MENZIES
RESEARCH CENTRE

Guarding your nest egg
Restoring independence to industry retirement funds

A report by the Menzies Research Centre

Guarding your nest egg: Restoring independence to industry retirement funds

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Foreword

Australians entrust almost $1.5 trillion of their retirement savings to the superannuation industry. It is critical that their hard-earned money is properly invested and protected to give them the secure retirement they expect. Prudent management of superannuation funds is important to every taxpayer since the cost of any shortfall is paid from the public purse through the aged pension.

In July 2017, the Government announced legislation to improve the governance of superannuation funds by giving fund members greater transparency into the way their savings are managed. Under the legislation, funds would be obliged to disclose when assets are transferred to third parties, and explain the benefit – or lack thereof – of the transaction to members. They would also be required to hold Annual General Meetings for members.

Yet increased transparency, welcome as it is, is not enough to ensure the security of Australia's retirement savings. Governance standards must be improved through the introduction of independent directors.

There is a strong case to mandate a majority of independent directors on the board of superannuation funds with an independent chair. However, the transition to this greater independence must also be a smooth one. It must not become an excuse for increasing the size of boards, many of which are already considerably larger than those in other sectors.

David Morrison, an Associate Professor at the University of Queensland, has conducted a painstaking review of the history and rationale for greater governance of superannuation funds for the Menzies Research Centre. He concludes that the introduction of independent directors on all superannuation fund boards is sound public policy that would clearly benefit fund members. Morrison notes that times have changed since the 1980s when the superannuation system was developed. He mounts a compelling case for devising one system of governance for all funds. It is especially important for the increasing number of savers in public offer funds or dealing and for members already in retirement. Morrison concludes that the arguments against independent directors are necessarily motivated by self-interest.

What's wrong with the current arrangements?

Australia's superannuation system is riddled with potentially conflicting parties each looking to benefit their own interests at the expense of members and their retirement savings. They include asset consultants, investment managers hired by super funds, managers of superannuation funds, unions, employer groups, political parties and directors on superannuation fund boards.

In economic text books, the 'principal-agent relationship' theory encapsulates the risks to individual investors when their interests are at odds with those of the people managing their investment. The separation of ownership and control can introduce conflicts between the outsiders (the owners) and insiders (those in control).

These agency conflicts are accentuated by an imbalance in knowledge between insiders and outsiders. For the superannuation industry, this imbalance favours superannuation fund insiders and their service providers. Without effective governance and transparency, superannuation fund boards will continue to amplify the risks to members' money.

Conflicts may result in insufficient attention to their members' objectives, such as the failure to appropriately monitor staff. They might result in extravagant investments in pet projects through unnecessary advertising campaigns, or investments in non-core business. There is an increased likelihood of entrenchment strategies, such as, investing in underperforming or old systems that only they can run. They may include self-dealing, such as the sponsorship of corporate boxes at sports stadiums, the financing of political parties or contracts written with friends or associates on non-commercial terms.

The risk of conflicts of interest should be mitigated by the fund's board of directors which have statutory and fiduciary duties to act in the members' best interests. It is hard, however, to see how this governance mechanism can operate effectively when only 6.9 per cent of superannuation fund directors are independent. This compares to the United States, the largest funds management centre in the world, where independent directors make up three-quarters of boards in 83 percent of fund complexes.

Do industry funds outperform others?

Those who favour the status quo frequently claim that their funds consistently produce 'superior' returns that will be jeopardized by changes to governance rules. They offer no empirical evidence to support the relationship between better governance and poorer returns. Indeed, common sense suggests that the presence of professional independent directors with expertise in financial services will mean that greater, and not less, attention is given to the interests of members.

The claim that industry funds outperform others is misleading at best. The Australian Prudential Regulation Authority (APRA) has consistently noted that these whole-of-fund performance claims misrepresent the underlying performance once differences in age cohorts and underlying investment objectives are considered. For example, a fund in which most members are under 40 will adopt a very different investment strategy than a fund in which most members are over 65. The claimed differences in overall performance may merely reflect the difference in returns between the adoption of an aggressive growth strategy and a cautious capital preservation approach.

There is no attempt, either, to account for the staggering market advantages enjoyed by funds backed by the union movement. The inclusion of default funds in industrial relations awards and enterprise agreements has a coercive effect that gives industry funds a free kick. A consistent inflow allows them to invest in assets with longer investment horizons and to capture the liquidity premium. Since this advantage is not provided to all members of superannuation funds in Australia, it begs the question: why should industry superannuation funds be granted favours that distort the market to the disadvantage of members of other funds?

It is sometimes claimed that the presence of an employee representative on the board safeguards the interests of members. Such reasoning is naive at best, particularly because since many of the funds in question are now open offer funds delinking them from a particular workforce.

