Submission to the Senate Economics Legislation Committee inquiry: Superannuation Legislation Amendment (Trustee Governance) Bill 2015

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EXECUTIVE SUMMARY

- The Macquarie University Centre for Workplace Futures (CWF) welcome the opportunity to make a submission to the Senate Economics Legislation Committee regarding the *Superannuation Legislation Amendment (Trustee Governance) Bill 2015.* This submission responds to the Bill's requirement that at least one third of directors, and the chair of registrable superannuation entities (RSEs) be 'independent from the RSE licensee' as defined by the Bill, as well as the definition of 'independent' in section 87 of the Bill.
- Our primary goal is to respond to the overarching proposition of the Government that a blanket provision of independent directors on superannuation trustee boards will strengthen the superannuation system. We submit that the evidence does not support the proposition that independence is a strong governance-enhancing mechanism. Indeed, the most characteristic feature of effective corporate governance is not independence, but representation.
- In recent years superannuation fund regulatory policy has placed increased emphasis on market governance. The expectation here is that informed and active fund members will act to reward better performing funds or fund options and penalise poorer performers. However, the ability of fund members to exercise market discipline is severely constrained by a general lack of understanding and knowledge of superannuation and the superannuation system, with most fund members able to be characterised as 'reluctant investors'. This limits the effectiveness of market-based mechanisms of governance.
- In defining 'independent' directors, the Bill adopts a broad (negative) definition which excludes anyone with ownership, employment, representative, or other business ties to the fund. This definition may maximise the degree of 'independence' of the directors, but this also has the effect of severely narrowing the pool of possible directors. There are subsequently some doubts about the industry's ability to meet these requirements cost-effectively.
- There is little clear evidence from corporate governance research demonstrating that more independent directors results in better governance and performance. Independent status does not guarantee non-conflicted outcomes, and visa versa a lack of 'independence' (as defined by the Bill) does not prevent directors from exercising objective and independent judgement. Although independence may bring benefits to *some* boards lacking diversity or appropriate separation from

management or company interests, the main effect of such a response is to create the *illusion* of independence. Meanwhile, empirical evidence on the performance effects of independence is mixed at best, but one clear conclusion is that independence is not a *panacea* for corporate governance, and indeed, may not even be the most important policy reform to pursue. The key governance problem is ensuring the alignment of interests and outlook between a board and its fund members, and this rather than independence should be the overarching policy goal of the government's superannuation governance policy.

- The representative governance model is not a perfect system by any measure, but the model remains diverse in appointment methods, the numbers of trustees and areas of governance. Remarkably, despite the diversity of representation, the common outcome of representation seems to be a closer alignment of trustees' and members' interests.
- Diversity of views, skills and experience is touted in the explanatory memorandum as one of the key benefits of increasing the number of independent directors. However, greater diversity seems strongly associated with the structure of the equal representation model, which limits excessive appointment of individuals from one particular group of 'insiders' and prescribes minimum numbers of appointees from different backgrounds. Accordingly, using independence to minimise potential conflicts of interest is likely to result in little meaningful improvement in this regard.
- Although managing conflict of interest will continue to be a challenge for all funds, the evidence shows that, particularly compared to their Retail counterparts, not-for-profit directors have more diverse backgrounds, hold fewer additional directorships, have less direct relationships to the fund or related service providers, and invest more of their retirement savings in the fund they represent. Such actions indicate an appropriate ability to manage existing conflict of interest and acting in the interest of the fund's members.
- The available evidence shows a clear causal relationship between the not-for-profit representative governance model and higher levels of returns for members. Extensive research based on both raw and risk-adjusted data supports the proposition that the two governance models produce significantly different performance outcomes. Ultimately, this data and all the empirical testing of the relationship between governance and performance, indicates that, regardless of the exact amount of influence fund governance has over returns, the representative

governance model is clearly responsible for helping produce significantly better performance for the vast majority of compulsory contribution fund members.

- Instead of implementing reforms based on the promise (which in turn is based on an uncertain premise) that independence leads to benefits for funds and members alike, this submission argues that the existing not-for-profit representative governance model already promotes higher levels of diversity and more effectively minimises conflicts of interest in comparison to the for-profit governance model. Critically, funds with representative trustee boards have continually and significantly generated higher returns for their members.
- Subsequently, we cannot recommend that the Bill be passed in its present form. The imposition of independent directors, and the repeal of Part 9 of the SIS Act and its requirements around equal representation, are likely to undermine the representative model which has been so successful up until now. Meanwhile, this will be at an additional cost to the funds, with no clear benefits to their governance.

1 INTRODUCTION

The Macquarie University Centre for Workplace Futures (CWF) welcomes the opportunity to make a submission to the Senate Economics Legislation Committee regarding the *Superannuation Legislation Amendment (Trustee Governance) Bill 2015* (hereafter 'the Bill'). This submission is an amended version of a previous submission by the McKell Institute and CWF regarding the government's November 2013 discussion paper entitled *Better regulation and governance, enhanced transparency and improved competition in superannuation* (hereafter the Discussion Paper).[1] The previous submission was in turn an abridged version of a McKell Institute and CWF report[2] released in March 2014, which systematically analysed the relationship between fund performance and governance structures of superannuation funds in the Australian market, and further assessed the ability of the existing Representative governance model under the *Superannuation Industry (Supervision) Act 1993* (SIS Act) to provide members with appropriate long term returns on their superannuation investments, as well as the likely impact on this performance of any policy to introduce independent trustees.[3]

This section responds to the requirement in section 86 of the Bill that at least one third of directors, and the chair, of registrable superannuation entities (RSEs) be 'independent from the RSE licensee' as defined by the Bill, the definition of 'independent' per section 87 of the Bill, and the repeal of Part 9 of the Superannuation Industry (Supervision) Act 1993 (hereafter the SIS Act), which had facilitated equal representation between employer and employee representatives in some RSEs.

Our primary goal is to respond to the overarching proposition of the Government that a blanket provision of independent directors on superannuation trustee boards will strengthen the superannuation system. In particular, we develop the case that the evidence and

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[1] R Markey, M Raffery and C Angus *Submission to: Australian Government regulation and governance, enhanced transparency and improved competition in superannuation Discussion Paper*, (submission by the McKell Institute and Macquarie University and Centre for Workforce Futures, February 2014).

[2] R Markey, M Rafferty, L Thornthwaite, S Wright and C Angus, *The Success of Representative Governance on Superannuation Boards,* (report for the McKell Institute by the Macquarie University Centre for Workforce Futures, March 2014).

[3] The present submission, following Section 62 of the SIS Act, measures performance in terms of maximising the retirement benefits to members. The operational form of that definition is the compounded net returns of the fund.

theoretical logic presents a challenge to the claim that independence—at least according to corporate governance models—increases diversity of views and helps resolve or at least better manage potential conflicts of interest, ultimately helping to generate increased performance.

We submit that the evidence does not support the proposition that independence is a strong governance-enhancing mechanism. Indeed, the most characteristic feature of effective corporate governance is not independence, but representation. Representative governance is generally seen as the most important way that corporate governance structures attempt to align shareholder and board interests. In contrast, the primary outcome of independence is better protection of minority interests, with negligible impact on performance.

Section 2 identifies the unique attributes of the Australian superannuation sector that make it different from other financial markets, both in the way participants are engaged in the industry, and how it is structured and operates. We show that these distinguishing features inevitably mean that market governance competition around price and performance is not a strong mechanism, and that prospects for it becoming so are similarly weak. This means that internal fund governance (non-market, internal structures and processes that discipline the fund's management to act in the best interests of its members) is a much more critical area for ensuring fund members' interests are advanced and protected. In this sense, the federal government's focus on the role of trustee-directors and fund trustee boards is well placed.

Section 3 analyses evidence of the impact of independence in research-based corporate governance literature, and critiques claims that it can adequately address issues of diversity, trustee objectivity and conflicts of interest in the superannuation industry. The suggestion that greater independence is a key to improved fund performance is not supported by economic and legal theory, and lacks empirical support. Importantly, the evidence in favour of increased independence is not only equivocal, but mandated independence risks either acting as a 'band aid' solution to the above issues if its definition is left too broad, or could result in a lack of available trustees if the definition is overly restrictive.

Finally, Section 4 demonstrates that of the two models of fund governance, there is almost overwhelming evidence that the not-for-profit representative governance model not only promotes diversity, but is the most effective way to minimise conflicts of interest. Crucially, we review the evidence on fund performance and conclude that the representative not-for-profit governance model has consistently outperformed its for-profit counterparts in generating higher returns for the benefit of fund members. The effects of the differential performance for the retirement living standards of fund members are substantial.

There is considerable debate about the effectiveness of independence as a *panacea* for the problems of board governance in the corporate sector. We submit that instead the government should support reforms to superannuation governance problems that are evidenced based in both corporate and superannuation sectors – by far the most important of these are representative governance structures and processes.

2 SUPERANNUATION AND ITS UNIQUE CHALLENGES

Superannuation is an industry that, along with the age pension and voluntary savings, forms the 'three pillars' of Australia's retirement system. Accordingly, it is charged with contributing significantly to the retirement financing of working Australians and to the government's overall goals for improving social wellbeing more broadly. As we demonstrate below, this means that the government has effectively delegated a significant part of its retirement policy to industry, in a way analogous to a public-private partnership.

