Australian Prudential Regulation Authority

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14 October 2015

Ms Toni Matulick
Committee Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Ms Matulick

Inquiry into the Superannuation Legislation Amendment (Trustee Governance) Bill 2015

Thank you for the opportunity to provide the attached submission to assist the Committee in its inquiry into the Superannuation Legislation Amendment (Trustee Governance) Bill 2015 (the Bill).

APRA is the prudential regulator of the Australian financial services industry, including supervising a significant proportion of the superannuation industry. APRA's prudential framework for all APRA-regulated industries has a strong emphasis on promoting the implementation of sound governance practices by the entities that we supervise.

APRA supports the direction of the proposed changes in the Bill as they will more closely align board composition requirements for the superannuation industry with those of other APRA-regulated industries.

APRA has been consulting with industry on changes to the prudential framework to support implementation of the Government's proposed changes to governance requirements for the industry, as set out in the Bill. APRA's experience has been that having some independent directors on a board supports sound governance outcomes.

The recent Stronger Super reforms, including the implementation of APRA's prudential standards, have contributed to some strengthening of governance practices within the superannuation industry, but there remains room for further improvement in a number of areas.

APRA's view is that there is a need for further legislative change, such as the changes proposed in the Bill, to support further progress. The superannuation industry has evolved considerably since the current legislative board composition requirements were introduced in 1993. A significant portion of the industry are now public offer funds with broad and

open membership, and the industry's importance, from both a financial system and retirement income policy perspective, continues to increase. It is therefore appropriate for the industry to ensure that it draws from the widest possible pool to ensure that boards have the necessary skills, capabilities and experience to meet the future needs of their members.

The attached submission details further background on superannuation governance arrangements and practices that may assist the Committee in its consideration of the Bill. It also outlines, for consideration by the Committee, a few refinements to the Bill, relating to board nomination, appointment and removal processes and voting practices, that in APRA's view would support achievement of the objectives of the Bill to enhance superannuation industry governance.

We are happy to answer any questions you may have in relation to this submission.

Yours sincerely,

Helen Rowell
APRA Member

Australian Prudential Regulation Authority

Inquiry into the provisions of the Superannuation Legislation Amendment (Trustee Governance) Bill 2015

APRA submission to the Senate Economics Legislation Committee

14 October 2015

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1. Introduction

The Australian Prudential Regulation Authority (APRA) is the prudential regulator of the Australian financial services industry.

It oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance companies, private health insurers, friendly societies, and most of the superannuation industry.

APRA was established on 1 July 1998 and is funded largely by the industries that it supervises.

APRA-regulated institutions currently hold $5.5 trillion in assets for Australian depositors, policyholders and superannuation fund members.

1.1. APRA-regulated superannuation entities

APRA supervises a wide range of superannuation funds under the *Superannuation Industry (Supervision) Act 1993* (SIS Act) – these are known as registrable superannuation entities (RSEs). Trustees of RSEs must be licensed by APRA under the SIS Act as a registrable superannuation entity licensee (RSE licensee).

At 30 June 2015, the APRA-regulated superannuation industry held assets totalling $1.2 trillion.

There are currently 138 RSE licensees responsible for managing 238 RSEs under their trusteeship.[1]

There are two main types of superannuation funds that are exempt from APRA supervision:

- 19 public sector superannuation funds under the responsibility of relevant Federal, State or Territory Governments are exempt from prudential supervision, unless they have opted to be supervised by APRA; and

- self-managed superannuation funds (SMSFs) are regulated by the Australian Taxation office (ATO). SMSFs can have no more than four members, all of whom are required to be trustees of the fund.

A register of RSE licensees and RSEs is available on the APRA website.

1.2. Overview of the prudential framework for superannuation

The primary purpose of the prudential framework for superannuation is to ensure, to the maximum extent possible, that trustees are undertaking their duties and responsibilities in the best interests of superannuation fund members.

[1] Note that, in addition to the 138 RSE licensees referenced above, there are also ten acting trustees, two groups of individual trustees and four RSE licensees that do not have any RSEs under their trusteeship. Note also that the 238 RSEs referenced do not include small APRA funds, which are APRA-regulated superannuation entities with fewer than five members.

The superannuation prudential framework has been significantly enhanced over the past decade. On 1 July 2004, the SIS Act was amended to implement a licensing regime which required trustees of all RSEs to obtain a licence and register all RSEs under their trusteeship. Once licenced, RSE licensees were required to meet specific requirements covering matters such as governance and risk management, as well as operating standards on fitness and propriety, adequacy of resources and outsourcing.

