FINANCIAL SERVICES COUNCIL

Committee Secretariat
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

By email: economics.sen@aph.gov.au

30 September 2015

Subject: Superannuation Legislation Amendment (Trustee Governance) Bill 2015

To whom it may concern

The Financial Services Council (FSC) supports the Government's proposed reforms to raise standards of governance in the superannuation industry.

The reforms contained in the Superannuation Legislation Amendment (Trustee Governance) Bill 2015 (the Bill) should be considered part of a package to improve standards of governance and increase competition in the superannuation industry. The package is intended to reduce fees for consumers, boost returns and increase consumer protections from conflicts of interest.

The Bill will apply equally to all superannuation trustees regulated by the Australian Prudential Regulation Authority (APRA). The Bill will ensure a single, minimum standard of governance in the superannuation industry, thereby increasing protections for consumers from potential conflicts of interest in our mandatory superannuation system.

An important outcome of the introduction of independent directors will be the role of these new directors will play in supporting industry consolidation to the benefit of consumers. Merger activity, in conjunction with the opening of the superannuation industry to competition, will reduce costs in the industry and put downward pressure on fees for consumers. This submission provides new actuarial modelling by Rice Warner on the likely benefits for consumers, in addition to supportive third party research by the Grattan Institute and Chant West.

A requirement for independent directors was examined by the *Super System Review* under the previous Government and the *Financial System Inquiry* under the current Government. These reviews consulted widely and concluded that the introduction of independent directors would align the industry with global best practice and was in the best interest of consumers. A requirement for independent directors is also consistent with recommendations by APRA Member for Superannuation, Helen Rowell.

The FSC urges the Senate Economics Legislation Committee (the Committee) to put aside the self-interest of opponent of the reforms and support this Bill in the interests of consumers.

Please contact me on   if you have any further questions in relation to this submission.

Yours sincerely

BLAKE BRIGGS
SENIOR POLICY MANAGER

YOUR
FUTURE
FIRST

Financial Services Council Ltd
ABN 82 080 744 163

Level 24, 44 Market St
Sydney NSW 2000

T. +61 2 9299 3022
F. +61 2 9299 3198

E. info@fsc.org.au
W. fsc.org.au

The Bill will set a minimum standard of governance in the superannuation industry

The purpose of the reforms is to improve governance standards by reducing the scope for potential conflicts amongst one-third of the directors. The reforms are not intended to address particular failings in the industry but represent the next step in the improved governance framework surrounding superannuation.

The *Superannuation Industry (Supervision) Act 1993* (SIS Act) does not require superannuation trustees to have any independent directors. As a result, the SIS Act does not effectively deal with a range of potential conflicts that arise in different types of superannuation funds, including retail, industry, corporate and public funds.

A requirement for a minimum of one-third independent directors is an important mechanism to ensure independent judgement for at least one group of directors on all types of superannuation funds.

The minimum standard of governance provided for in the Bill will protect consumers from circumstances where the judgement of non-independent directors may be influenced by the interests of a subset of the membership, a shareholder or a sponsoring organisation.

Arguments that the reforms are not necessary because funds with no independent directors have a track record of good investment performance misrepresent the purpose of the reforms. The focus of the reforms is governance and the behaviour of boards, not investment performance. All superannuation funds, be they retail, industry, public or corporate funds, have the capacity to improve their governance process.

Recommendation: The Committee support these reforms as they create a minimum standard of governance to better protect consumers that are members of all types of APRA-regulated superannuation funds.

Super System Review

The *Super System Review* (the Cooper Review) of superannuation was conducted by the previous Labor Government in 2010. The Cooper Review argued in favour of requiring fund boards to have independent directors. The Cooper Review concluded that “best practice in corporate governance includes the presence of independent directors on the board.”[1]

The Cooper review concluded:

> The Panel believes that outsiders or ‘non-associated’ trustee-directors (that is, people who generally have no historic connection with the fund or the appointor) could help to provide an objective assessment of issues that would assist the employer and member representatives.

And

> The Panel believes that those trustee-directors have brought great value to the boards that they serve, a proposition borne out in several submissions.”[2]

The Cooper review recommended that superannuation legislation be amended to require one third of equal representation boards should be independent directors.[3] This recommendation was not implemented by the previous government.

[1] Super System Review Final Report, Recommendation 2.8 at 55
[2] Ibit at 55
[3] Ibid, Recommendation 2.7 at 56

Financial System Inquiry

The Financial System Inquiry (FSI) recommended in 2014 that all superannuation trustee boards, including both industry funds and retail funds, should be required to have a majority independent directors.