Further, with an ageing population, the superannuation system has yet to mature. Without independent directors on superannuation fund boards, it is hard to see who will represent the interest of members in retirement. The primary concern of both union leaders and employee representatives is the active workforce. Independent directors, on the other hand, have no such vested interest.

Will better governance add to administrative costs?

Opponents of independent directors argue that the new governance structure will be more expensive, and will be difficult to implement for want of a pool of independent directors with sufficient skills.

Research conducted by the Menzies Research Centre released earlier this year shows this is patently not the case. On the contrary, non-profit superannuation trustee boards are among the most expensive to run.

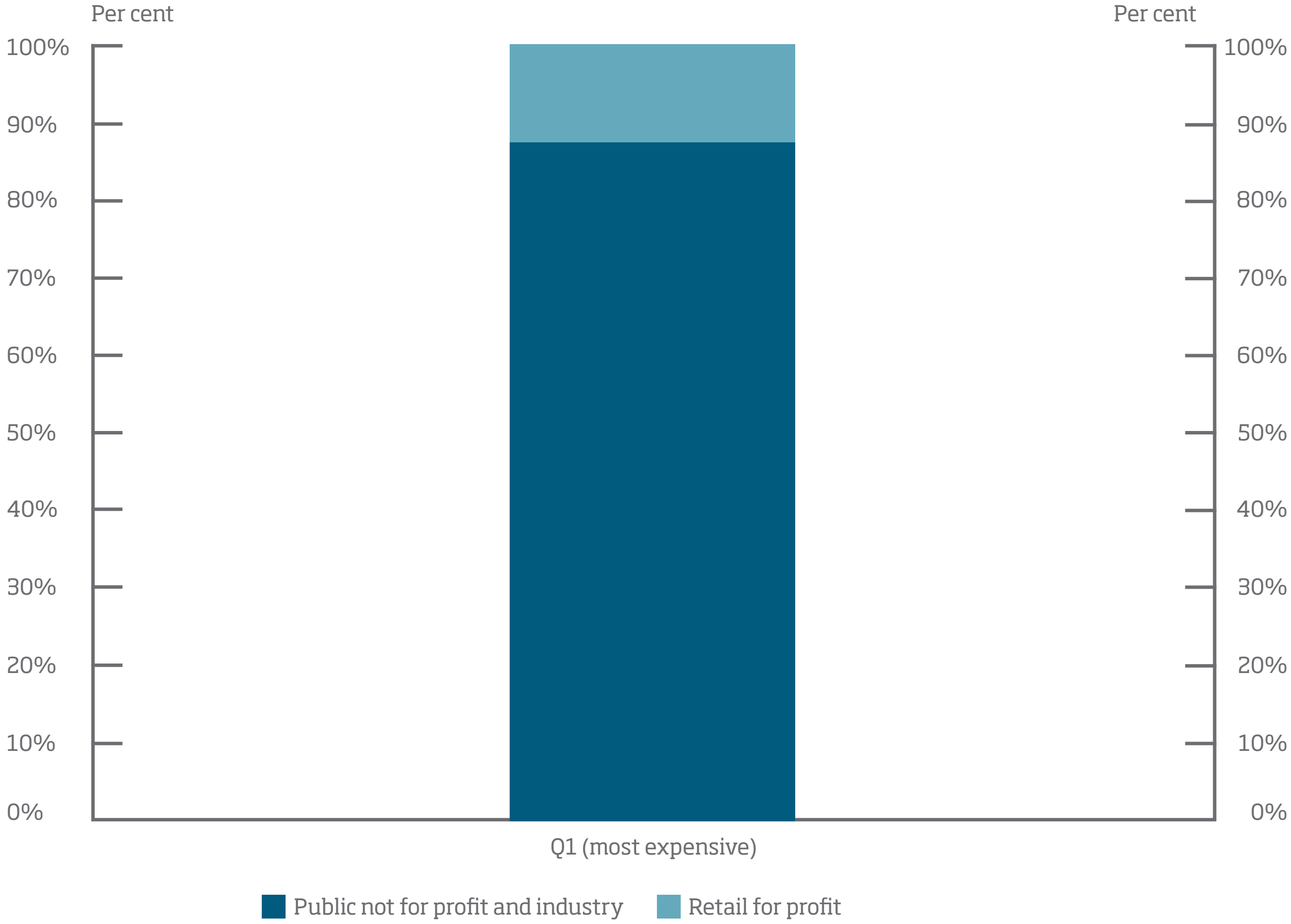
When the MRC analysed APRA data to rank funds according to the total paid in directors' fees, it found that 88 per cent of funds in the top quartile were not-for-profit funds. Only 4 of 32 of the most expensive boards were in the for-profit sector (figure 1).

