12 August 2018

By email: super@pc.gov.au

Ms Karen Chester, Deputy Chair
Productivity Commission
Canberra ACT 2600

Dear Ms Chester

Re: Governance of Superannuation Funds: Inquiry into the Assessment of the Efficiency and Competitiveness of the Superannuation System

In a recent post-draft submission, published on 3 August 2018, the Australian Prudential Regulation Authority (APRA) has continued to hold an erroneous view on superannuation governance in stating (p.12 of submission):

> *APRA's long-held view is that the appointment of directors able to bring new and objective perspectives to board deliberations, including the appointment of independent directors, can result in improvements to the quality of decision-making. Additionally, APRA continues to support the Government's proposed amendments to require a minimum of one-third independent directors and an independent chair on superannuation boards.*

The concept of "independent" has not been clearly defined here or in the proposed *Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017,* but it can be inferred to be inconsistent with s181 of the *Corporations Act 2001*.

A different concept of independence has been misapplied in the proposed amendments to superannuation trustee directors who are regulated under the *Superannuation Industry (Supervision) Act 1993*. The proposed legislation would wrongly prioritise the importance of investment expertise in directors ahead of their alignment of interests with members.

- The Hayne royal commission has recently provided many examples of highly skilled *Retail* fund directors who have unlawfully damaged the interests of superannuation members.
- Over long periods, *Retail* funds with most "independent" directors have performed significantly worse on a consistent, persistent and predictable basis relative to other superannuation funds which have few, if any, "independent" directors.

Concepts of "independent" are clarified in my November 2017 submission (enclosed below) to the Senate Economics Legislation Committee for rejecting the above Bill. The PC should ensure that superannuation governance principles are correctly prioritised.

Yours sincerely

Dr Wilson Sy

Superannuation Governance: If it ain't broke…

Wilson Sy
(Senior adviser to the Super System Review 2010)

17 November 2017

> The current Bill for "strengthening trustee arrangements" before Parliament has a non-standard definition of independence which prevents the alignment of interests between directors and members of superannuation. This alignment of interests with members is good governance because it reduces conflicts of interests. Since the Bill proposes a concept of independence which is bad governance and it is potentially harmful to superannuation, Parliament should reject it.

The current Government seems to be doing its best to destroy Australian superannuation. Since the Wallis inquiry in 1996, nearly twenty years of performance data show that *Industry*[1] funds performed, on average, more than two percent per annum better than *Retail*[2] funds – a significantly better result. Nevertheless, the Government seems impelled to change how *Industry* funds are run, at the behest of the lobbyists of the $147 billion financial services industry.

The governance model of *Industry* funds are similar to those of the best performing pension funds in the world, for example, those of The Netherlands, Denmark and Canada. Yet when David Murray, a former CEO of the Commonwealth Bank and the chair of the 2014 Financial System Inquiry (FSI) was interviewed in October 2017 on why the best governance model needs to be changed, he said:

> *In my view that is not a sufficient condition, independence and skill set are more important.*

By asserting that the best model is insufficient, David Murray has ignored the fact that *Retail* funds, with a commercial model, supposedly having the greatest independence and skill set, have performed worst and relatively poorly against other funds, not to mention being convicted of numerous crimes and subjected to various scandals. The facts contradict David Murray's theory. The Government's rationale for legislative changes appears to have little scientific basis. On *Industry* fund governance, the Government seems to be saying:

> It works very well in practice, but it doesn't work in theory. If the facts do not fit the theory, then change the facts.

Reforming superannuation governance is how the Government is going to change the facts. However, could it be that the theory is wrong or the theory is misunderstood?

[1] An *Industry* fund is a *non-profit* organization managing the superannuation portfolios of its mutual members.

[2] A *Retail* fund is a commercial organization managing to make profits for its shareholders by selling superannuation products to its members, as consumers.

According to current government policy of *economic rationalism, Industry* funds are not driven by the need to make profit in the market, therefore they cannot possibly be competitive or efficient like *Retail* funds are expected to be. However, facts have contradicted theory dramatically in the global financial crisis (GFC), and more generally and persistently in Australian superannuation and many other economic situations.