The FSI drew on overseas research that suggests that "good governance adds one percentage point to pension fund returns." [4] The FSI concluded that:

> Including independent directors on boards is consistent with international best practice on corporate governance. Independent directors improve decision making by bringing an objective perspective to issues the board considers. They also hold other directors accountable for their conduct, particularly in relation to conflicts of interest.

The FSI examined the rationale for allowing different types of funds to have different board composition from other corporate entities and argued that there was not a strong case for ongoing special treatment of superannuation funds if the result was weaker standards of governance in the context of a mandatory $2 trillion superannuation system.

The FSI concluded that as fund members exercise choice, directors appointed by employer and employee groups are less likely to represent the membership of public offer funds. Given the diversity of membership, it is more important for directors to be independent, skilled and accountable than 'representative'.[5]

The FSI recommended "a majority of independent directors, with an independent chair, would strengthen the governance of superannuation funds."[6]

Independent directors and competition will drive consolidation and reduce fees

An important outcome of the introduction of independent directors will be the role of these new directors will play in driving the mergers of subscale and inefficient superannuation funds.

Merger activity, in conjunction with the opening of the superannuation industry to genuine competition, will reduce costs in the superannuation industry and put downward pressure on fees for consumers.

The Financial System Inquiry concluded that fees in the superannuation industry had not fallen by as much as would be expected given the substantial increase in size and scale of the system. The FSI demonstrated that between 2004 and 2013, average fees only fell by 20 basis points, whereas the size of the average fund increase more than twelvefold over the same period.

Based on the independent analysis of Rice Warner (enclosed) and statements from senior superannuation executives, it is clear that independent directors on superannuation boards would be expected to increase merger activity. This is more likely to occur as independent directors are free to take a critical look at operating costs of small, subscale superannuation funds and assess whether those funds are viable over the longer term, or should merge with a larger, more efficient fund.

This analysis of a fund's viability would be more effective if the government proceeds with reforms to promote competition to the superannuation industry by allowing all MySuper products to compete for default status.

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[4] Financial System Inquiry Final Report, Chapter Two; Governance of Superannuation Funds
[5] Ibid
[6] Ibid

Competition and independent directors will lower fees for superannuation consumers

Rice Warner research commissioned by the FSC modelled the impact that competition and fund mergers would likely have on fees in the superannuation industry. Rice Warner concluded that consolidation of the industry would generate material cost reductions and reduce fees for consumers.[7]

Rice Warner's analysis shows that competition in the superannuation industry could result in average fees falling by 15 basis points, from 110 basis points to 95 basis points, should the proposed reforms drive scale so that all funds were over $5 billion.

Industry consolidation that drives the minimum fund size to $20 billion would result in average industry fees experiencing a 25 basis point reduction to 85 basis points.

Rice Warner shows that the more considerable the scale derived from competition, the greater the fee reductions for consumers.

Table 1. Expected reduction in fees as a result of the scale in the superannuation industry

Minimum Size ($b)	Number of APRA regulated funds 30 June 2014	Estimated Reduction in costs (bps)
1	97	9
2	78	11
5	48	15
10	28	20
20	14	25

Rice Warner also estimates that the reduction in fees would be significantly greater amongst small, subscale superannuation funds.

Members of small, inefficient superannuation funds managing under $1 billion currently pay, on average, 141 basis points per annum in fees; 31 basis points above the entire industry average. Consolidation of these inefficient superannuation funds would result in members paying fees of only 94 basis points; a substantial 47 basis point reduction.

Rice Warner's analysis demonstrates that industry consolidation amongst these inefficient funds would materially improve retirement outcomes for Australians. Table 2 provides an analysis of the benefits that would be experienced by the average female and male members of subscale industry funds at ages 20, 30, 40 and 50.

An average 20 year old woman who is a member of a subscale fund, for example, would retire with $55 000 in additional retirement savings by the time she retires if her fund merged, enabling it to reduce its fees to the forecast industry average.

[7] Rice Warner, *Superannuation Fees Report 2014*, page 15-21

Table 2. Projected impact of average fee differential for subscale superannuation funds

Age	Fees of 94 bps		Fees of 141 bps		Difference	
	Balance ($)	Income ($p.a.)	Balance ($)	Income ($p.a.)	Balance ($)	Income ($p.a.)
Males						
20	533,100	46,400	477,900	42,600	55,200	3,800
30	306,700	36,500	279,000	34,300	27,700	2,200
40	231,400	32,700	214,600	31,200	16,800	1,500
50	182,000	30,100	173,200	29,100	8,800	1,000
Females						
20	532,600	43,800	477,600	40,300	55,000	3,500
30	303,100	35,100	276,000	33,000	27,100	2,100
40	218,400	31,200	203,100	29,900	15,300	1,300
50	154,100	28,000	147,400	27,300	6,700	700

Grattan Institute and Chant West research on industry consolidation

Similar analysis has been conducted by independent and ratings agency and think tank, Chant West and the Grattan Institute. Their research demonstrates that significant efficiencies and lower fees for consumers can be achieved in the default MySuper market through consolidation of subscale superannuation funds.