There is ample evidence to suggest that in the long run, independent boards will lead to quantifiable reductions in administrative costs that will boost the returns for members. Inflated board costs are likely to be the tip of the iceberg; if directors can't control their own expenses, how can we expect them to control other much larger administrative expenses? Independent directors, unencumbered by self-interest, are likely to pay closer attention to dead-weight administrative costs and ensure a better return for members.

An important point to note is that the overall cost of running a board is determined by the size of board as well as by the size of fees paid to individual directors. Union-controlled funds consistently have larger boards than others for no apparent reason.

The addition of independent directors must not be used as an excuse to expand bloated boards still further. In fact funds should consider reducing the number of members to bring them in line with accepted industry practice.

Figure 1: Superannuation Trustee Board Fees, top quartile (most expensive) per cent profit and public not for profit and industry funds



Conclusion

Superannuation fund directors are appointed to safeguard the interests of all members. They are required to exercise a professional standard of care, skill and diligence to ensure that the fund's decisions benefit union members, non-union members and retirees alike.

Competency and diversity are crucial requirements for any board, not least those entrusted with the retirement savings of millions of Australians. Independent directors will enhance the competency of boards and introduce a greater degree of detachment. Independent directors will guard against unconscious self-interest and groupthink.

The arguments in favour of the status quo are flimsy at best and duplicitous at worst. Those who propagate them have a clearly vested interest in maintaining control of lucrative organisations established on the back of ordinary workers' savings.

The mandatory appointment of independent directors will allow funds to balance the experience and skills required to deliver sound governance and give members confidence that their life-savings are in safe hands.

Spiro Premetis
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Introduction

Whether there ought to be a minimum number of outside or independent directors appointed to superannuation funds is the subject matter of this report. The answer to the proposition is that there are compelling reasons for the Commonwealth to mandate independent directors in the conduct of all superannuation funds in Australia that take contributions from members of the public. This report sets out the three primary reasons for the adoption of the independent director proposal currently posed by the Commonwealth; the views of previous inquiries around independence and disclosure and, finally, concludes with the key points supporting the recommendation for independent directors.

The legislation recommends that the conflicts of interest within the compulsory superannuation system require further oversight and management. Superannuation fund consumers, as de facto investors, have good reason to be concerned about the conflicts of interest that exist in non-private superannuation funds. This conflict exists in all funds regardless of type, whether profit or non-profit. No superannuation fund can counter this concern by citing market place behaviour or performance statistics. The conflict concern goes to the Commonwealth's view of strategic governance of its residual risk and accordingly extends to the governance of all superannuation funds with collective membership howsoever structured.

Superannuation fund members are best provided for by sufficiently qualified persons who independently ensure a check and balance between the owners of the superannuation fund and the fund itself. It is almost 10 years since a government review recommended independent directors be required on superannuation funds. It is apparent that enactment of this overdue recommendation will increase the confidence of the community in the governance of superannuation funds overall.

Primary Reasons for Independent Directors

The call for independent directors on all superannuation fund boards is reasonable

The call for independent directors is reasonable and is sound.

Most commentators dismissive of proposals calling for independent directors to serve on not for profit boards of superannuation funds, concede that there is no harm in having independent directors.

The better aspect of the argument of some of the dissenters appears to be that there are more important board standards to focus upon, rather than simply appointing independent directors. This is an entirely reasonable argument and one that is countered in large part by understanding that independent directors will better facilitate the kinds of governance mechanisms and other improvements that the dissenters refer to. This is because their independent status requires it of them.

Suggesting that there are more important particular issues to focus upon is symptomatic of the underlying problem and puts the cart before the horse. The first step is to make the strategic changes necessary to facilitate governance improvement and then second, for the representative board to consider the options most pressing for the particular superannuation fund.

Having a representative board will facilitate the interaction with outside stakeholders, including government, to drive a superannuation agenda that benefits all, including the discussion of governance aspects for further examination.

If the legislation is proposed and passed, and the adjustment/transition period is entered into, the modifications necessary to improve the governance of superannuation funds will become apparent to superannuation boards of directors. These changes may of course include refinements around the independent directors *per se*.

Continual examination, increased transparency and more assistance around performance and fund management are critical factors for the Commonwealth in managing and maintaining and improving Australia's enviable superannuation scheme management record.

Corporate governance in superannuation funds requires further transparency

The process of examination, improvement and feedback of the superannuation governance environment is key in maintaining the high standard that is currently met. It is also imperative that the public becomes more interested in superannuation fund governance since its aim is to reduce the residual safety net obligations of the Commonwealth around pensions and other government funded sources of social security. Increased public interest will, in turn, put pressure on superannuation fund managers to disclose their activities and to demonstrate their performance around the proper governance of the superannuation fund. This is an important step towards an open and accountable system of superannuation fund governance that will, in part, be facilitated by the proposal for the appointment of independent directors by the Commonwealth.