Independence

In the Bill for “strengthening trustee arrangements”, before Parliament, the Government has proposed that superannuation board should be legally required to have one-third independent directors and an independent chair, as Rowell (2017) explained the position of the Government and the Australian Prudential Regulation Authority (APRA):

> *…some comment on the Government’s proposed legislative amendments to require a minimum of one-third independent directors and an independent chair on superannuation boards APRA’s position on the value of having independent directors on boards remains unchanged.*

Directors are to be *independent* from what? Without clearly defining what is meant by *independent*, the Government has conflated two different ways in which director independence is used in public discussion. To avoid muddled thinking, we define the two different concepts for *independent director* in Australian superannuation as follows.

> An ***e-independent*** director is one who has no relationship with executives, employees, investment managers or service providers of the fund.
>
> An ***m-independent*** director is one who is not related to the fund, is not a member of the fund, and is not a member of an organization which represents members of the fund.

The concept of director independence in corporate law is same as the definition of *e-independence* given here. Good corporate governance requires board directors to protect the interests of minority shareholders against potentially predatory actions by executives. Independence refers normally to what we are calling in this paper *e-independence* and it is widely accepted as desirable and is enshrined in Section 181 of the *Corporations Act 2001*.

The *e-independence* definition has recently been reaffirmed by the Australian Securities and Investment Commission (ASIC, 2017) in a stricter application of the restricted use of the word, *independent* under Section 923A of the *Corporations Act 2001*, relating to when financial advisors could claimed that their businesses are “independently owned”. The definition of *e-independence* should apply uniformly and consistently across all entities regulated by ASIC or APRA, but this consistency will be prevented by the proposed Bill.

Directors of *Industry* funds are *e-independent* because generally they have no direct relationships with the executives or service providers of their funds. On the other hand, many directors of *Retail* funds, particularly those directors related to financial conglomerates, are not *e-independent*, because *Retail* fund directors are often also directors or executives of the service providers of their funds. This situation creates conflicts of interest.

In an official survey (Sy et al., 2008), it was found that nearly 60 percent of *Retail* board directors have one or more associations with fund service providers, about three times greater

on average than those in the *non-profit* sectors. Also, on average, *Retail* directors have seven simultaneous directorships, about three times as many as *Industry* fund directors. More recently, Liu and Ooi (2017) have confirmed that *Retail* funds outsource to service providers which are predominately related parties.

Conflicted directors could make decisions which profit their related service providers at the expense of members of their own superannuation funds (Liu and Ooi, 2017). Despite the greater investment skill set of *Retail* directors, the empirical evidence on the poor investment performance of *Retail* funds suggests that the lack of *e-independence* has been harming members of *Retail* funds. Hence in accordance with good corporate governance,

> Directors of superannuation funds should be *e-independent*, with no relationships with the service providers of their funds.

However, instead of using *e-independence* as the definition of independence, the financial services industry, the Government and APRA have made a confusing switch and used *m-independence* as the definition of independence. That is, the standard meaning of independence has been replaced by a different meaning of independence without clear warning or justification. The Government simply assumes that *m-independence*, and only *m-independence*, is good governance.

The Senate Economics Legislation Committee (SELC, 2015) has noted the *Dissenting Report by Labor Senators* who have objected to the conflation of the two different models of governance. It should be re-iterated and emphasized here that

> The conflation of *e-independence* with *m-independence* is unhelpful for the formulation of sound governance policy in Australian superannuation.

Alignment of Interests

More clearly stated, the Government has proposed (Rowell, 2017) that superannuation board should have at least one third directors who are *m-independent*, which is inconsistent with the meaning of *independent* when applied to the directors of other APRA regulated entities. Is *m-independence* or non-alignment of director interests with those of their beneficiaries, a good thing for superannuation governance?

The implicit assumption is that there should be a sufficient number of directors who are not members or do not represent members of their funds, because *m-independence* or non-alignment of interests is assumed somehow *necessary* for good governance. This idea goes against the experiences of the whole financial services industry. For example, corporations typically issue their directors and executives with shares so that their interests are aligned with those of their shareholders.

Similarly, most money managers (e.g. Warren Buffett) take great pains to convince their investors that they have "skin in the game" by managing all their own money alongside their clients in a comingled fashion to demonstrate a total alignment of interests. That is, they are showing that they are managing other people's money as their own. By declaring that *m-independence* is necessary for good governance, APRA is indirectly asserting that total alignment of interests is bad governance. To emphasize,

> If alignment of interests of directors with those for whom they serve is good governance, then by implication *m-independence* is bad governance.

For example, *Retail* fund directors may approve paying high fees to associated service providers, something which they would not have done if their own retirement savings were also in the fund. Clearly, from a member's point of view, *m-independent* directors are undesirable. *Retail* directors are mostly *m-independent*.