One direct consequence of recognising this fact is that the government has a much greater and more direct interest in the performance of the industry than it does in other areas of the market. In particular, Australia's mandatory contribution system means that superannuation is of more than just prudential interest to the federal government.

The superannuation industry has considerable funds under management, with total assets valued at $2.02 trillion at June 2015, having increased by a sector average of almost 10 per cent during the year to 30 June 2015.[4] These savings are set to increase substantially in coming decades, with the 2010 Super System Review ('Cooper Review') estimating that these collective savings will be valued at $6.1 trillion by 2035.[5]

Public support for 'super' is overwhelming. A 2013 survey conducted by the Financial Services Council and ING Direct (FSC/ING) reported that 89 per cent of Australians support superannuation, and 83 per cent further supported increasing the compulsory contribution rate to 12 per cent.[6] The reason for this near-universal support is clear – Australians understand the necessity of having a decent income stream for their retirement, and superannuation provides a market-based means of wealth creation to reach this goal.[7]

However, superannuation has a number of unique characteristics that set it apart from other areas of finance, creating distinct challenges when reform is sought.

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[4] APRA, *Superannuation Fund-level Profiles and Financial Performance- interim edition* – 2014 (issued May 2015), apra.gov.au.

[5] Australian Government, *Super system review* (Final Report, 2010) 55. ('Cooper Review')

[6] Financial Services Council, ING Direct, *Superannuation – Australia's view* (Report, 2013).

[7] Ibid.

2.1 An overview of superannuation governance systems

Corporate governance literature defines two complementary forms of governance mechanisms:

Market (or external) governance: The discipline exerted by market processes, rewarding better performing financial institutions or corporations and penalising poorer performers (such as by greater inward fund flows or more share purchases, improved share price, etc.); and

- **Non-market (or internal) governance:** The organisational structure and administration of a company or financial institution, and how those delegated with the job of managing an organisation are supervised and held to account.[8]

This submission discusses the different forms of governance and their robustness in the superannuation industry further in the following sub-section. For now, we wish to note that there are two basic types of non-market governance structures in Australian superannuation. While funds are typically classified into four broad types: Retail, Corporate, Public Sector, and Industry,[9] two relatively distinct types of fund governance have evolved in the occupational superannuation industry, based on different business, distribution and representation models:

- **For-profit (appointed trustee) model:** Funds run and administered by financial institutions, which have a high sales and distribution component, where fund boards are made up of appointed trustee directors; and
- **Not-for-profit (representative governance) model:** Funds in which distribution is largely at or through the workplace, and with both member and employer representation on the fund board.

Retail funds are typically governed using the for-profit model, with Corporate, Public Sector, and Industry funds generally operating under the representative governance structure.[10] Although many of the latter three fund types are non-public offer funds, available only to certain employees or individuals, a majority of Industry funds have entered the public offer

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[8] E Fama, M Jensen, ‘Separation of Ownership and Control’ (1983) 26 *Journal of Law and Economics* 301.

[9] APRA, ‘Superannuation fund governance: Trustee policies and practices’, (2008) 1 *Insight* 2.

[10] Ibid.

competitive arena occupied by Retail funds. As of June 2015 nearly 79 per cent of Industry funds are public offer funds,[11] placing the majority of Industry funds in direct competition with their Retail counterparts for new members and their retirement savings.

2.2 The importance of internal governance for superannuation

In recent years superannuation fund regulatory policy has placed increased emphasis on market governance. In particular, fund regulation has attempted to ensure greater competitive discipline of private fund managers by freeing up restrictions on fund flows and increasing transparency around price and performance, allowing fund members to switch funds to different investment options and to different funds. The expectation here is that informed and active fund members will act to reward better performing funds or fund options and penalise poorer performers.

Indeed, the viability of any market-based system of fund governance depends critically on a strong disciplining role of fund flows on fund manager performance. As Navone notes:

> …competition among funds to attract new capital is one of the most powerful tools available to solve the agency problem that arises between fund managers and investors.[12]

However, the question for Australia's regulatory framework is whether fund flows are performance-seeking enough to bridge the gap between the large and complex financial institutions managing the funds and the fund members, who since 1992 have been required to hand over a proportion of their incomes to funds and expect to have their funds managed wisely and in their best interests.[13]

Unfortunately, widespread public support for superannuation has not translated into widespread understanding by Australians of their retirement investments. A 2008 study found that 80 per cent of fund members felt they knew very little about their super,[14] while

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[11] APRA, *Statistics: Quarterly Superannuation Performance, June 2015*, issued 20 August 2015, www.apra.gov.au, p. 8.

[12] M Navone, Mutual Fund Competition with Misspecified Investment Objectives (2003) 1.

[13] To the best of the authors' knowledge only an unpublished study by Bryan et al (2010) has looked at the relationship between fund performance and fund flows. It found no statistically significant relationship between the two.

[14] AIST, Superannuation mind and mood: Quantitative report (December 2008).

the FSC/ING survey found that a majority of Australians were confused by the superannuation system and were thus content to let their superannuation 'look after itself'.[15] Instead, most Australians are content to let others deal with their superannuation. Surveys in 2013 found that around 84 per cent of superannuation products obtained over the past five years were through an individual's employer,[16] while 74 per cent of Australians simply accepted their employer's default fund or recommendation, putting their super 'out of sight, out of mind'.[17]

The compulsory, universal nature of superannuation appears to be one reason most Australian fund members can be described as 'reluctant investors', if indeed they consider themselves as 'investors' at all. These characteristics mean that in many ways superannuation is akin to a public-private partnership for the delivery of part of the government's retirement policy. In a very real sense, the government effectively acts as a co-investor or partner in the superannuation industry, and has a direct interest in and responsibility for industry performance that it does not have in voluntary market sectors.

Members' disengagement with their superannuation funds may also be a consequence of a majority of Australians who, according to the ABS, lack the financial literacy skills necessary to manage their finances.[18] According to the Cooper Review, these deficiencies mean that many Australians struggle to understand job applications and payroll forms, leaving them unable to meet the demands of Australia's knowledge-based economy.[19] However, in a compulsory system substantial member disengagement may be a fairly rational outlook due to the system's complexity, confusing nature and long-term outcomes. From the evidence above, it appears that most fund members believe that compulsion equates to government assuming substantial responsibility for superintending the institutions that get access to their compulsory savings, and under what terms.

In such circumstances, superannuation cannot be reasonably viewed as a typical private market populated by rational and informed adults, a key assumption made by previous

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[15] Financial Services Council, ING Direct, above n 4.

[16] Roy Morgan, On the money: Australians' changing attitudes to wealth, debt, superannuation and plans for their financial future (Press Release, 28 November 2013).

[17] Financial Services Council, ING Direct, above n 4.

[18] Australian Bureau of Statistics, 4228.0 – Adult literacy and life skills survey, summary results, Australia (Report, 2006).

[19] Cooper Review, above n 3, 8.

inquiries into the financial sector.[20] Such a challenge was recognised by the Cooper Review, which recommended that an approach of 'libertarian paternalism' be taken in response – namely, the creation of MySuper, a basic yet robust product system that attempts to meet the objective needs of inactive fund members.[21] There is, however, a case to be made that having made that recognition the Review did not go far enough in protecting the reluctant, conscripted superannuation participant. Although it set some general criteria for access to default status, the Review did not deal with issues of fund governance in any detailed way, instead leaving it to the market and greater transparency to discipline fund performance.

The Cooper Review and other empirical evidence makes clear that market governance in compulsory superannuation is unlikely to provide the sort of discipline on funds required to make the industry efficient in the near future. In the shadow of the poor record of and prospects for market governance, non-market governance mechanisms such as organisational structure, including the type and composition of boards that oversee superannuation funds, becomes increasingly important.

Accordingly, any reforms that are made to non-market governance mechanisms should be strongly grounded in evidence about the relationship between governance and performance. Although provision should arguably be made for fund members with the confidence and financial acumen needed to actively tailor their investments, the focus of any changes to the superannuation system must remain with the reluctant investors who form the vast majority of beneficiaries of the superannuation system. Indeed, as we have argued above, the government has a direct interest here because, in essence, superannuation funds are being contracted to deliver a significant part of government retirement policy.

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[20] For example, see: Australian Government, *Financial system inquiry* (Final Report, 1997) 264.

[21] Cooper Review, above n 3.

3 PROBLEMS WITH DEFINITIONS AND THE PREMISE OF INDEPENDENCE

3.1 Defining 'independence' in the Bill

Independence is a nebulous concept. In the words of Larkin, ''we all know what it means', yet its full significance, intricacies, and implications still seem beyond our grasp'.[22] Under the ASX's Corporate Governance Principles, independence is defined according to negative criteria:

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.[23]

The current SIS Act defines an 'independent trustee' similarly, stipulating that a person cannot be a fund member, an employer-sponsor or affiliated with one, nor acting in the interests of a trade union or employee/employer-sponsor.[24] These definitions are in line with international standards, which define an independent director as an individual who is free of material conflicts of interest, particularly conflicts concerning management, that impact upon their ability to make decisions.[25]

This definition contrasts with the Cooper Review's proposal for 'non-associated' trustees, namely, trustees or directors:

> … free of connections to, or associations with, employer sponsors, the appointer (other than by reason of the appointment itself), entities related to the trustee, employer groups, unions, service providers and should not be current or former executives of the fund of a related entity.[26]

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[22] R Larkins, 'Judicial independence and democratization: A theoretical and conceptual analysis' (1996) 44 *American Journal of Comparative Law* 605, 607.