The road to increased transparency for all stakeholders is vital in addressing the agency problem that pervades funds management. (As an example, the current bank inquiry evidence is proving this to be true with one major Australian financial institution suggesting that more than 1000 employees have been disciplined for not meeting the code of conduct.)

The agency problem arises because the agents acting on behalf of the superannuants will not always have the best interests of these stakeholders at heart, notwithstanding their assertions to the contrary. It is therefore necessary for measures to be put in place that provide incentives for the alignment of desirable behaviour. Superannuation fund governance is not immune from the agency problem, even though superannuation funds are implicitly understood to be different from companies in material respects.

Recognition of the agency problem is important and the appointment of independent directors will go some way to ensuring that a cohort of ‘insiders’ with singular interests find it more difficult to engage in behaviour that effectively reduces returns to superannuation members and untidy management practices that lead to poor governance.

There is less likely to be an agency incentive problem from the Commonwealth that is seeking to reduce agency costs, than from directors of funds with a vested interest in the status quo, hence the support this report offers for the appointment of independent directors.

Fund performance, by way of return on funds, is one aspect of fund management that is in turn, a function of fund governance. The Commonwealth’s focus on fund governance, by seeking to appoint independent directors, is an entirely appropriate strategic initiative since it focusses on the larger more complex task of improving governance first, rather than focussing on a subset of the bigger picture.

This approach will, in turn, allow the constituent parts of superannuation fund governance to be addressed for the benefit of all, regardless of fund type. The strategy requires the might of independent directors to ensure that the necessary changes are made within the governance structures of superannuation funds.

The need for change in a stagnant superannuation fund system

It is no longer sustainable for the Commonwealth to have multiple levels of superannuation fund compliance based on fund-type.

The weight of superannuation in terms of dollars invested by Australians and its importance as part of the social obligations assumed by the Government requires that compliance be addressed.

There are good reasons for different levels of superannuation compliance requirements, and they are mostly historical. Because Australia’s approach to wide-spread superannuation savings was generated by government policy via the superannuation guarantee, the industry did not have pre-existing standards and the legislation grew along with the kinds of funds that were established. This is a perfectly acceptable way to get a large project off and running and the government of the time managed it well; better in fact than the investment advice industry (also essential to a well-functioning funds management industry and hopefully an aspect that will continue to improve). Therefore, as a matter of the organic growth of various kinds of superannuation savings and the rapidity of the industry as a whole coming of age, it is hardly surprising that non-profit funds have been left to become self-governing, especially since, most claim their ‘returns’ are better than the for-profit funds.

This does not, of itself, however, justify a continuation of the status quo. Simply because the regulations around governance are in place and working does not displace the need for review, particularly as the governance mechanism is required to be responsive to all changes, including those to fund size and changes in the residual risk borne by the Commonwealth as a result of an ageing population and an increasingly disruptive workplace environment. As superannuation funds under management now exceed some $2 trillion, the quantum of funds collectively under management attract interest from many whose incentives are not aligned with the superannuants. The opportunities to take advantage are many, both internally and externally.

While it is true that comparisons with other jurisdictions will not necessarily result in adjustments relevant to Australia, it is not true to suggest that all governance comparisons are irrelevant. Mercer Consulting noted that one of the differences between Australia (and the US) on the one hand, and other offshore funds on the other, is that Australia has a more dispersed ownership structure, a structure that has been countered in the US by understanding and acting on the separation of ownership from control (agency) problem.

Because most agree that superannuation fund directors are to act in the best interests of the collective that they represent, this fiduciary obligation is not contested. The difficulty is that whilst the law makes it clear that the obligations be complied with; there are very few prosecutions of directors in breach of their duties pursuant to the law. It is possible that the lack of prosecutions point to the law being perfectly adequate and directors behaving well, however the anecdotal evidence surrounding some decisions made by superannuation fund directors suggests otherwise. Whilst these decisions do not necessarily transgress the bounds imposed by the law, they are nonetheless questionable from a governance point of view. Appointment of at least one-third of independent directors to all boards will assist in the determination of matters that are marginal and contribute to the effective governance of the superannuation industry.

It seems logical for the Commonwealth to take breath and consider the benefits of uniform superannuation fund governance mechanisms. Such action ought not to be equated as being a discussion of fund-type or fund-diversity, or as against any particular sector. This contribution to the debate around superannuation governance is focussed merely upon inferring that superannuants will have less choice or be worse off because of some likely fundamental shift in the type of fund offered.