Chant West, for example, presented the following data in August 2015:

MySuper fees – by size

Weighted average MySuper fees (% pa) on a $50k balance

Product Size	No. of Products	Admin. Fee (bps)	Invest. Fee (bps)	Total Fee (bps)	75% Within Range (bps)
> $10 b	16	26	60	86	72 – 110
> $5 b - < $10 b	13	46	57	103	84 – 121
< $5 b	87	46	59	105	81 – 123
Total	116	33	59	92	80 – 130

Chant West's analysis shows that consumers that are members of funds managing less than $5 billion under management are paying fees that are 19 basis points higher than members in funds managing over $10 billion.

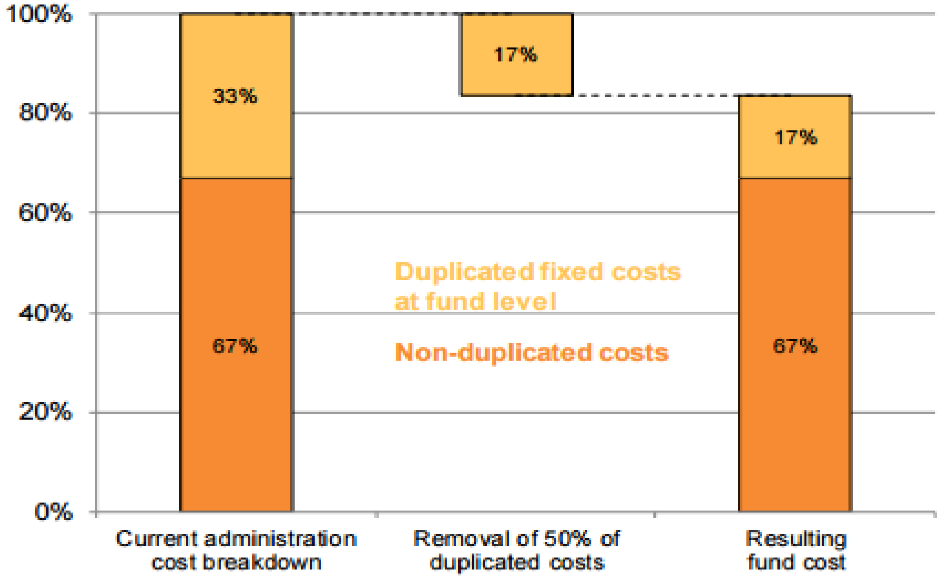
Chant West also concluded that members of larger funds are getting a higher quality of service for the lower fee, as well as greater exposure to more sophisticated and higher returning asset classes, such as direct infrastructure and private equity. Their analysis shows, however, there remain 87 funds under $5 billion in the superannuation industry and those consumers may be paying higher fees for a lower quality service.

Recent analysis by the Grattan Institute reached a similar conclusion. The Grattan Institute examined the default superannuation market in its *Super savings* report and concluded that a significant driver of lower fees in the default market would be the merger of subscale superannuation funds[8]:

> There are too many superannuation funds, all performing similar activities and duplicating costs. Removing duplication with a round of fund mergers could save at least $500 million.
>
> Running a superannuation fund involves some fixed costs that are largely separate from the number of members it serves. They include setting up the product range, building technology and compliance platforms, and paying for general management and trustee functions…
>
> Savings from a merger can take time to be realised and are not guaranteed. But the strong relationship between unit costs and fund size suggests that over time the resulting increases in average fund size will help to reduce costs.

The Grattan Institute concluded that merger activity within the superannuation industry could deliver a 17 per cent reduction in costs for superannuation consumers.[9]

Figure 4: Fund mergers could cut administration costs by one-sixth
Per cent of administration costs



Notes: For an average fund.
Sources: Grattan analysis of ASFA (2014), SuperChoice (2009), SuperPartners Pty Ltd (2013), Australian Administration Services Pty Limited (2013).

Grattan also concluded that, whilst mergers would cut costs in both the default and choice segments[10]:

> The opportunity for savings is likely to be larger in the default segment because there are relatively few constraints on mergers between industry funds, which predominantly serve that segment.
>
> The 50 or so industry funds charge total administration fees of about $1.6 billion. If each of these funds merged with one of a similar size and cost structure, creating about 25 industry funds, total administration expenses could be about a sixth, or $270 million, lower.