[23] ASX Corporate Governance Council, Corporate governance principles and recommendations with 2010 amendments (2nd ed, 2010) 16.

[24] Superannuation Industry (Supervision) Act 1993 s 10.

[25] International Organisation of Securities Commissions Corporate Governance Task Force, *Board independence of listed companies* (Consultation Report, November 2006) 32. ('IOSCO Report').

[26] Cooper Review, above n 3, 55.

The Bill, defining independence in Section 87, effectively expands on the previous definition in the SIS Act and adopts this 'non-associated' definition as recommended by the Cooper Review. Section 87(1)(a)-(b) restricts 'independent' directors to those who do not have substantial ownership interests of more than 5 per cent in the RSE licensee or a related organisation. 87(1)(c)-(e) restricts 'independent' directors to those who have not in the last three years:

- been employed in any capacity by the RSE licensee
- had a business relationship with the RSE licensee or any of its trustees or directors
- been a director or executive officer of a large employer-sponsor, employer group representing employer-sponsors, or union representing members or sponsors of the fund.

The Australian Prudential Regulation Authority (APRA) has also been given powers in sections 88-90 of the Bill to determine 'independence' on the basis of whether it believes the proposed director will be able to exercise independent judgement, and in section 87 to make regulations with respect to the circumstances determining dependence or otherwise.

This broad definition adopted by the Bill is likely to excessively restrict the available candidates for directors. Most potential trustees unlikely to be able to satisfy the high threshold proposed by the Bill. Although the Bill's expanded definition attempts to address the problems of independence that occur when the threshold is set too low, the need to be free of many current or former connections to the fund and other related parties means that there will be an extremely high threshold for directors to satisfy. Indeed, some observers have raised doubts that this broad definition can even be satisfied by most potential appointees currently available to join superannuation boards.[27]

Exacerbating this issue is evidence suggesting a pre-existing lack of appointees that satisfy even the less stringent independence definitions. A study of 122 ASX200 companies between 2004 and 2007 found that only 10.2 per cent of non-executive directors appointed in 2006-07 were 'new' directors, while existing board members running for re-election received, on average, a 96.2 per cent vote in their favour.[28] Meanwhile, a 2005 APRA

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[27] Scott Donald, 'Independent from what?', *UNSW Centre for Law, Markets and Regulation* (20 October 2013) http://www.clmr.unsw.edu.au/article/accountability/corporate-governance/independent-what

[28] R Williams, 'Once a director, always a director', *The Age* (27 June 2008) 1.

Discussion Paper noted concerns by a number of submissions of an inability to find new directors, and that doing so would come at the expense of knowledge and experience.[29] The issues faced by ASX companies indicate some of the potential limitations of relying on a policy of independence to solve the problems of governance in the superannuation industry.

3.2 The equivocal and contested benefits of independence

The Bill as proposed, and indeed the policy alternatives outlined in the explanatory memorandum, are premised on the view that independent directors can increase board diversity and reduce material conflicts of interest, ultimately maximising benefits to members in the future. Indeed, the explanatory memorandum to the Bill proposes that the very measure of the Bill's success is the extent to which it succeeds in increasing the number of independent directors, rather than measuring success in terms of better outcomes for members. This submission challenges this fundamental premise. In the view of this submission, based on available empirical evidence and supported by economic and legal theory, the claimed benefits of independence are overstated.

There is little clear evidence from corporate governance research demonstrating that more independent directors results in better governance and performance – instead, the primary purpose of independence in corporate governance is the protection of minority shareholders (i.e. 'insiders' versus 'outsiders'). The economic logic here supports this conclusion – adding independent directors to insider-dominated boards is unlikely to overcome the insider group's dominance, nor is there any guarantee that an independent director will even know the interests of minority/outsider groups. In other words, the key governance problem is ensuring the alignment of interests and outlook between a board and its shareholders or, in the case of superannuation, its fund members. Alignment rather than independence should be the overarching policy goal of the government's superannuation governance policy.

In the field of corporate governance, independence currently receives considerable policy attention. According to the International Organisation of Securities Commissions ('IOSCO'), non-executive board members with current or former personal or economic links with the company or its executives risk being unable to act with full independence from management.[30] In contrast, independent non-executive board members are popularly believed to bring objective perspectives to management evaluations, while assuring market

[29] APRA, Governance for APRA-regulated institutions (Discussion Paper, 18 May 2005).

[30] IOSCO Report, above n 23.

participants that their interests will be defended where the interests of management, shareholders and the company diverge.[31]

However, the academic literature paints a much more complex and ambiguous picture, with research indicating that having a greater number of independent directors on company boards does not guarantee such highly sought-after outcomes, and may even be anathema to them.

Implementing mandated independence guidelines creates a structural test that ostensibly determines, according to defined criteria, whether a person is or is not 'independent'. The objective here is to ensure that governance is not monopolised by one group at the expense of another, even if that group is a majority, thereby minimising conflicts of interest on company and trustee boards.

However, independent *status* (i.e. classified as such under statute or a code of practice) does not guarantee non-conflicted *outcomes* (i.e. the actual ability of a board to exercise objective judgement in the best interests of its principals).[32] Although independent outcomes may be easier for individuals who do not hold material conflicts of interest, it must be emphasised that this does not mean that individuals who do have such conflicts cannot exercise objective, independent judgement.[33] According to Wheeler, '[h]istory tells us unequivocally that the presence of independent directors neither guarantees good financial performance, nor freedom from scandal.'[34]

A number of observers have criticised the use of structural tests to encourage independence, noting that such behaviour is more likely to occur by chance than through corporate governance mechanisms.[35] Others contend that structural barriers alone do not prevent negative influences from arising and are unlikely to create the necessary conditions

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[31] Ibid.

[32] Ibid.

[33] Ibid.

[34] S Wheeler, 'Do we really need 'independent' directors on super boards? , *UNSW Centre for Law, Markets and Regulation* (5 September 2013) <http://www.clmr.unsw.edu.au/article/accountability/corporate-governance/do-we-really-need-independent-directors-super-boards>

[35] S Wheeler, 'Independent directors and corporate governance' (2012) 27 *Australian Journal of Corporate Law* 168. 187.

for more substantive independence.[36] Some, such as Clarke and Dean, reject the notion of independence entirely, arguing that by itself the concept is 'virtually useless [and] operationally bankrupt':

> It is useless because it doesn't faithfully describe or reinforce how essential it is that both directors and auditors in going about their tasks are extremely well informed, and operationally bankrupt because it is, at best, functional only as a reactive rather than proactive tool, and of dubious benefit in any event.[37]

Independence is, in their view, used much too often to improve the *appearance* of integrity on company boards or auditors rather than reducing conflicted decision making in *reality*. In fact, the authors warn that focusing excessively on appearances is likely to give investors unwarranted confidence and a false sense of security, increasing the shock when companies continue to fall into disrepute or insolvency.[38]

This is a view of the potential counterproductive outcome of independent directors that is also supported in the fund management sector. Haslem has argued that there is little evidence that independent directors have changed fund fiduciary behaviour, and that instead the consequence of the gap between reality and promise has been the creation of 'cover for [the] self-interested behaviour of fund advisors.'[39]

Nevertheless, if independence can be shown to result in better performance, this would give some credence to the argument that more independent directors are needed on superannuation boards. However, the empirical research paints a much more complex picture, with existing corporate governance research producing mixed evidence for claims of better performance (see Section 3.2.1). One clear conclusion from the empirical evidence is that independence is not a *panacea* for corporate governance, and indeed, may not even be the most important policy reform to pursue. Such contradictory conclusions mean that the Bill's ultimate goal—to create a stable and efficient superannuation system that best serves

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[36] S Le Mire, G Gilligan, 'Independence and independent company directors' (2013) 13 *Journal of Corporate Law Studies* 443, 472, 474.

[37] Frank Clarke, Graeme Dean, *Indecent disclosure: Gilding the corporate lily* (Cambridge University Press, 2007) 45.

[38] Ibid 46.

[39] J Haslem, 'Mutual funds are imperfectly competitive' (2013) 4 *Journal of Index Investing* 32. See also J Haslem, 'Why Have Mutual Fund Independent Directors Failed as 'Shareholder Watchdogs'?' (2010) 19 *Journal of Investing* 7.

members' interests—may not be achieved as a result of increased levels of independent directors on superannuation boards.

It appears that although independence may bring benefits to *some* boards lacking diversity or appropriate separation from management or company interests, the main effect of such a response is to create the *illusion* of independence. There is little indication that such perceptions in any way reflect the reality of boards, and as such independence alone is unlikely to materially address the dual challenges of diversity and conflict of interest that boards must manage.

3.2.1 Conflicting results over the value of independent directors in corporate governance

Following mandatory changes in the composition of United States company boards under the *Sarbanes-Oxley Act*, a 2013 study found that companies with majority independent directors enjoyed increased turnover of poorly performing CEOs, leading to improved firm performance.[40]

In contrast, a study into the 2003 change to the ASX's listing rules requiring boards to adopt a majority of independent directors or 'if not, why not', concluded that companies with a majority of independent directors were *less* likely to replace poorly performing CEOs, and in addition were more likely to demand higher remuneration fees for decreased firm performance.[41] Ultimately, these consequences of independence resulted in an estimated loss of $69 billion between 2003 and 2011.[42]

Further compounding these mixed results, a 2012 study of all Australian publicly listed companies found that as the numbers of independent directors on a board increase, the company performance measured by both accounting and market-based measures diminishes.[43] Nevertheless, the study's conclusion was that *some* independence could provide greater levels of oversight,[44] making it even more unclear whether independence is valuable, and how much so if answered in the affirmative.