The independent director recommendation simply represents a shift towards greater accountability and investor protection. It is an appropriate step forward by the Commonwealth, as the ultimate bearer of risk of the financial cost of fund shortfall or failure, in seeking to minimise its exposure to increased residual risk within the sector.

The evidence for or against independent directors is subjective and a matter of opinion and is necessarily motivated by self-interest group behaviour

Superannuation balances now exceed the value of the family home for many investors. This is a trend that will continue. It is critical that the governance function and management of monies held in superannuation is, at best, practice standard. Unlike bricks and mortar, funds management is not usually a topic of family conversation and it is not as widely understood, nor part of the vernacular of most. A greater level of trust is therefore placed by superannuants in the "system" in as much as it is placed in their particular superannuation fund. Most superannuants will not know the differences between funds and their governance characteristics; placing the onus squarely on the funds for best practice governance and upon the government to ensure that uniform standards across the sector are implemented.

It is very difficult to assess whether or not the recommendation that all superannuation funds have independent directors will improve the governance of a particular fund or all funds presently that do not have independent directors. This is because the 'evidence' presented so far in the debate is primarily based on opinion. For the commentary that provides data, the proxies for good governance that are used are also debateable. This may provide insight as to why the debate around independent directors is politicised.

Of those against the introduction of the independent director requirement, some assert that there is no need for not-for-profit funds to have independent directors because the relevant funds are outperforming funds with independent directors. While it might be true on the face of the comparison, it is not a valid comparison to make because of the differences between the specific funds within a particular sector. It is also not a valid assertion because it does not provide comprehensive proof of the need, or absence of same, for independent directors.

Return on funds is one measure of how a superannuation fund is being managed. It is however not determinative. This is because risk and return are strongly related. The return is derived based on an investment strategy devised for the particular fund. Assuming that the superior returns are mapped over a longer time period, the return on funds invested is not a sufficient piece of evidence to point to independent directors being harmful to superannuation returns. Given the fact that independent directors are paid like most directors, it seems remarkable to suggest that a random sample of skilled independent directors, *ceteris paribus*, underperform a particular interest group that draws directors from its own members and their circle of influence. In any event, examining the return on funds of a superannuation fund and seeking to imply that a fund with higher return of funds is better governed is illogical because the return on funds is only one measure of a board's financial performance, and financial performance is not necessarily relevant in determining whether or not the governance mechanism is working. Further, it makes no mathematical sense to do so, without accounting for financial impact differences between funds, including, for example, differences in the age and risk profiles of the fund members.

Even if evidence can be produced that shows the same level of risk as between comparison funds, (one with independent directors and the other without), with differing returns due to cost structures, namely where the funds without independent directors outperform those with independent directors, it is not possible to draw the conclusion from the evidence that the fund with the higher returns has better governance mechanisms. This is because the return on funds invested is only one measure of how well a superannuation fund is managed. In fact, it is only a measure that is useful in the investment decision part of the portfolio of decisions (financing, dividend) that the directors must make. All directors' decisions are critically important and all of those decisions contribute to effective governance decisions. The governance function oversees not simply decisions with respect to financials but the interaction of those decisions and understands the nuance of those decisions on the well-being of the fund. The idea that such decisions are made equally competently as between funds is nonsense. Simply stating that the sector is well regulated, or that it is "doing fine", is a misleading oversimplification of the governance issues currently at stake. An implication that funds do better with an absence of independent directors is as misleading as the suggestion that the addition of an independent director to a fund will reduce the fund's performance. In any event, as made clear above, discussion of financial performance is simply a distraction from the independence governance issue at hand.

All superannuation funds, regardless of type or sector, are faced with the same governance challenges including, but not limited to, the ageing of the Australian population and diminishing return opportunities in the market place. Challenges previously faced by superannuation fund governance were, in a sense, masked by better economic times and the stream of net monies flowing into the funds fuelled by pre-retirement baby boomers. Governance around performance and capital maintenance are not given the same amount of scrutiny in such circumstances. The current marketplace, however, faces critical concerns around the management, and therefore governance, of all superannuation funds. Independent directors will add a variety of informed opinion and critical review to the matters discussed in board meetings of superannuation funds, thereby opening the debate for wider consideration in the interests of a more transparent mechanism, especially for those of whom the superannuation funds act on behalf of the superannuants.