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[8] The Grattan Institute, *Super savings*, 19 April 2015 page 13
[9] The Grattan Institute, *Super savings*, 19 April 2015 at 14
[10] Ibid

> The 160 or so retail and public sector funds charge about $3 billion in administration fees. Mergers among public sector funds may be difficult where one or both funds manage a defined-benefit plan, as each current plan sponsor may have ongoing liabilities. Similarly, the relatively concentrated retail segment may have less opportunity for mergers. If just a quarter of funds merged into existing ones, savings could be close to $260 million.
>
> Perhaps $350 million in savings across fund types would accrue to funds and account holders in default superannuation, with the rest accruing in the choice segment.

Unfortunately for consumers, the current board composition of superannuation funds is preventing consolidation and can inhibit achieving economies of scale.

Independent directors would be expected to take a critical look at the operating costs of subscale funds and assess whether those funds are viable over the longer term.

Whilst it should be expected that all trustee directors would undertake such analysis, there are examples of directors of superannuation funds putting the interests of their sponsoring organisation ahead of the interests of consumers.

The case study below examines a recent, public example where the proposed merger between Equipsuper and Vision Super collapsed after a lengthy and expensive due diligence process due to disagreement between unions and employer organisations on the number of board positions each party would receive.

Equipsuper and Vision Super

Equipsuper and Vision Super were finalising a merger to create a $10 billion superannuation fund with 160 000 members.[11] The two super funds had been in merger talks for three years and undertaken expensive due diligence. The merger was scheduled to be complete in July 2012.

On the eve of the merger, however, Equipsuper pulled out. Equipsuper's Chair, Andrew Fairley, publicly cited Vision Super's sponsoring unions' and employer organisations' inability to reach agreement on the number of seats each would receive on the board of the merged entity as the major roadblock to the merger.

It was reported at the time that:

"… at the heart of the problem was an inability to agree on which trustees from both boards would form the newly-merged board. Put simply, industry fund boards are made up of an equal number of union-backed trustees and employer-backed trustees, so each representative organisation wants to keep its ratio of spots."

"… Vision Super, which has four representatives from the Australian Services Union and four from employer groups including the Victorian Employers Chamber of Commerce and Industry, the Victorian Water Industry Association and the Municipal Association of Victoria."

"Fairley said getting all organisations on the Vision Super board to agree on the representation on the merged entity was a major roadblock." [12]

Board seats are an important source of revenue and influence to sponsoring organisations. In many instances the salary paid to the board member is paid back to the sponsoring organisation and helps fund

[11] *Vision super didn't see merger failure* coming, Sydney Morning Herald, 29 May 2012
[12] *Vested interests to blame in merger collapse*, Sydney Morning Herald 28 May 2012

their day-to-day activities. Sponsoring organisations therefore have an incentive to put their own interests ahead of the interest of the fund members.

Referring to the importance of achieving economies of scale the CEO of Equipsuper, Danielle Press, commented in October 2012 that "$5bn is only just big enough."[13] Following the failed merger Equipsuper remains only $7 billion three years later.[14]

A requirement for independent directors would protect consumers from the instances where directors put their own interests, or the interests of their sponsoring organisation, ahead of the members' interests. This principle applies to all types of superannuation funds; retail, industry, corporate and government.

The Chairperson of Industry Funds Services and Senior Advisor to Industry Super Australia, Cath Bowtell has also recently confirmed at the Committee for Sustainable Retirement Incomes conference that some directors put their own interest ahead of the interests of fund members[15]:

> "Mr Murray has also argued that the government should do more to encourage smaller 'sub-scale' super funds to merger, a call endorsed by Ms Rubinsztein.
>
> "Ms Bowtell agreed that there was a good opportunity for more industry consolidation, but stressed that funds could also achieve better results by collaborating and working with big service providers.
>
> "The self-interest of board members and executives wanting to keep their jobs was a common obstacle to funds merging, [Ms Bowtell] said."

A requirement to appoint independent directors on all trustee boards will introduce directors to subscale boards who are free from the potentially conflicted values of sponsoring organisations.

Independent directors would be expected to take a more objective view of the ongoing viability of a trustee.

This would particularly be the case if the superannuation industry was opened to genuine competition as funds who have previously had their market share protected under legislation would face the prospect of losing members if their fund is high cost and uncompetitive.

Independent directors of high cost and uncompetitive funds would therefore be more likely to act in the interests of members of the fund by supporting a merger.

Recommendation: The Committee support this reform as part of a larger package to promote scale and efficiency in the superannuation industry to bring down superannuation fees through competitive pressures.

[13] *Super chief expects to see more mergers*, The Australian, 8 October 2012
[14] Equip Super information is available here: www.equipsuper.com.au/pages/Facts-about-Equip-superannuation
[15] *Default fund choice aired*, Australian Financial Review, 4 June 2015