[40] L Guo, R Masulis, *Board structure and monitoring: New evidence from CEO turnover* (Study, UNSW Australian School of Business, 25 January 2013).

[41] M Fischer, P Swan, Does board independence improve firm performance? Outcome of a quasi-natural experiment (Study, UNSW Australian School of Business, 25 Oct 2013).

[42] Ibid.

[43] J Christensen, P Kent, J Stewart, 'Corporate governance and company performance in Australia' (2010) 55 *Australian Accounting Review* 372.

[44] Ibid.

Indeed, we suggest that there is a very simple reason why increasing the number of independent directors may not in and of itself resolve the problems of corporate governance. As mentioned above, the purpose of increased independence is to counter the dominance of insiders (whether a majority or not) who may not act in the best interests of *all* shareholders. However, the overriding challenge of corporate governance is to align the interests of the corporate board, and management more generally, as closely as possible to those of the shareholders.

The central way corporate boards attempt to achieve such an alignment is via representation, with board members elected by shareholders. Representation is without doubt the most powerful mechanism within corporate governance for aligning the interests of boards and shareholders, because having shareholders on the board helps to bring the interests of shareholders directly into the boardroom. While there are recognised problems with representative models (including representative political models) or the protection of minority interests, representation is seen as critical to giving the majority of citizens, shareholders or fund members a voice.

Ultimately, this submission proposes that the importance currently ascribed to independence in non-market governance is not reflective of the equivocal research into its ostensible benefits. It should be noted that some individual superannuation funds nevertheless contend that increased independence may be necessary for other reasons, one example being a means of expanding the pool of potential appointees for trustee boards where funds face difficulties recruiting from existing representative organisations. Although we accept that reforming the SIS Act so that funds, for such purposes and at their discretion, can more easily appoint independent directors on their boards, we reiterate that any Bill proposed to this effect should be one that improves the alignment between the board and fund members, rather than mandated independence requirements.

4 THE BENEFITS AND SUCCESS OF REPRESENTATION

The representative governance model is not a perfect system by any measure. For example, the Cooper Review noted that the model does not necessarily achieve its original purpose of ensuring both employee and employers in a single-employer defined fund were given legitimate opportunity to operate a fund, and also suggested that the model may be vulnerable to the perception that individual trustees are answerable to or dictated to by the organisation that appointed them.[45] However, the representative model remains diverse in appointment methods, the numbers of trustees and areas of governance. Remarkably, despite the diversity of representation, the common outcome of representation seems to be a closer alignment of trustees' and members' interests.

This submission contends that, in spite of some shortcomings, representation is actually the model that most closely satisfies the Bill's objectives. The evidence for this claim is overwhelming – the not-for-profit representative trustee model has outperformed its for-profit appointed trustee competitors on virtually every important criterion of superannuation performance over a long period. Although there may be scope for further improvement of the representative governance model, it promotes higher levels of diversity amongst trustees, more effectively minimises conflicts of interest, and, importantly, has continually outperformed the for-profit model over the past decade, generating higher net returns for fund members.

In order to support the claims in our submission, we now review the evidence on the relationship between the two main governance models and some of the performance objectives. This evidence is derived primarily from data supplied by the respected superannuation research and ratings firm Rainmaker International, and from a governance survey undertaken by APRA.

4.1 Higher levels of diversity

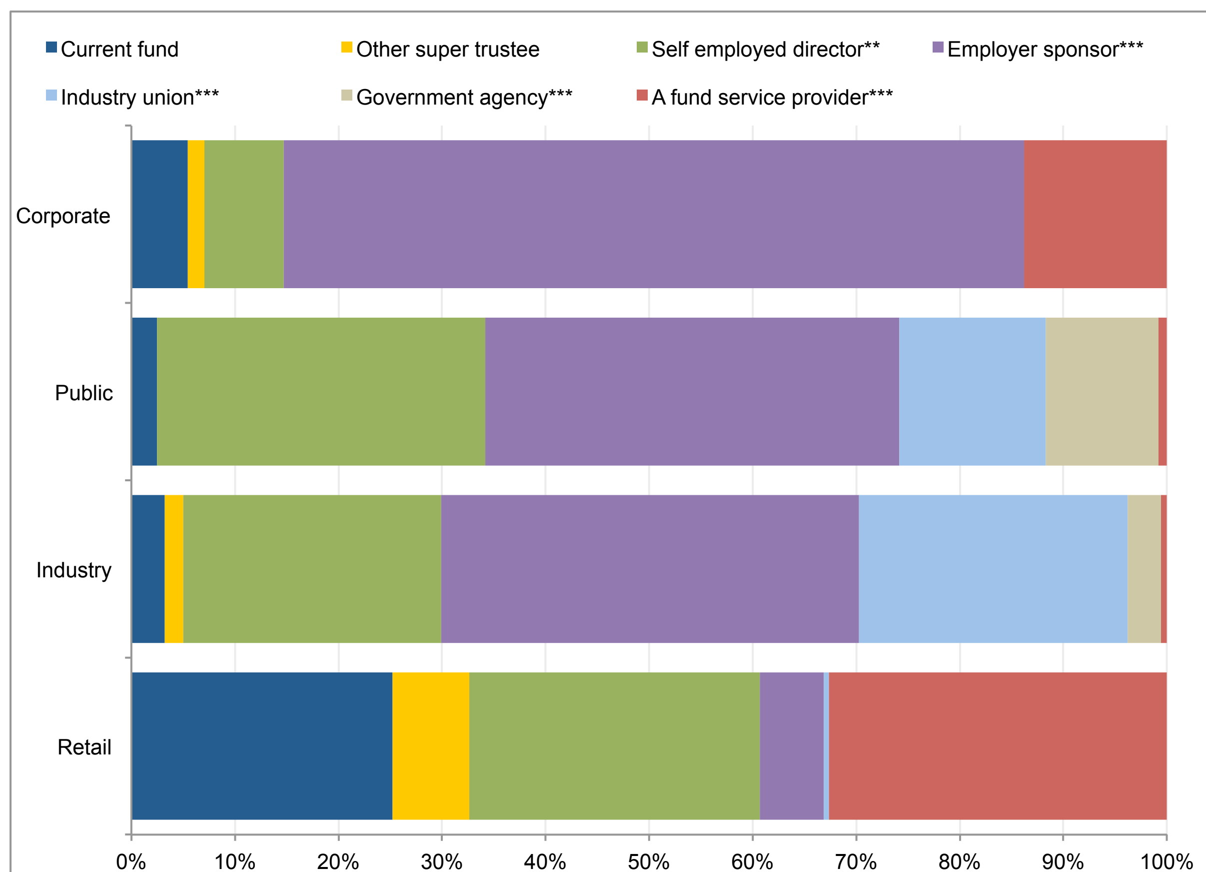
Diversity is increasingly acknowledged as crucial to effective governance by a wide range of sources. The common argument in its favour is that diversity helps reduce the possibility of myopic 'group-think' that limits the ability of boards to make effective strategic decisions in face of a host of competing and conflicting priorities. Indeed, diversity of views, skills and experience is touted in the Bill's explanatory memorandum as one of the key benefits of independent directors. However, greater diversity seems strongly associated with the

[45] Cooper Review, above n 3, 53-4.

structure of the equal representation model. Although this submission does not suggest that existing levels of diversity within the superannuation sector are ideal and cannot or should not be improved, the evidence demonstrates that, compared to for-profit Retail funds, not-for-profit superannuation boards have higher levels of diversity.