In June 2014, the McKell Institute commissioned a well credentialed team to consider representative governance on superannuation boards. The Institute acknowledged the differences between the higher obligations of trustees of trusts as distinct from directors of companies; the equivocal research around independent directors delivering better performance in terms of higher returns; the not for profit model 'out performing' for profit funds and greater trustee diversity; and finally, the challenge of good governance to align interests (namely to reduce the separation of ownership and control problem). The overriding concern with respect to governance and performance is that the focus on super fund performance has been levelled at the return on fund performance. This is so for various reasons including: the focus of the funds management industry generally on percentage-based performances; the publication of research on investment performance being around return on funds invested (including APRA that produces this kind of data), and the seemingly general acceptance, at least while returns are healthy, that investment returns are best evaluated from this perspective.

Whilst this is a reasonable approach, if one is only interested in outright financial performance and comparison on a yearly basis, it is by no means adequate in determining the true measure of superannuation fund performance. This is because the superannuation funds require very special and highly skilled management in circumstances where, whilst yearly returns are important, capital preservation and management are decisive in the context of the maturation of the fund, the ageing of the membership and the ability to make adequate provision for members drawing down their capital via superannuation annuities. The management of superannuation funds is complex, and while rate of return is important, so too are the risks that the fund is exposed to with the way the structuring of the investments that super fund capital is used for, as are economic fluctuations in the market place and whether or not the board is adding value. All are important factors. The best interests of members must take into account the effective management of superannuation fund capital, separate and distinct from the equally important fund performance.

A US study (ref 2), based on a survey of 88 senior US pension fund executives, reveals that they understand the purpose of their funds and that they have the 'right' strategic planning in place. The pension fund executives perceived that strong organisation values and trust within the pension fund was critical. However, the survey found that the selection process for fund managers was deficient and there is not a high level of self-evaluation of board effectiveness. The survey also found that 'weak' oversight functions lead to difficulties in sorting out the competing financial interests of differing stakeholder groups. They also lead to organisation dysfunction. '(Page 14, reference 2 'specific examples lack of delegation, clarity between board and management responsibilities, board micro-management, and non-competitive compensation policies in pension funds'). The paper also sought to determine empirically the relationship between governance quality and performance of funds and concluded that whilst the metrics used were not perfect, 'a positive statistical association between the two would surely exist' (at p 15). In short, there is no perfect empirical means of showing the "for" or "against" position of independent directors.

The wealth of accepted economic literature with respect to the incentives involved for the running of companies by managers who are not significant owners is best described as the agency problem (proposed in the seminal work of Jensen and Meckling (ref 69). Specifically, where there are a large number of stakeholders with a common economic interest, who entrust that interest to a small cohort of managers, there exists the problem of the separation of the ownership of the assets from the control of the assets ('separation of ownership from control'). The larger the body of stakeholders are, the greater the separation of ownership from control, and the more likely the split of incentives as between the owners of the capital and the managers of the capital. The best examples of these issues exist in large public companies in free markets around the world and in those same markets the management of governance of superannuation funds notwithstanding the differences in regulations as between them. Because understanding director independence is complex and, because there is no universal agreement as to what constitutes perfect governance generally, including for superannuation funds, it is crucial that open minds address the debate. There is no definitive answer as to optimal indicators or strategies of fund governance. However, collective superannuation savings are the primary means of storing wealth for most Australians and having independent directors serving on all superannuation funds in the public domain, no matter how rudimentary a mechanism it may be perceived by some, is superior to the absence of same, if for no other reason than it will add to the considerations made by the board about the welfare of the fund. That, of itself, is an improvement for all funds that invite members of the public to be superannuants.

The regulatory regime and the impact of compliance

The regulation of superannuation in Australia is covered in other reports perfectly adequately and will not be repeated herein. There is an abundance of regulation around superannuation, however it is not so voluminous as to compare unfavourably with the raft of the *Corporations Act* provisions around, for example, company fundraising. It is axiomatic that where members of the public are voluntarily contributing and/or having contributions made for their retirement into a common fund of money, that there is sufficient and adequate protection of both the management of those funds and the protection of the funds in their role of long-term capital for use in retirement. Given increased longevity and associated increased costs in health-care, and associated infrastructure required to maintain an ageing population, it is apparent that the retirement period for Australians is likely to be prolonged and, by necessity, made more expensive.

If the intention of the Federal Government is to reintroduce its Bill that includes, *inter alia*, a requirement for superannuation funds to have at least one-third of its directors as independent (as distinct from The Financial System Inquiry Ref 48 that suggested a majority of directors). This proposal is based on the assumption that such a rule is "best-practice". Similar to the views expressed by Mr Fraser, it is agreed there are a multiplicity of factors and debate as to how best-practice might be determined. The key point is the observation made by the panel consulted by Mr Fraser in the preparation of his report (p 5) that:

> "While not opposed to appointing independent directors, the broad view of the panel was that appointing independent directors was not an end in itself, but needed to be considered in a broader context and undertaken with a specific purpose."

