX principles, where the director must not be a substantial shareholder, or be employed in an executive capacity within the last 3 years. Trying to align all these definitions with perceptions is obviously an arduous, but necessary task.

Defining independence that inhibits recognition of other skills may result in a group of high level 'independent' directors who are very efficient at their oversight function being classified as 'associated' and therefore not independent. In order to promote stability and transparency, the current definition should be narrowed, but perhaps more aligned with ASX principles with a period of time e.g. 'no association within 5 years' rather than no prior association at all.

² *Superannuation Industry (Supervision) Act 1993* (Cth) s 10

³ Hwang, B.-H. and S. Kim (2009). "It Pays to Have Friends." *Journal of Financial Economics* 93: 138-158.

⁴ Hwang, B.-H. and S. Kim (2009). "It Pays to Have Friends." *Journal of Financial Economics* 93: 138-158.

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

Corporate Governance and ASX principles suggest that boards should feature a majority of Independent directors. However, it is essential to recognise the diversity within our Superannuation industry, especially between Retail and Industry funds. Throughout my research, I classified board structures according to their relative independence and found that for Retail funds, those that feature a majority of 'non-associated' or 'non-executive' directors tend to perform better than those who feature more 'associated' or 'executive' directors. However, it is important to note that such funds are closely aligned to financial institutions and as such their board structures may be developed from corporate boards.

The results of the effect independent directors had on different fund types seem to challenge this theory. Industry funds overall benefit from the presence of a greater proportion of independent directors, whereas for retail funds, a larger number of independent directors had a negative effect on financial performance. What these results suggest is that impact is highly correlated to individual structures.

My study did not attempt to analyse an 'optimal level' of relative independence or appropriate proportion, but this does highlight the diversity of superannuation fund structures. The Coalition presented the 3+3+3 model to replace the Equal representation model required for Industry funds in response to the Cooper Recommendation 2.7. Imposing this 'one third' arrangement on all superannuation board structures may yield some very interesting results. Whilst I believe this is a positive policy reform, it is my recommendation that the definition of 'independence' be formally tightened before we recommend appropriate proportions.

However, this also presents a very pertinent problem; a failure to recognise the contribution and wealth of knowledge that 'Associated' directors make to trustee boards. The fundamental characteristic of an 'Associated' director is that they are managers of the firm, enhancing board governance due to enhanced knowledge of firm operations.⁵ However, independent directors do not have a distinct connection to the organisation and can only rely on information presented to them within meetings. It is the diversity of the board and the differences in experience and knowledge that assist to create effective trustee governance.

Recently, Union-backed Industry funds have made a push for the appointment of more independent directors, effectively decreasing the influence union officials have over Superannuation funds. Yet, industry funds are still hesitant to appoint a majority of Independent directors. Diversification amongst trustee directors is the key and I support the Coalition's 3+3+3 policy.

⁵ Hess, D. and G. Impavido (2003). Governance of Public Pension Funds: Lessons from Corporate Governance and International Evidence. World Bank Policy Research Working Paper 3110, Rutgers University and the World Bank: 1-35.

4. Should superannuation trustee boards have independent chairs?

One component of my research looked into the impact of independent chairs. Unfortunately, my evidence was unable to present any significant findings for this particular variable. Overall, independent chairs are in an excellent position to perform the management oversight function. ASX principles and APRA requirement support the appointment of independent chairs. With regard to trustee boards, it is where a board features a lower proportion of independent directors that an Independent chair would be most effective. For example, where a fund cannot appoint independent directors in line with the 3+3+3 policy, it is recommended that the fund have an independent chair.

5. Does it matter how independent directors are appointed?

Although my area of research did not extend specifically to appointment, I can make some general comments and suggestions.

Rather than focus on appointment streams and processes for directors, a talent pool needs to be developed specifically for independent directors. This pool could focus on training and development to ensure that those featured are equipped with appropriate knowledge and expertise. The key differences between Retail and Industry funds present issues when considering independent director appointment. Centralising the appointment process may assist to reduce unnecessary complexities.

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

Diversity amongst board members is an important characteristic of efficient and effective boards. If all board members were appointed through the same channels, this diversity function would be decreased. Perhaps if some new models were developed that did not follow the equal representation function or appointment from corporations, then comment can be made in due course. However, I support that it is necessary to ensure due process without creation of unnecessary complications.

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

There are two modes of governance in Australia; Trustee Governance (generally falling under Trust Law) and Corporate Governance (governed by the Corporations Act 2001 (Cth)). The fiduciary duties that underpin Trustee Boards are the relationship that is formed between Trustee and Beneficiary. This is contrasted to that of a corporation, where the fiduciary relationship forms between the Company and the Shareholders. The SIS Act attempted

to formulate a hybrid model, yet this created a system of complexity and confusion. Australia currently operates under a Prescriptive system of Superannuation, whereby certain obligations (such as the sole purpose test) must be followed. My study focussed on theory surrounding Agency Theory or conflicts of interest between agents and principles, whereby managers maximise their own utility over those of shareholders.

Obviously, conflicts of interest do eventuate within organisations and it is through effective governance that such conflicts are managed. APRA's conflict of interest prudential standard requiring conflicts management policies and framework and the register of relevant interest and duties is an effective mechanism to manage potential conflicts. However, these are heavily reliant on individual disclosures and there needs to be a recognition that conflicts will occur. Developing strong internal governance practices, where conflicts can be adequately managed in a transparent manner is the only recommendation I can make to assist with strengthening the conflicts of interest regime.

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

My study did not feature analysis of board tenure, but I can recommend that appointment renewal be based on performance, rather than length of time. There is a great deal of wealth and experience that directors can bring, so it would seem unjust to impose a maximum tenure.

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

Regular appraisals are one of the most important methods to strengthen internal governance. Monitoring, service and strategic planning efficiencies has a substantial impact on board performance. This is defined as the director's ability to execute their nominated roles. Carefully considered performance parameters should be created and monitored both internally and by the regulator. Perhaps these can be based on whole of fund performance, whereby additional appraisals are triggered when there are poor performance results or internal governance failures.