In 2012 and 2013, the Stronger Super reforms brought about fundamental changes to the way APRA regulates the superannuation industry, including granting APRA the power to make prudential standards applying to the superannuation industry. This allowed APRA to more closely align the prudential requirements for the superannuation industry with those that had been in place for a number of years for authorised-deposit taking institution (ADI) and general and life insurance industries.

These prudential standards were a major step towards harmonisation of APRA's prudential frameworks across all APRA-regulated industries.

Under the new prudential framework, APRA issued prudential standards relating to, amongst other things, risk management and governance, fitness and propriety requirements for persons holding positions of responsibility, outsourcing, business continuity, audit and conflicts of interest. These standards took effect in late 2012 and mid-2013 and set heightened expectations in these key areas, with a view to encouraging enhancements in RSE licensees' governance frameworks and the effectiveness of decision-making for the benefit of superannuation members.

2. Existing superannuation governance requirements

2.1 Existing RSE licensee structures

Of the existing 138 RSE licensees:

- 91 RSE licensees hold a class of licence that enables the RSE licensee to offer superannuation to the general public (i.e. either a 'public offer' or 'extended public offer' licence); and

- 47 RSE licensees hold a class of licence that restricts them to offering superannuation to members linked to a standard employer sponsor (i.e. a 'non-public offer' licence).

The existing Part 9 of the SIS Act requires the board of an RSE licensee that holds a non-public offer licence to be constituted of an equal number of member and employer representatives. Such boards may also appoint an independent director if the appointment is permitted under an RSE's governing rules and is requested by the employer or member representatives on the board. The legislation also permits these RSE licensee boards to seek APRA's approval to appoint additional independent directors.

There are no legislated requirements relating to the board structure of RSE licensees that are licenced to offer superannuation to the general public.

In addition to the 47 RSE licensees that are required to have an equal representation board, there are also 39 RSE licensees that maintain an equal representation board structure by choice (by way of the RSE licensee's constitution).

Some RSE licensees that do not have an equal representation board structure have adopted industry guidance (such as that released by the Financial Services Council[2]) in determining the composition of their boards; these boards have appointed directors that are independent by reference to broader concepts of independence and non-affiliation.

2.2 APRA's governance-related prudential standards

Governance has been described as 'the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled' within an entity.[3] This covers how a board and individuals who control the entity set and achieve objectives, monitor and assess risks, measure and optimise performance and are held accountable.

Effective RSE licensee governance arrangements promote the interests of beneficiaries of RSEs by ensuring that the RSE licensee and its directors continue to meet their legal obligations in a manner that meets the best interests of beneficiaries.

Existing RSE licensee governance arrangements and practices must comply with a number of regulatory requirements. These encompass general law duties, the covenants contained in s. 52 of the SIS Act, general director duties articulated in the *Corporations Act 2001* and the trustee composition obligations in Part 9 of the SIS Act, as discussed above.

APRA has also determined three prudential standards that relate to the governance of RSE licensees:

- *Prudential Standard SPS 510 Governance* (SPS 510) establishes minimum requirements for the manner in which RSE licensees govern themselves to ensure that they conduct their affairs with a high degree of integrity. SPS 510, which commenced in 2012, requires RSE licensee boards to have a board audit committee and board remuneration committee, a policy on board renewal, procedures for assessing board performance and a remuneration policy that aligns remuneration and risk management. With the exception of board composition requirements which are prescribed in Part 9 of the SIS Act, SPS 510 is substantially aligned with the requirements in APRA's cross-industry *Prudential Standard CPS 510 Governance* (CPS 510), which applies to the banking and general and life insurance industries.

- *Prudential Standard SPS 520 Fit and Proper* (SPS 520) sets out minimum requirements for RSE licensees in determining the fitness and propriety of individuals to hold positions of responsibility, including directors. SPS 520 requires RSE licensees to develop and implement a fit and proper policy and undertake at least annual re-assessment of the fitness and propriety of responsible persons.

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2 Refer to http://fsc.org.au/standards-guidance/financial-services-council-standards.aspx for details of the Financial Services Council guidance.

3 Refer to *Corporate Governance Principles and Recommendations with 2010 Amendments*, (2nd edition, ASX Corporate Governance Council) page 3.