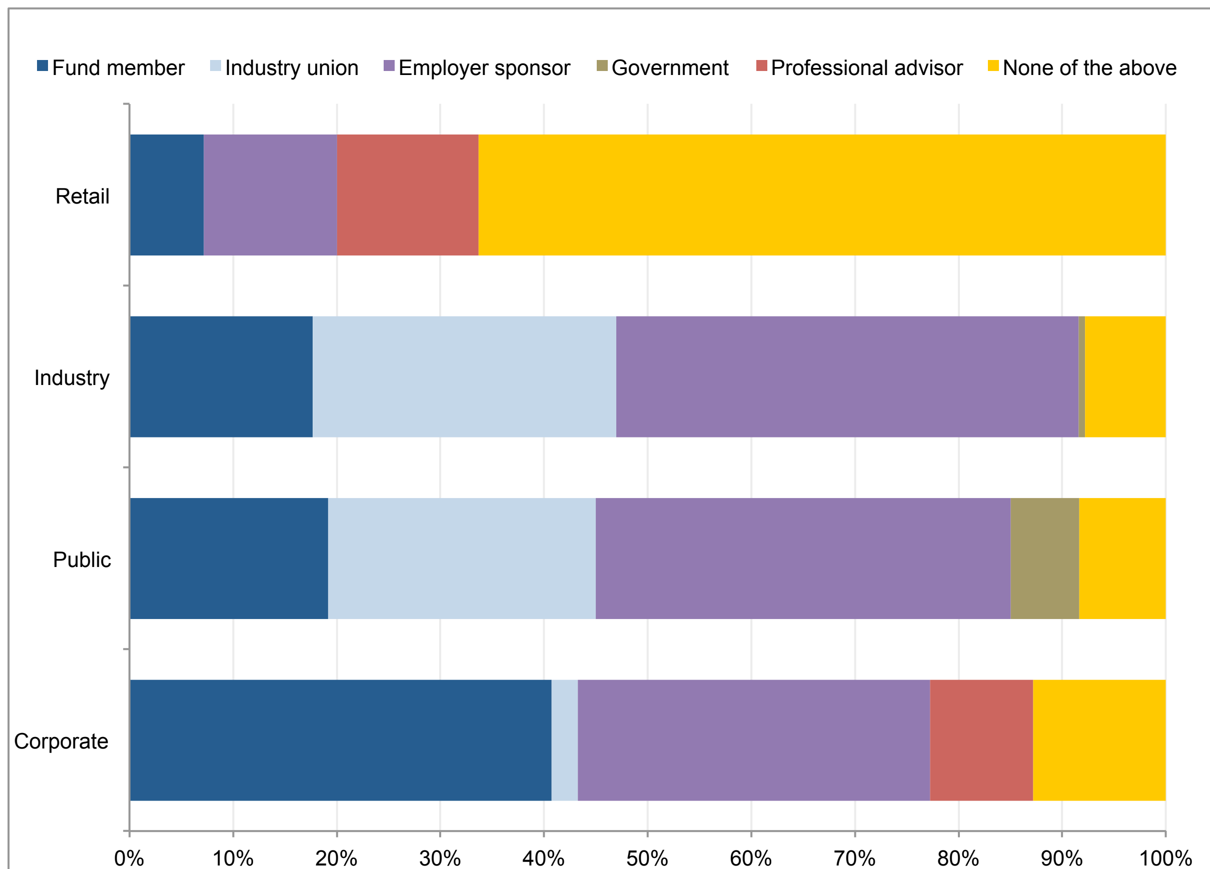
As shown by Fig 4.1.1 below, a majority of Retail directors are employed either by the current fund (25.2 per cent) or the fund's service provider (32.6 per cent), with only a small proportion of directors representing other defined interest groups. In contrast, not-for-profit fund trustees—Industry and Public Sector types in particular—tend to have more widely dispersed sources, notably from employer groups and industry unions.

Figure 4.1.1 Employer of trustees/directors on superannuation boards



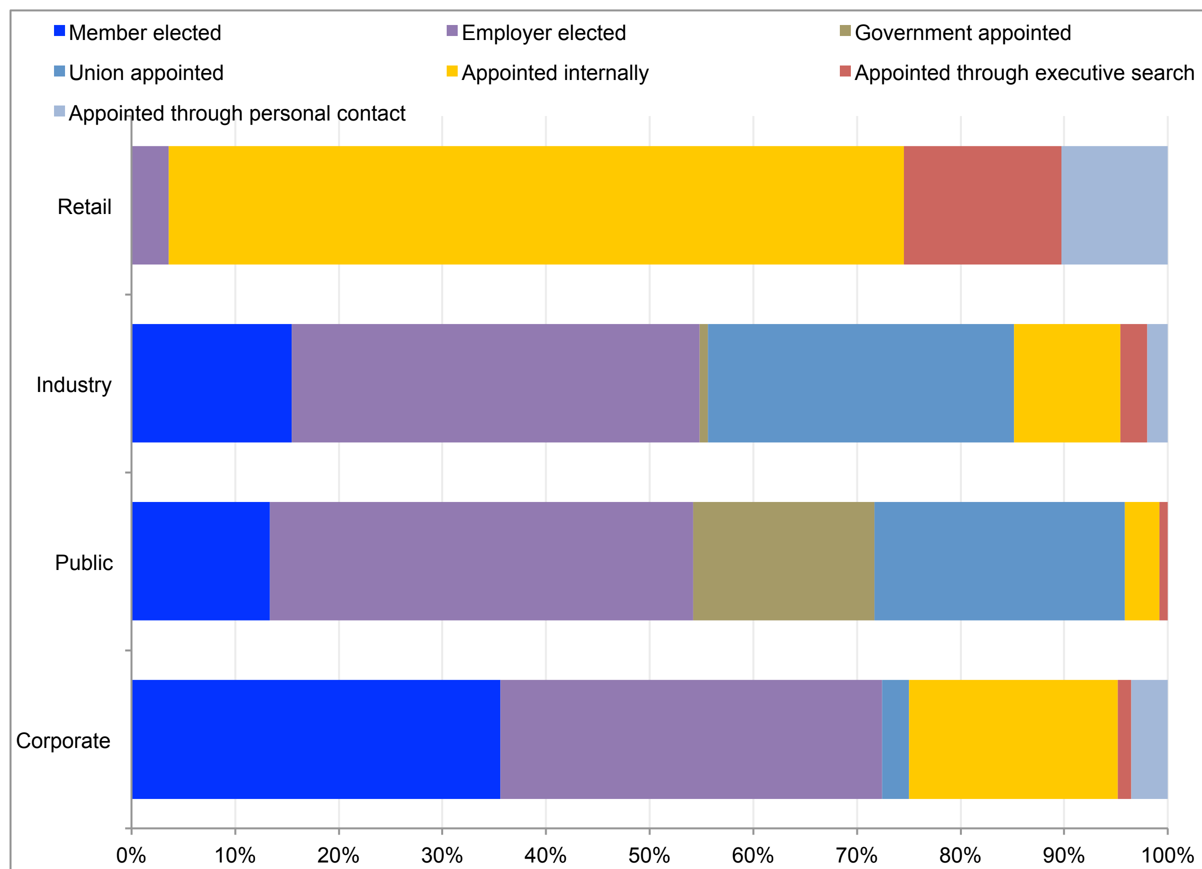
A similar finding occurs when reviewing the various types of board representation (Fig 4.1.2), with not-for-profit trustees far more likely to represent the interests of fund members, employers and industry unions than Retail directors.

Figure 4.1.2 Types of board representation



Importantly, not-for-profit funds tend to be appointed from sources external to the fund significantly more often than for-profit funds, which overwhelmingly appoint directors from internal sources (Fig 4.1.3).

Figure 4.1.3 Method of board appointment



It does not necessarily follow that for-profit funds must alter their governance systems to emulate their not-for-profit counterparts, or that individual not-for-profit funds must be prohibited from appointing independent directors according to individual fund discretion. As stated in section 3, there may be other reasons for independence that justify a fund attempting to recruit more independent trustees, and overly prescriptive laws and regulations against independence may prove as problematic as laws and regulations for mandated independence.

Nevertheless, we believe that the ability of not-for-profit funds to appoint trustees from more diverse backgrounds stems directly from the representative governance model, which limits excessive appointment of individuals from one particular group of 'insiders' and prescribes minimum numbers of appointees from different backgrounds. Accordingly, using

independence to minimise potential conflicts of interest is likely to result in little meaningful improvement in this regard.

4.2 Ability to minimise conflicts of interest and act in members' best interests

Section 2 of the submission noted that a key concern of corporate governance research and policy is attempting to maximise the alignment of agents charged with managing other people's money and those who invest that money. To put it another way, the objective of corporate governance is to minimise the potential and actual conflicts of interest between investors and the corporate managers of that money. This principle applies equally to fund governance.

As stated by John Bogle, former CEO of the Vanguard Group, managing conflict 'is a matter of fiduciary principle, as no man can serve two masters.'[46] Nevertheless, minimising and managing conflicts of interest will almost certainly be a permanent challenge for corporate and fund governance policymakers.[47] Accordingly, the modern response to this issue is to structure governance processes to minimise conflict as much as possible, and then use disclosure to appropriately manage such issues and avoid excessive conflict where possible.

The majority of not-for-profit funds trustees hold relatively few directorships outside the fund to which they are a trustee. In particular, Industry and Corporate funds are over four times more likely than Retail funds to hold no additional directorships at all. Conversely, compared to Industry and Corporate funds, Retail fund directors are six times more likely to hold more than 15 directorships (Fig 4.2.1).