Retail directors not aligned with the interests of their members pose the greatest risk to the retirement savings of those members. Only about 21 percent of *Retail* directors are members of the funds of which they are directors. On average, only 12 per cent of their personal superannuation assets are in those funds. The correspondence figures for the directors of other funds are 62 to 73 percent and 44 to 63 percent respectively (Sy et al., 2008).

Apart from *Retail* funds, most Australian superannuation funds are **not** *m-independent*; that is, their directors have substantial alignment of interests. Table 1 shows how funds from different sectors are classified according to the two definitions of director independence.

Table 1: Director Independence

Sector	e-independent	m-independent
Industry	Yes	No
Retail	No	Yes
Self-managed	Yes	No

On average, *Retail* funds have performed worse than funds in the non-profit segment (Sy, 2017). Therefore, the empirical evidence shows that *m-independence* has not helped *Retail* funds to deliver good performance results. Instead, high or total alignment of interests in *Industry* funds and *Self-managed* superannuation funds has helped, certainly not harmed, their performances. With neither theoretical nor empirical justification,

> It is questionable whether *m-independence* has any relevance to good governance of Australian superannuation funds.

In the same interview, Jeremy Cooper, the chair of the 2010 Super System Review (SSR), took the idea of alignment of interest even further. He suggested that there should be many more 80-year-old directors because in future, superannuation funds will be run to provide income streams for those who have long retired. This suggestion is entirely consistent with the principle that good governance should involve alignment of interests.

Instead of *m-independence*, on the contrary, an abundance of research has shown that *e-independence* is important in corporate governance. Yet the Government has substituted for *e-independence* with an unproven and potentially harmful *m-independence*. *Retail* funds are not *e-independent* and yet they are not the focus of governance reform in Australian superannuation when they should be.

Investment Skills

Echoing David Murray's remarks, Rowell (2017) continued the above quotation by saying that investment skills were the common rationale for independent directors:

> *As I indicated in this forum back in 2015, independent directors broaden the skills and capabilities that can be brought to the board table, and improve decision-making by bringing an objective perspective to issues the board considers.*

An implicit assumption in this statement is that skills and capabilities can be brought to the board only if directors are *objective* by being *m-independent* or have non-alignment of interests. This belief can be challenged by the evidence.

Retail fund directors generally have higher educational qualifications, more hands-on work experience in the financial services industry and presumably a greater investment skill set than directors in other sectors (Sy et al., 2008). However, the empirical evidence shows that this advantage appears irrelevant and even counter-productive in delivering benefits to the members of *Retail* funds. There are several possible reasons for this.

The first reason, which is rarely mentioned, is that the lack of investment skills at the level of superannuation board matters far less than it appears because board directors are rarely involved directly in investing. Superannuation boards generally have sufficient resources to hire asset consultants for advice on portfolio design, for implementation and for performance monitoring. What matters most in a director, is diligence and a genuine concern for the investment performance and operation of their funds.

A certain level of investment knowledge is certainly required of directors but beyond that more investment skills do not necessarily translate to better investment performance for the funds. Choosing the right advisors who choose the right investment managers making the right decisions is how superannuation funds are normally expected to discharge their fiduciary duty. As on other corporate boards, superannuation directors are generally not fund executives but watchdogs who monitor and supervise executive performance.

A much more important reason for poor performance is the lack of *e-independence* of *Retail* directors who, as mentioned above, are often related to service providers of their funds. The conflicts of interests often resolve in favour of related service providers at the expense of members who merely rely on the honesty of directors to do their fiduciary duty, under Section 52 of the *Superannuation Industry (Supervision) Act 1993*.

Conflicts of Interest

Continuing further with the above quotation, Rowell (2017) asserts that independent directors are well capable of managing conflicts of interest:

> *They are also well-placed to hold other directors accountable, particularly in relation to conflicts of interest. This is as relevant for directors of industry and other not-for profit funds that may face potential conflicts with the interests of their stakeholders (such as nominating organisations), as it is for directors of retail funds.*

Again, the facts contradict this assertion because *Retail* funds have mostly *m-independent* directors. Yet, over long periods, *Retail* funds have under-performed other funds significantly, consistently and persistently. Moreover, more than other types of funds, *Retail* funds have had numerous scandals with fines and convictions which are sufficient to be reported by the financial media.