- *Prudential Standard SPS 521 Conflicts Interest* (SPS 521) establishes requirements for the identification, avoidance and management of conflicts of interest by RSE licensees, including the development, implementation and periodic review of a conflicts management policy.

On 31 August 2015, APRA released a consultation package, 'Governance arrangements for RSE licensees'.[4] This package proposes amendments to APRA's governance prudential framework in light of the Government's proposed legislative amendments. The proposed updates to its prudential framework are designed to support RSE licensee boards as they move to the new governance environment envisaged by the Bill.

The coordinated consultation on the proposed legislative amendments and proposed changes to APRA's prudential standards and guidance also assists industry to respond to the proposals by providing a complete picture of the proposed policy changes. Industry has indicated the need, and hence their support, for this coordinated approach in previous consultations that involve changes to both legislation and APRA's prudential standards (such as on the Stronger Super reforms).

3. Further enhancements to superannuation fund governance

The superannuation industry has evolved considerably since the current Part 9 board composition requirements were introduced into the legislation in 1993.

Approximately 80 per cent of superannuation assets in the APRA-regulated sector are held in public offer RSEs with broad and open membership, and the industry's significance, from both a financial system and retirement income policy perspective, continues to increase.

APRA's view is that it is therefore essential that the industry draws from the widest possible pool to ensure that boards have the necessary skills, capabilities and experience to meet the future needs of their members.

3.1 Harmonising the prudential framework

The size of the industry, and individual funds within it, has increased significantly in recent years. At 30 June 2015 average fund size was $5 billion, with some funds having total assets comparable to larger ADIs and insurers.[5]

The boards of all ADIs and general and life insurers have been required, by APRA's prudential standards, to have a majority of independent directors and an independent chairperson since 2006.

APRA's experience has been that having some independent directors on a board supports sound governance outcomes. Independent directors improve decision-making by helping to bring an objective perspective to board deliberations. Independent directors also help to hold other directors accountable for their conduct, particularly in relation to conflicts of interest. APRA considers the diversity of views and experience that independent directors bring supports more robust decision-making by boards.

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4 http://www.apra.gov.au/Super/Pages/Governance-arrangements-August-2015.aspx

5 Note that this average fund size applies only to RSEs with more than four members.

APRA's view is that it is therefore appropriate for the governance requirements for the superannuation industry to be more closely aligned with those that apply to the banking and insurance industries (via CPS 510).

3.2 Governance practices in the post Stronger Super environment

The Stronger Super reforms and APRA's prudential standards have contributed to some strengthening of governance practices of RSE licensees. APRA's view, however, is that there is significant room for further improvement in governance practices across the industry, as demonstrated by APRA's recent thematic review into management of conflicts of interest.[6]

Some RSE licensee boards are currently constrained by the existing board composition requirements (whether required by Part 9 of the SIS Act or as enshrined in the governing rules of an RSE) from being able to appoint directors with the right mix of skills, capabilities and experience to best serve the interests of beneficiaries. The composition requirements prevent some boards from implementing effective board nomination, appointment and removal processes to support board renewal when there is recognition that independent directors have an important role to play in boards having the right mix of skills and experience.

The effect of these constraints is highlighted, for example, by the relatively long tenure of directors on superannuation fund boards.

APRA data indicates that average tenure of directors on RSE licensee boards is 6.7 years (slightly higher for corporate and industry funds and lower for retail and public sector funds).

Over 20 per cent of RSE licensee directors have more than 10 years of tenure (over 25 per cent for industry and corporate funds) and a significant number of RSE licensees have directors with more than 20 years (and in some cases more than 30 years) of tenure. In contrast there is evidence that, in the broader corporate community, only 7 per cent of independent directors have tenure longer than 12 years and only 3 per cent have tenure longer than 15 years.[7]

There is clearly a balance to be struck between ensuring continuity of experience and appropriate review and renewal of skills and capabilities as the industry and individual funds evolve. However, it is hard to see how the spirit of the prudential standard requirements in relation to board renewal are being met where a substantial proportion of directors on a board have in excess of 10 years' tenure.

As discussed further below, APRA's ability to require change on specific boards to address this is significantly limited under the current legislative framework. RSE licensees are overseeing and safeguarding the investment of members' monies. Strong governance frameworks are therefore critical to protecting the best interests of members. APRA's view, based on its experience over the past decade, is that there is a need for further strengthening of the requirements applying to RSE licensees, such as the changes proposed in the Bill, to support and encourage further enhancements in this area.