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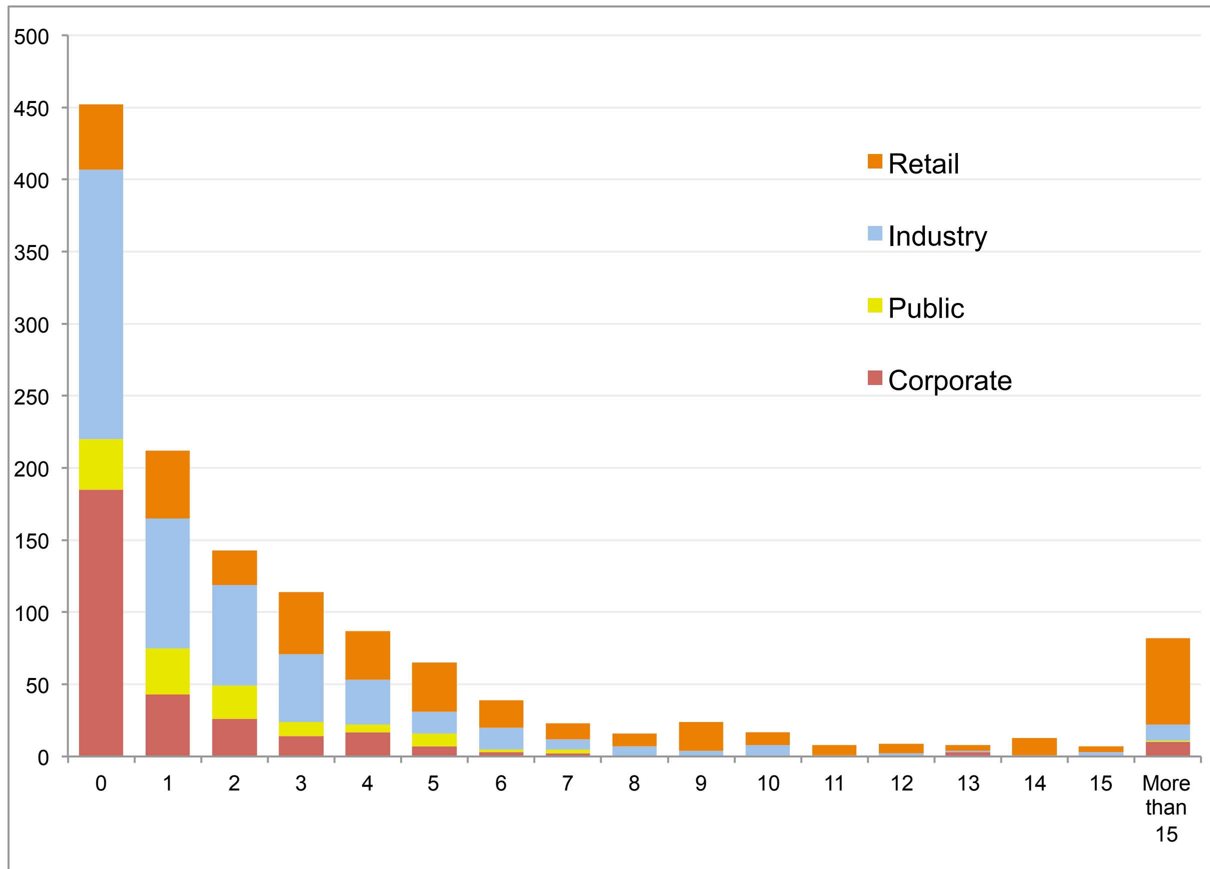
[46] J Bogle 'Bringing mutuality to mutual funds' (2008) 1 *Rotman International Journal of Pension Management* 1, 57.

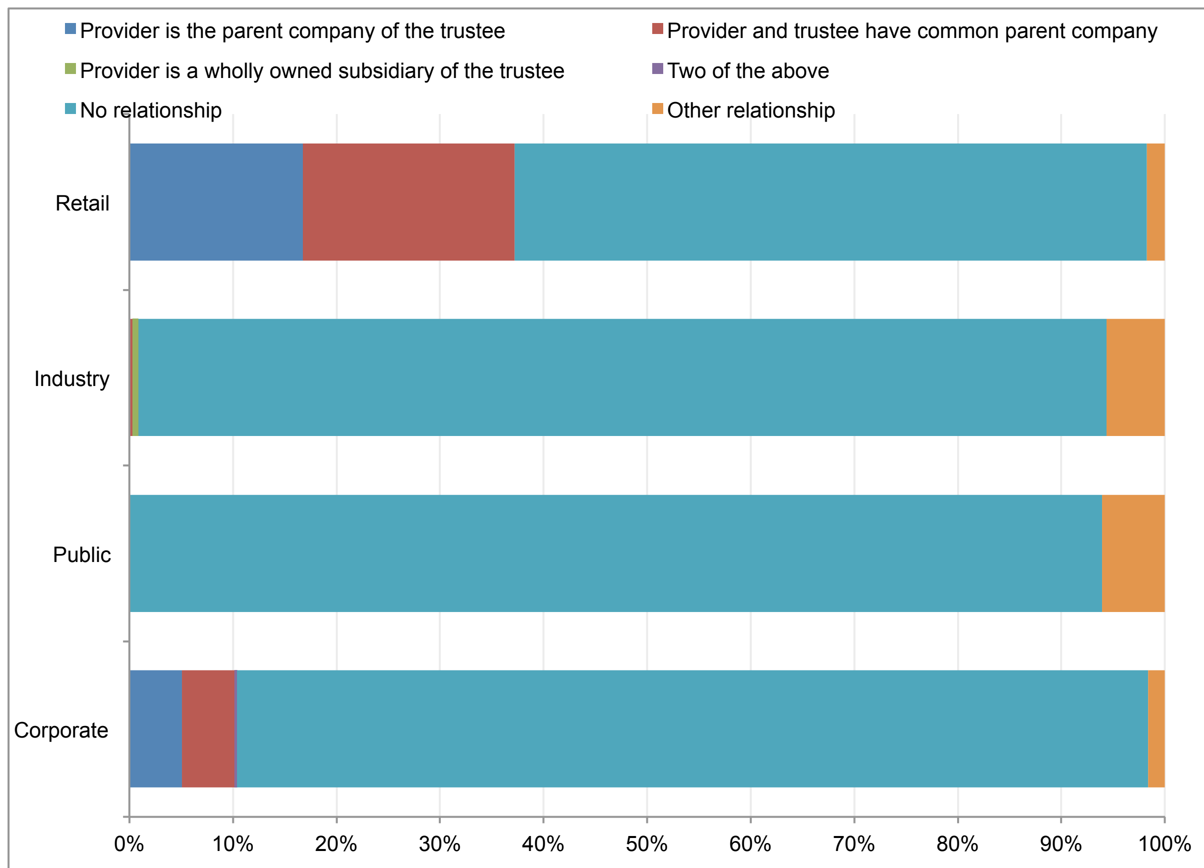
[47] J Harris, Company Law: Theories, Principles and Applications (LexisNexis, 2012) 282.

Figure 4.2.1 Number of other directorships currently held



And the issue of potentially conflicted relational links that might affect governance goes even further. Fig 4.2.2 shows that over a third of Retail funds' service providers are either the trustees' parent company or share a common parent company, compared with 0.3 per cent of Industry funds' service providers.

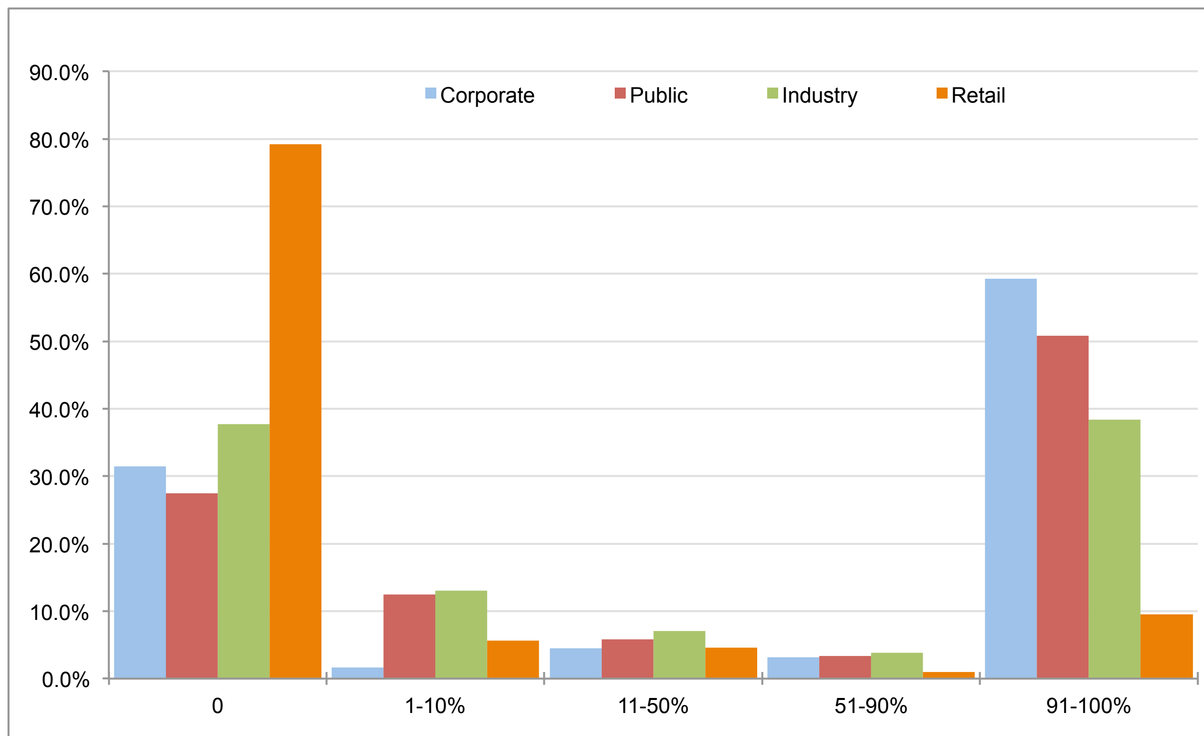
Figure 4.2.2 Service provider relationship to fund



One possible way of minimising this potential structural conflict of interest is to make trustees have their own superannuation savings in the fund – to have what North Americans term 'skin the in game'. Although not a cure-all for the problem of conflict, the understanding that a trustee-directors' retirement savings will be affected by the strategic decisions they make is thought to more likely to temper potentially conflicted decision-making.