In fact, it is highly unlikely that *m-independent* directors are capable of managing their own conflicts of interest, let alone those of others. Directors who have significant investment skills are likely to have multiple directorships simultaneously as shown by official data (Sy et al., 2008). They are therefore unlikely to be *e-independent* as required by the *Corporations Act 2001*. To emphasize,

> Directors with high investment skills are more likely to have significant conflicts of interest, because they usually have multiple directorships, some of which are likely to be with service providers.

Even an *m-independent* director with only a single directorship of a superannuation fund does not itself guarantee freedom from conflict, because the director could be induced to make decision favourable to an interested party at the expense of members of the fund. For example, an employer may be induced by cheap business loans offered by a financial conglomerate to choose a *Retail* fund which may be against the interests of their own employees. Financial advisors are *m-independent* and yet through kick-backs, trailing commissions and other inducements, some of them have acted against the interests of their own clients.

It was not any actual issues of conflicts of interest which attracted the Government's attention on the governance of *Industry* funds. Rather, the various Government inquiries, e.g. SSR and FSI, implicitly noted potential issues in the way *Industry* fund directors are elected. The main concern relates to the power of the trade unions to elect directors: whether the directors are appointed on skills and merit or whether they are appointed as reward for successful careers in the trade unions.

The real issue is more about whether the directors are fairly and appropriately elected and less about whether the interests of members have been damaged. Clearly, it is desirable to have a fairer process based on merit rather than favouritism and the potentially corrupt processes may need to change. This is a problem which the anti-corruption regulators and the trade unions themselves should address, but it is not a problem which could be solved appropriately by legislating for *m-independent* directors.

However defective may be the process of electing directors, the empirical evidence suggests that the interests of members of *Industry* funds have not been damaged. The reason is: the losses from questionable spending by sinecure directors pale in comparison to the losses arising from conflicts of interest which could result in many billions of *Retail* savings being diverted to the financial services industry.

In 2017, CBA group reported $9.9 billion annual profit, with about a quarter of this profit coming from $5.5 billion of income from providing services in funds management, market dealing and related institutional banking. The superannuation funds of large conglomerates have been looted for profit, operating some of the worst performing funds in the industry (Sy, 2017).

In the above mentioned interview, a journalist asked why some of the largest companies in Australia have had independent directors for years and yet have been involved in law breaking and misbehaviour. David Murray replied:

> *That may be the case, but I don't see how that can be related to the objects of a good design. You can have a good design and a problem.*

Any design manifestly having many problems arising from conflicts of interest and misbehaviour is, by definition, not a good design. A good design should not have many instances of misbehaviour as has been the case with *Retail* funds. Clearly, the evidence on best practice has shown,

> The best defence against the problems of conflicts of interests is the solution of alignment of interests. This solution is prevented by the proposed legislation to have *m-independent* directors.
>
> ***An independent director in superannuation should be defined simply as a director who is free from conflicts of interest which could damage the welfare of members.***

Conclusion

In superannuation governance, the Government has changed the meaning of *independent* from one (*e-independent*) which is widely acknowledged as desirable to one (*m-independent*) which is undesirable. To put this simply, for superannuation, *e-independence* is good governance which the Government ignores, while *m-independence* is bad governance which the Government wants to enshrine in legislation.

The call for independent directors in superannuation by the Government is therefore a piece of casuistry, because politicians and the public may not be aware that the meaning of independent is different from what they normally understand. In a moment of carelessness or hurry, the Bill could be passed by Parliament giving APRA unwarranted discretionary powers (Schedule 1, Part 9, Section 90(1)) to determine

> *…that a person is not independent from an RSE licensee if APRA is reasonably satisfied that the person is unlikely to be able to exercise independent judgement in performing the role…*

Being independent from a responsible superannuation entity (RSE licensee) is by definition being *m-independent* from a superannuation fund. To exercising independent judgement means to exercise judgement independent of the interests of members of the superannuation fund. This *m-independence* is undesirable for the performance of the fiduciary duty of Section 52 of the *Superannuation Industry (Supervision) Act 1993*. The proposed legislation is therefore against the interests of the members of superannuation funds. The proposed legislation has the effect of making the governance of *Industry* funds more like that of *Retail* funds: a retrograde step, allowing the camel's nose in the tent.

The current Government seems to be doing its best to destroy Australian superannuation. The Bill for "strengthening trustee arrangements" actually weakens superannuation governance and therefore should be rejected by Parliament. Instead, the Bill should be amended so that the definition of independence for superannuation is *e-independence*, consistent with that of the *Corporations Act 2001*.

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