Mr Fraser states (p 6) that the "limited recommendations in this report seek to promote members' interests by elevating the sources of potentially greatest benefit to [NFP funds] – the values, skills and experience of their Boards – to top billing, ahead of independence as such".

This is a troubling statement in the sense that having independent directors, whilst not a panacea for future superannuation fund issues does not, by having the independent director requirement, trump the interest of members; nor is it, with respect, a zero sum game as intimated.

Even Mr Fraser acknowledges: "This is not to imply that 'independence' as such is unimportant – or that independent directors and Chairs cannot bring critical values and skills (they can and do in many cases)". From these statements, it is difficult to understand how the regulatory environment is not enhanced by having all superannuation funds meet certain basic requirements, including a mandatory proportion of independent experts who can and will be required to provide a measure of impartial expert assistance to the conduct of the fund.

The Federal Government is the ultimate underwriter of insufficient superannuation fund savings

The Federal Government is the body that collectively underwrites the shortfall of funding in retirement for individuals, *inter alia*, in the provision of the old age pension and associated health care benefits. It is reasonable, therefore, that the Commonwealth is able to mandate how they wish to manage and minimise the risks associated with the magnitude of the shortfall.

To be clear, there will always be a shortfall, however the ability of the Commonwealth to provide for its constituents is diminishing in any event due to population ageing and economic shifts away from traditional employment and the steady income of PAYG tax receipts.

As superannuation funds reach the stage where their capital management is around the drawing down of the fund (because contributions and returns are exceeded by retiree withdrawals); careful judgment and expertise will be at the forefront of the risk management of these funds.

Inevitably there will be shortfalls, caused not only by insufficient savings, but also for other reasons and unexpected events, economic and otherwise. Given this is likely unavoidable; it is not unreasonable for the Commonwealth (regardless of political affiliation) to be concerned about its residual obligations. A prudent Commonwealth will propose measures that address those concerns, entailing the adoption of measures, such as director independence and increased transparency, already applying to other key institutions within the Commonwealth that include ASX listed companies and all prudentially regulated sectors.

Such thinking is long-term and strategic, a rarity in the political process. It is critically important that superannuation savings are thought of and regulated in this light. At no point have the proposals for independent directors been offered as a panacea, nor has it been suggested that this measure is the only measure that will be considered, nor have the proposers suggested that it will not be carefully monitored and adjusted if necessary. It seems remarkable that the current position of some commentators is that whilst the quantum and risk of superannuation capital is in change, there is no need for the government to act on its risk position as it sees fit.

Mr Fraser says that if the system is not broken then there is no need to fix it and this includes a reference to the one-third director rule. A similar argument may be posited that runs as follows: what is the harm done by the introduction of independent directors? Providing there is a sufficiency of available talent to add to these boards, surely in the absence of evidence to the contrary, an independent marker of knowledge and skill can at best improve the governance of the fund and at worst do no harm? After all, the balancing of risk required in the mature stage of superannuation fund management requires expertise and careful independent thought.

Mr Fraser's views on independence and transparency therefore seem out of touch with the Commonwealth's concerns and risk position. The recommendations made by Mr Fraser are also at odds with concerns raised by two previous Reports, both recommending improvements with respect to director independence and transparency. Those recommendations are consistent with adverse findings from within both the retail and wholesale superannuation sectors, and findings around directors outside the sector (ref 29).

The following table summarises the key recommendations made, first by the Cooper Report (2010) followed by the Murray Report (2014) with respect to these twin concerns.

Super System Review Final Report (Cooper Report 2010)	**RECOMMENDATIONS FOR GOVERNANCE**
	1. Code for Trustee Governance proposed.
	2. Create new office under statute – 'trustee director'.
	3. A minimum number (1/3) of 'non associated' trustee-directors should be required on all superannuation trustee boards and equal representation between employer and employee.
	TRANSPARENCY
	1. Increase mandate to oversee and promote the overall efficiency and transparency of the Superannuation systems.
	2. APRA give a standards-making power in superannuation as a tool for driving transparency.
	3. Transparency and disclosure are essential for the effective operation of the system.
	4. There is an overall lack of transparency and comparability of superannuation products. There is also a lack of accountability that can only be improved by targeted and proportionate regulation.
	5. 'systemic transparency'.

Financial System Inquiry Final Report (Murray Report 2014)	**RECOMMENDATIONS FOR GOVERNANCE**	
	1.	Mandate majority of independent directors on the board of corporate trustees of public offer superannuation funds (arm's length definition of independence).
	2.	Independent Chair.
	3.	Align penalties for director misconduct with those of managed investment schemes.
	4.	Strengthen disclosure arrangements, increase incentive for all directors to act in the best interest of superannuation fund members.
	5.	Strengthen conflict of interest requirements.
	TRANSPARENCY	
	1.	Transparent Reporting.
	2.	Lack of transparency affects market pricing.
	3.	Improve Fee Transparency.
	4.	FWC selection process lacks Transparency.
	5.	Make relevant information public; avoid room for gaming the process; ensure metrics are clear, simple, difficult to dispute and difficult to manipulate.