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6 Refer to http://www.apra.gov.au/Insight/Pages/Insight-Issue-One-2015-HTML.aspx

7 Refer to http://eganassociates.com.au/infographic-director-tenure/

4. APRA comments on specific provisions in the Bill

If passed, the proposed requirements of the Bill, supported by APRA's prudential standards, will require RSE licensees to consider the appropriateness of their current governance structures (including the size and composition of the board) in the context of their current (and future) fund membership, strategy and operations.

Boards will need to ensure that the requirements in relation to the minimum proportion of independent directors are met, and that the board as a whole has the skills and capabilities needed to ensure sound governance and that its obligations to members are met.

Beyond these requirements, however, RSE licensees will have the flexibility to determine the composition of the board. That will enable those RSE licensees that wish to do so to retain an equal representation model for the appointment of the non-independent directors should they feel that continues to be appropriate to their circumstances.

APRA supports these changes to Part 9 of the SIS Act. Some specific matters related to the Bill for consideration by the Committee are outlined below.

4.1 APRA's powers to determine a person's independence

APRA's current powers to address governance-related concerns, including issues relating to board composition and fit and proper, are limited.

Section 29EB of the SIS Act provides that APRA may direct an RSE licensee to comply with the SIS Act, SIS Regulations and prudential standards (amongst other related laws). This process, however, requires the RSE licensee to first contravene the law; if there is no contravention, APRA cannot make such a direction.

If passed, proposed s. 92 in the Bill will allow APRA to issue a direction to an RSE licensee to comply with the new independence requirements. However, for APRA to exercise this power there needs to be a contravention of the law and proposed s. 92 only allows APRA to act after a director is appointed to the board. Stopping the appointment of a prospective director is far less disruptive than removing an existing director from the board (if required).

To help address these limitations, the Bill therefore contains provisions (i.e. ss. 88 and 90) for APRA to make determinations about whether a person is able to exercise independent judgment in performing the role of director. This mechanism is necessary to ensure that there is certainty where an individual might have a non-typical relationship with an RSE licensee such that it is unclear whether the individual is 'independent'. It reflects the practical reality that it is not possible to clearly address in the legislation all situations that may arise in practice; it is essential that APRA be able to respond to unusual circumstances to provide the necessary certainty to industry.

Concerns have been raised, however, about when and how APRA intends to use the proposed powers in s. 88 and s. 90.

APRA expects to use the proposed power in s. 90 (to determine a person as not independent) infrequently as the legislative definition of independence should provide sufficient information to undertake a robust assessment of a director's independence in most

circumstances. APRA will also provide supporting guidance to assist RSE licensees as they undertake such assessments. The draft version of SPS 510, updated to reflect the proposed legislative changes and currently undergoing public consultation, also encourages RSE licensees to refer the matter to APRA for guidance where they may be in doubt about a director's independence.

Similarly, APRA expects that the combination of the certainty in the legislative definition and additional guidance issued by APRA over time will mean that RSE licensees will be confident to appoint persons as independent directors without having to seek confirmation from APRA by way of a determination under proposed s. 88 that a person is independent. As with similar application processes in the SIS Act and other legislation administered by APRA, APRA will consider each application made on a case by case basis. Further, when exercising these powers, the Bill makes it clear that APRA's decision must take into consideration the definition of independence.

Any decision that APRA makes using the powers in either s. 88 or s. 90 is a reviewable decision within the meaning given in the SIS Act.

The proposed powers in ss. 88 and 90 in the Bill would enable APRA to make a declaration in relation to a person who meets the legal definition of independence but not the spirit of the legislation (or vice versa) both (a) before an individual is appointed to the board, and (b) without there needing to have been a breach of RSE licensee law, which could cause damage to the interests of beneficiaries.

APRA's view, therefore, is that it is important that proposed ss. 88 and 90 are retained in the Bill to enable APRA to address material concerns in relation to board composition and fit and proper matters (in relation to independent directors) earlier than is currently the case.

4.2 Board nomination, appointment and removal processes

Proposed s. 86(1)

The Government has indicated that the aims of the Bill are to broaden each board's pool of experience and to increase the accountability of decisions made by directors.

Proposed s. 86(1)(c) of the Bill requires that RSE licensees comply with any requirements of APRA's prudential standards relating to the appointment or removal of *independent* directors (emphasis added).