Currently, the absence of skin in the game seems to exert a reinforcing rather than a moderating effect on the problem of conflict of interest. Not-for-profit trustees are substantially more likely to be invested in the fund they manage than for-profit directors (Fig 4.2.3). Notably, almost 80 per cent of Retail directors invest none of their superannuation contributions in the funds they manage, compared to between 28-38 per cent for not-for-profit trustees. In contrast, between 36-58 per cent of not-for-profit trustees invest *all* their superannuation in the funds they run, compared to 9 per cent of Retail funds.

Figure 4.2.3 Percentage of directors invested in fund they manage



This section has presented evidence that there are several grounds for thinking that *prima facie* there are different conflicts of interest in different fund governance structures in superannuation. However, it must be emphasised that the myriad relationships that superannuation trustees and directors may manage while sitting on fund boards do not automatically give rise to actual conflict of interest. As argued by respondents to the Cooper Review, the majority of trustees understand the need to represent all members of a fund rather than a single stakeholder or class of fund member.[48]

Although managing conflict of interest will continue to be a challenge for all funds, the evidence shows that for not-for-profit directors have more diverse backgrounds, hold fewer additional directorships, have less direct relationships to the fund or related service providers, and invest more of their retirement savings in the fund they represent. Such actions indicate an appropriate ability to manage existing conflict of interest and acting in the interest of the fund's members.

[48] Cooper Review, above n 3, 54.

4.3 Governance and performance – the evidence

Diversity, minimising conflict and ensuring that fund trustee-directors act in the best interests of their members count for little should members' retirement savings be invested poorly. In fact, the overarching aim of these attributes is to maximise the performance of the fund for members, with the core performance metric being the long-term net returns for members. In maximising performance, the fund aims not only at providing ample finances for each individual's retirement, but to also allows this important pillar of Australia's retirement system to remain viable in the long-term.

As explained in Section 2, superannuation is a complex sector, with issues of member compulsion, fund and asset size, fees and a quasi-public-private industry structure all contributing in some fashion to long-term performance. As such, many of the corporate governance concepts proposed as means of improving superannuation governance—independence being the primary example in this submission—are not guaranteed to translate into better industry performance, even if one disregards the contested nature of many of these concepts in other settings.

Despite these caveats, the available evidence does show clear causal relationship between not-for-profit representative governance funds, and higher levels of returns for members. Many types of empirical testing has been undertaken on superannuation performance in Australia, some using raw returns, others attempting to see if adjusting for risk would change the results of the simple compounding tests. Both raw and risk-adjusted research supports the proposition that the two governance models produce significantly different performance outcomes.

Previous research has broadly concluded that, compared to for-profit performance, not-for-profit superannuation funds (i.e. Corporate, Industry and Public Sector) have consistently generated higher returns for their members, up to 2.4 per cent per annum higher on a risk-adjusted basis.[49] Industry Super Australia recently affirmed this finding, concluding that had all superannuation funds returned the not-for-profit funds' 5.7 per cent long-term annual average, Australian retirement savings would be $88 billion higher than it currently stands.[50]

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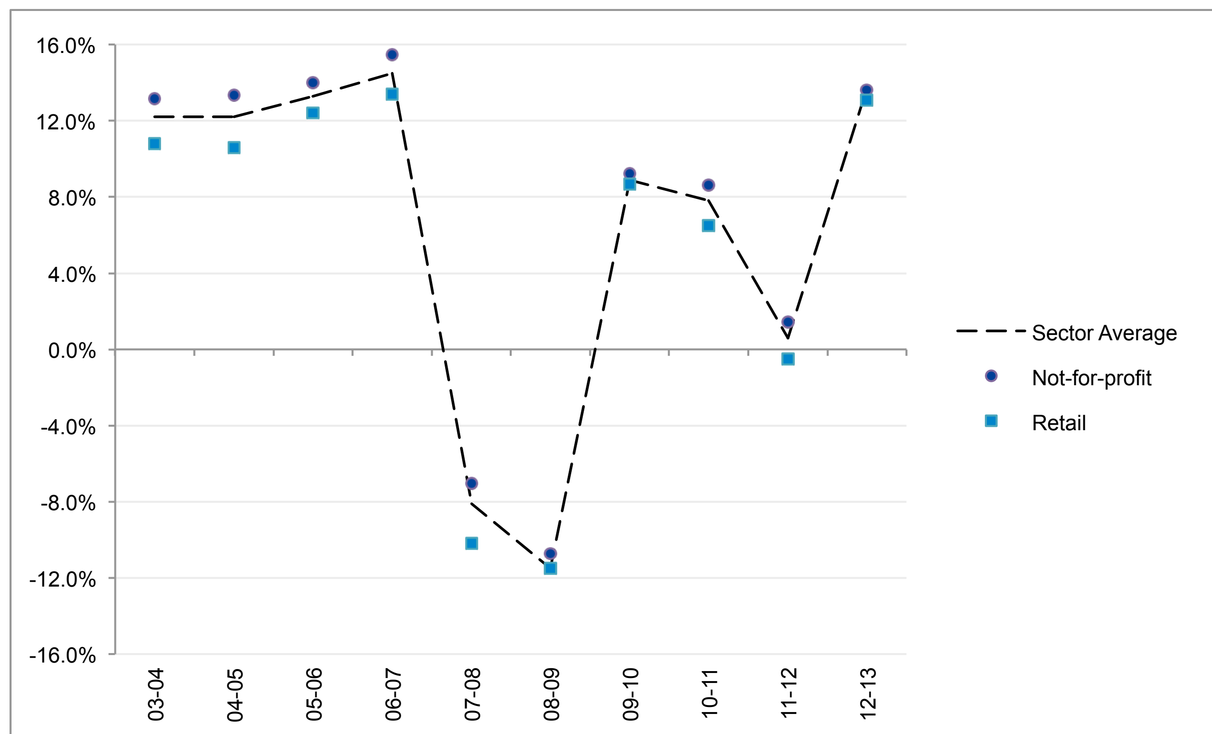
[49] D Bryan, R Ham, M Rafferty, K Yoon, *Governance and performance in the Australian occupational superannuation industry* (Australian Institute of Superannuation Trustees, March 2009).

[50] Industry Super Australia, Long term superannuation investment performance: An update to A Comparison of Long term Superannuation Investment Performance (October 2013).

The most recent rate of return (ROR) data from APRA indicates the superior performance of not-for-profit funds. The ROR for Industry funds to year ends June 2014 and June 2015 were 12.7 and 9.8 per cent respectively, and for Public Sector funds 12.1 and 9.8 per cent respectively. The comparable Retail fund RORs for these years were 10.5 and 7.7 per cent respectively.[51] Figure 4.3.1 below indicates that, in each financial year between 2003-04 and 2012-13, not-for-profit funds outperformed their for-profit counterparts between 0.5 and 3.2 per cent in every year.

Figure 4.3.1 Rates of return percentage by market segment 2004-2013



[51] APRA, *Statistics: Quarterly Superannuation Performance, June 2015*, issued 20 August 2015, www.apra.gov.au, pp. 20, 24, 28.

In order to bring previous research together and provide a more pragmatic illustration of the importance of strong performance, this submission analyses actual crediting rate data from Rainmaker International for balanced and default funds between 1987-88 and 2012-13, and provides two scenarios to illustrate the long-term effects of fund performance of not-for-profit and for-profit funds.

The first graph (Fig 4.3.2) demonstrates fund performance if an initial $1000 investment was in the fund at the beginning of the 1987-88 financial year, with only the crediting rate added annually and compounded. This scenario is representative of an individual who no longer contributes to their superannuation and relies solely on the fund's performance for wealth growth. The second graph (Fig 4.3.3) also begins with an initial $1000 investment, but an additional $1000 per annum is also contributed to the balance. As per Fig 4.3.2, the crediting rate is then added and compounded annually.

These two scenarios act as proxies for two basic types of fund member – Fig 4.3.2 depicts retired individuals who no longer contribute to their funds, while Fig 4.3.3 depicts working individuals still in the accumulation phase of their superannuation life-cycle and therefore continue to make superannuation contributions.

As shown in both graphs below, not-for-profit balanced/default funds have consistently and significantly outperformed for-profit funds during the 26-year sample period. The results in Fig 4.3.1 shows a $2,806.38 difference in return in favour of not-for-profit funds, a performance difference 56.5 per cent higher than for-profit funds over the sample period. Fig 4.3.2 demonstrates that investing in a not-for-profit fund and making an additional contribution to the fund of $1000 each year will give $18,462.27 more than the equivalent investment option in for-profit funds, a 31.8 per cent difference in return over the sample period.