The Explanatory Memorandum for the previous Bill *(Superannuation Legislation Amendment (Trustee Governance) Bill* 2015) makes clear the possibilities for agency problems in superannuation board governance and giving the Trio Capital example (p 34) and that APRA does have cause to exercise its right to disqualify directors (p 34) from time to time. Both reports make specific recommendations for transparency measures.

Mr Fraser's report, (below), seeks assurance before legislative change. Mr Fraser also seeks "hard" evidence supporting independent directors; evidence that is not apparent in his report in favouring the alternate view. "Not broken" is a timely reminder for all legislatures to consider as a general rule; however, it is not established in Mr Fraser's report with respect to superannuation governance mechanisms in Australia. All directors are required to obey their fiduciary obligations, regardless of fund type and those obligations apply notwithstanding "stark differences" as between funds in the industry. The best qualified chair is a good idea; however, it is not guaranteed if only one-third of a superannuation fund's directors are independent.

Board Governance of Not for Profit Superannuation Funds (Fraser Report 2017)	**RECOMMENDATIONS FOR GOVERNANCE**
	1. There is no guarantee that mandating a minimum number of "independent" directors will deliver quality or "best practice."
	2. The main proposals in the Bill rely on assertions and not hard evidence.
	3. The current NFP model (equal representation) is not broken, net returns to members of NFP funds have consistently and significantly exceeded returns to members of retail funds.
	4. Equal representation model means directors have close ties with the industries their fund members work in. This bolsters "member first" focus of NFP funds.
	5. To mandate the same board governance requirements for all super funds, ignores the stark differences within the industry.
	6. Australian superannuation industry overall has maintained high governance standards.
	7. Governance arrangements and reviews for the Board of superannuation funds are subject to considerable regulation by APRA, ASIC and SIS Act.
	8. Values and culture of different funds do not figure prominently in APRA's Prudential Standards relating to Board Governance.
	9. NFP funds should always appoint best available candidates as Chair, whether independent or not.
	10. NFP funds could best be improved by continuing to build their strengths in values and skills.
	TRANSPARENCY
	1. All boards are required by APRA to have a procedure for handling conflicts of interest.
	2. Incidences of conflict would be greater in case of retail funds.
	3. It is essential to be transparent and accountable for what the directors do.
	4. Boards of NFP funds should commit to explicitly addressing governance issues of these kinds in t heir annual report to members, and proactively at other times (member conferences and meetings).

The agency problem is one that exists in any organisation where there is a separation of ownership from control; including not-for-profit superannuation funds. Mr Fraser remarkably asserts that retail funds have more incidence of conflict; however, this is not established with examples and incidences of conflicts within both the for-profit and not-for-profit superannuation sectors. Mr Fraser does not refer to existing case studies outlining incidences of conflict for both profit and not-for-profit superannuation funds that are readily available.

Conclusion

Independent directors are an important and essential piece of the fabric of an open and accountable financial system: that is the focus of this report. Such a system necessarily includes superannuation funds. Superannuation funds are individually and collectively influential in the Australian financial system and it is appropriate for the Federal Government to take a close interest in their operation.

The ideals previously set out in the Explanatory Memorandum to the 2015 Bill, and previous government inquiries recommending independent directors, remain relevant: namely that the superannuation system is strengthened by improved governance over both the decisions that superannuation boards make and the process of making those decisions. Independent directors are central in providing oversight as to accountability and as an important watchdog, particularly around related party matters.

Transparency and accountability are important twin outcomes of having mechanisms in place to give them their best chance to be realised. Persons who are independent of the superannuation fund are in the best position to ensure that critical thinking around important superannuation fund decisions exclude considerations that are inconsistent with impartial and objective analysis.

It follows that other mechanisms for the enhancement of transparency ought to, and will, follow the appointment of independent directors to superannuation funds, and, that these include more transparent reporting of operations to members and consideration of members' meetings where reports ought to be delivered and the opportunity for questions is given. It is encouraging that the Minister for Revenue and Financial Services has recently (24 July 2017) flagged reforms that will introduce annual member meetings and information measures to assist transparency. This is a good start, noting however that it takes a sufficiently independent board to ensure objectivity, transparency and accountability.

This report recommends the adoption of the minimum one-third director recommendation and the 2015 Bill in its entirety.

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