Strong nomination, appointment and removal processes for directors ensure that those appointed to the board have the necessary skills, capability and experience to meet their obligations to act in member best interests. It is important that these processes enable the board as a whole to have a substantive role in determining appointments to and removals from the board, in addition to any nominating bodies or other nomination and appointment processes. Accordingly, to support the objectives of the Bill and consistent with international best practice on corporate governance, the proposed changes to APRA's prudential standards

cover processes and procedures for the nomination, appointment and removal of *all* directors, including independent directors.[8]

APRA's view is that the implementation of appropriate nomination, appointment and removal processes for all directors is critical to the achievement of the objectives of the Bill in relation to enhancing superannuation industry governance.

APRA therefore requests that the Committee consider whether s. 86(1)(c) of the Bill should be amended to clearly provide for APRA's prudential standards to make requirements relating to the appointment and removal of all directors (not just independent directors).

Proposed s. 93B

As indicated above, there are 86 RSE licensees that constitute their boards in accordance with the equal representation requirements. The constitutions of these RSE licensees typically provide the right to veto the appointment or reappointment of directors to the nominating organisation. Accordingly, the board cannot veto an appointment (or reappointment) made by the nominating organisation nor is it able to seek the removal of a director from the RSE licensee board without the agreement of the nominating organisation.

To provide RSE licensee boards with the ability to veto appointments of independent directors, the Bill includes an override provision. Proposed s. 93B provides that the requirements set out in Part 9 of the Bill override any contradictory provisions in trust deeds and other rules governing a regulated superannuation fund, including the constitution of a corporate trustee or any other documentation that imposes requirements on the RSE licensee relating to the appointment of directors or trustees.

APRA considers this provision requires clarification to ensure that the effectiveness of the Bill in achieving its objectives is not hindered. This is because:

- the override does not extend to the removal of directors or trustees. If, for example, an RSE licensee forms the view that an independent director is no longer independent, the RSE licensee board is unable to remove the director unless the RSE licensee's constitution allows it;

- there is doubt as to whether the override extends to the appointment of all directors and trustees. The Explanatory Memorandum to the Bill suggests that the intention of the override is to enable the board to satisfy requirements relating to independent directors, yet the provision in the Bill includes all directors.

In the absence of an RSE licensee board having the power to appoint and remove directors, a number of equal representation boards may create additional seats on the board to meet the new independence requirements. This is because boards may not be able to remove or reclassify existing director seats as independent director seats unless the nominating bodies agree to give up their right to appoint a director or agree to appoint an independent director (rather than representative director) to that seat.

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[8] Under s. 34C of the SIS Act, APRA may determine prudential standards relating to prudential matters, where this term is defined to include inter alia, conduct by an RSE licensee in such a way as to 'protect the interests of the beneficiaries of the registrable superannuation entity, or meet the reasonable expectations of the beneficiaries of the registrable superannuation entity'.

This is likely to lead to larger boards than is desirable for effective governance and may therefore undermine the Bill's stated objectives. Similarly, boards will not be able to address situations where a nominated director exceeds the tenure policy agreed by the board or is viewed as not meeting the skills, capability or performance requirements of the board, however the nominating body is unwilling to put forward an alternative candidate that does meet these requirements.

Accordingly, APRA requests that the Committee consider whether a specific provision should be included in the Bill which would allow RSE licensee boards the right to veto all appointments and reappointments of directors, and to seek the nomination of replacement candidates in specific circumstances, regardless of whether they are independent directors or not. APRA's prudential standards would then require the RSE licensee to have policies and procedures for exercising this veto, though it does not intend to set requirements to determine when the veto must be used. This is consistent with the principles based approach taken in APRA's prudential standards.

4.3 Removal of the two-thirds voting rule

Currently, RSE licensees that are required to comply with the equal representation requirements are also required to comply with the two-thirds voting rule. That is, decisions must be made with a majority of two-thirds of director votes, rather than a simple majority. This requirement will be removed with the repeal of the equal representation rules.

The absence of a formal voting requirement raises the possibility that board resolutions could be passed according to a simple majority, which may preclude the involvement of independent directors on the board.

APRA proposes to include guidance in *Prudential Practice Guide SPG 510 Governance* (currently undergoing public consultation) on matters for RSE licensee boards to consider when establishing their voting procedures. In particular, the proposed guidance notes the importance of establishing rules and procedures that seek to ensure that the views of all directors (independent and non-independent) are adequately reflected in any decisions made by the board.

The Committee may wish to consider whether it would be appropriate to include in the Bill requirements in relation to voting rules, such as requiring a two-thirds majority for decisions.