Figure 4.3.2 Crediting rates and impact on initial $1000 investment

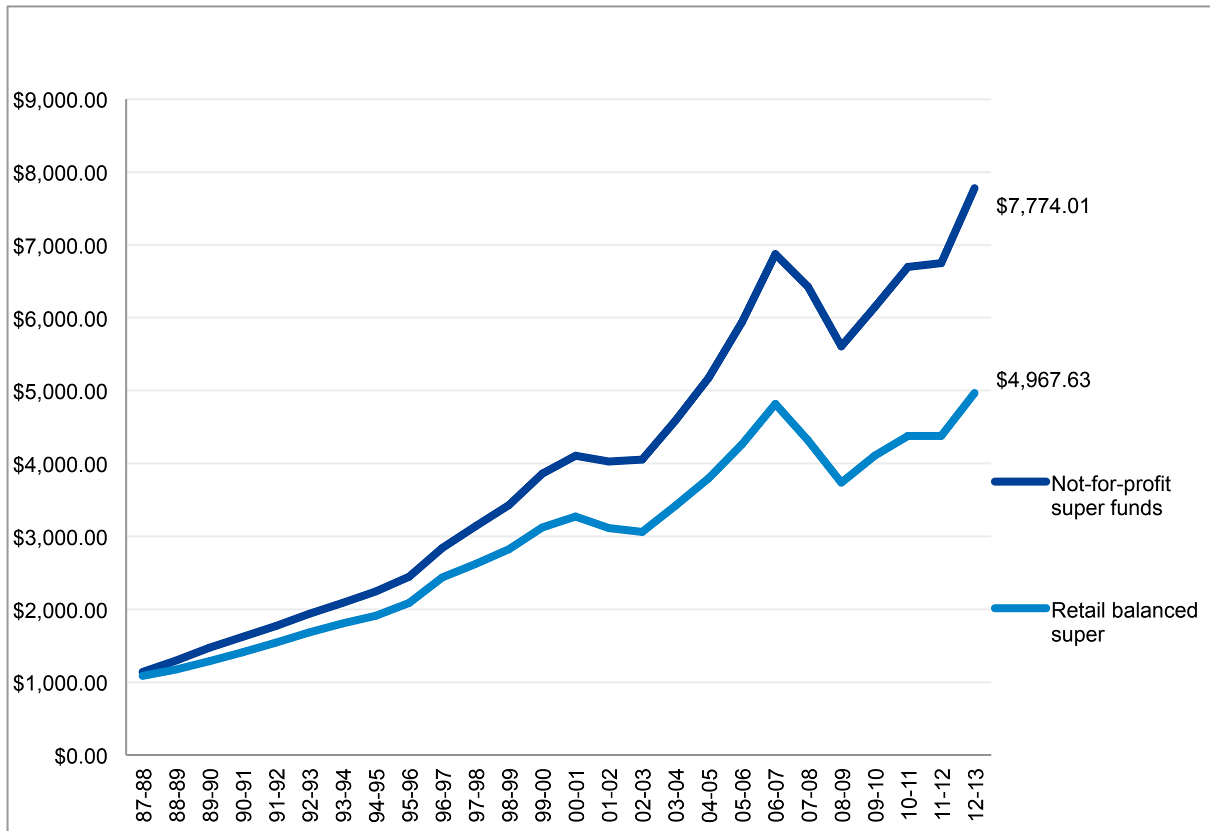
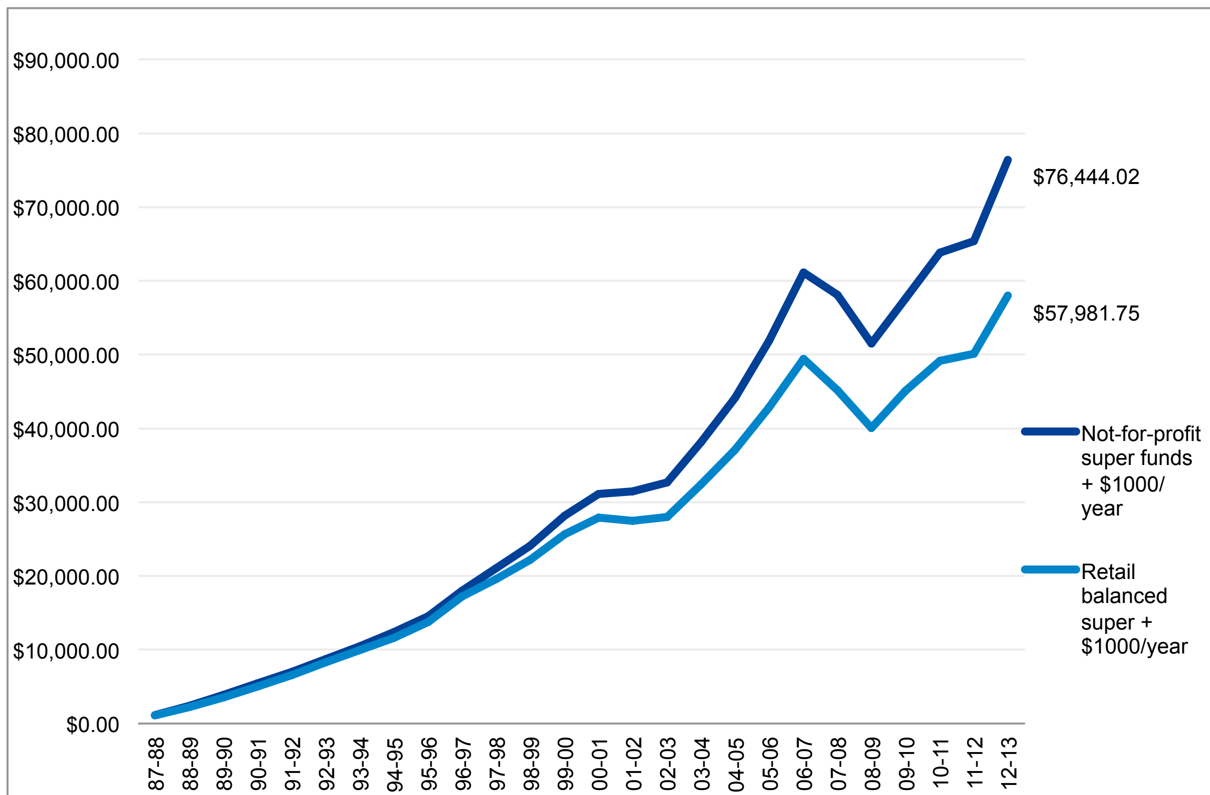


Figure 4.3.3 Impact on $1000 investment plus additional $1000 per annum



In our research report for the McKell Institute[52] we decomposed the results into a range of sample periods to see if the outperformance can either be attributed to one particular period, or if the performance difference has changed over time. We find that the outperformance was sustained across the sample period, and in both upswings and downturns in asset markets.

We should stress, that this scenario relies on actual crediting rate data over a 26-year time period. This period was chosen for the simple reason that this was the longest credible data available. A typical working life will be much longer than this, and it would be quite easy to extrapolate from these results to the likely effect of such a performance difference over a typical working life. Essentially, the compounded effects of outperformance over an even longer period would magnify the scale of the existing difference, and make even starker the effect of that outperformance on retirement living standards.

It may be contended that the greater diversity of investment options offered by many for-profit funds demonstrate that the for-profit model can bring greater returns to the members who actively choose such investment options. Such analysis has not been conducted by this submission. However, even assuming that this assertion is correct, it does not change the force of the results presented here.

In any case, such an assertion is beside the point, as it disregards the fact that the vast majority of Australian superannuation fund members are 'reluctant investors', either uninterested in managing their 'super' or lacking the financial literacy skills necessary to properly understand performance and act to reward better performing funds. This structural fact was the reason for the introduction of MySuper. While some fund members undoubtedly will switch, the ability of the minority of fund members interested or skilled enough to manage their superannuation should not be used as justification for reform that is not in the interest of the majority of Australians.

Ultimately, this data and all the empirical testing of the relationship between governance and performance, indicates that, regardless of the exact amount of influence fund governance has over returns, the representative governance model is clearly responsible for helping produce significantly better performance for the vast majority of compulsory contribution fund members.

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[52] *The Success of Representative Governance,* above at n2

5 RECOMMENDATIONS

This submission supports the government's concern with the internal (non-market) governance of superannuation funds in Australia. We have argued that it is a reform area likely to have a substantial impact upon the long-term performance of the superannuation sector. This is because of the sector's unique attributes – namely, a majority of fund members characterised as 'reluctant investors', who do not have the interest or financial acumen necessary for market governance to play a significant role. These constraints on the role of market governance are exacerbated in an industry that typically competes for funds under management and market share rather than performance and price.

However, this submission demonstrates that increasing the proportion of independent trustee-directors is unlikely to bring about increased levels of diversity, lower levels of potential and actual conflicts of interest, and improved fund performance for the benefit of members. Conversely, introducing non-associated trustee-directors as per the Bill is likely to exacerbate existing issues surrounding a lack of suitable trustees.

Instead of implementing reforms based on the promise (which in turn is based on an uncertain premise) that independence leads to benefits for funds and members alike, this submission argues that the existing not-for-profit representative governance model already promotes higher levels of diversity and more effectively minimises conflicts of interest in comparison to the for-profit governance model.

Critically, funds with representative trustee boards have continually and significantly generated higher returns for their members. While representative governance may not be the only factor allowing not-for-profit funds to perform better than their for-profit counterparts, the success of this governance model nevertheless indicates that mandated independence is unnecessary to give fund members appropriate levels of retirement income.

Indeed, if there is one lesson that can be learned from an evidence-based approach to superannuation governance, it is not the role of independent directors to protect minority shareholders. Rather, the lesson is that representative governance is a decisive factor in closely aligning the interests those who are charged with managing funds with the majority of fund members.

Subsequently, we cannot recommend that the Bill be passed in its present form. The imposition of independent directors, and the repeal of Part 9 of the SIS Act and its requirements around equal representation, are likely to undermine the representative model

which has been so successful up until now. Meanwhile, this will be at an additional cost to the funds, with no clear benefits to their governance.

6 ABOUT THE CENTRE FOR WORKPLACE FUTURES

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