

CORPORATE SUPER ASSOCIATION

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The Chairman
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Dear Sir

SUPER SYSTEM REVIEW PHASE ONE: GOVERNANCE: ISSUES PAPER

The Corporate Superannuation Association appreciates the opportunity to comment on the above Paper ("the Governance Paper") issued on 25 August 2009.

Background – Corporate Superannuation Association

Established in 1997, the Association is the representative body for large corporate superannuation funds and their employer-sponsors. The Association represents a total of 46 funds controlling 39 billion dollars of member funds. In general, these funds are sponsored by corporate employer sponsors with membership restricted to employees from the same holding company group, but we also include in our membership a few multi-employer funds with similar employer involvement and focus.

Our funds typically are established without shareholder interests in the governing body, and no profit is derived from the operations of our funds. This also means that any cost of compliance increase has a direct impact on members' benefits. The funds are run as mutual entities, where the decisions are the responsibility of a trustee board. The board provides equal representation for employer and employee interests.

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COMMENT ON THE GOVERNANCE ISSUES PAPER

Summary comments

In the view of the members of our Association, there is little in the trustee governance model itself that requires fixing. This is demonstrated in the not-for-profit sector, particularly in the corporate fund sector.

Where there are concerns that the trustee model is falling victim to conflicts, the trustees involved should be reminded of their duties to operate in the best interests of their members. The imposition of a different, corporate based model such as the Managed Investments Scheme model, would not mitigate these conflicts, which would then be deepened by the loss of the protection of trustee obligations.

We believe that trustee bodies in their current state and composition, and with current requirements for integrity, provide the appropriate balance between skills and governance with probity. A requirement for an increase in 'professionalism' would reduce the strength derived from diversity of skills and backgrounds.

We oppose suggestions that investment should be directed by Government or mandated in other respects. We believe that APRA regulated trustees are aware of their obligations in this area and that the major influence that may detract from investment performance and the interests of members is conflict of interest, leading to investment in entities connected with the trustee, and the provision of investment and other services by similarly connected entities. There is international consensus that 'agency costs' and poor fund governance practices cost members money. We welcome the Review's attention to this area.

Specific issues

We have provided comments on specific areas of focus as follows.

5.1.1 Global Financial Crisis

The superiority of the current governance model especially in the not for profit sector, and the consequent high level of member trust in their representatives, resulted in minimal liquidity impact. Nevertheless, the crisis highlighted some deficiency in Risk Management Statements in respect of liquidity risk, particularly in regard to hybrid cash products, property and infrastructure.

5.1.3 Trust model for super

Suggestions have been raised that the trust structure for superannuation funds and the governance system formalised under the SIS Act are no longer suitable for superannuation funds, particularly given the increased role of public offer funds and the tendency for corporate funds to migrate to master trusts. Some parties would prefer funds to be regulated under a regime similar to or identical to that applicable to managed investments. This involves regulation primarily under the Corporations Act and the diminution or abandonment of the trustee governance model.

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We would strongly oppose such an approach, as we are of the view that the trustee model is robust and does not require fundamental change. We maintain that the trustee model as set under the SIS Act contains safeguards that are absent from the corporate model. The trustee model has operated effectively for decades without failure arising from structural issues.

The trustee model has particular strengths when it operates as envisaged under the SIS Act with significant involvement from stakeholders – employer and employee representatives. We acknowledge that the involvement of employer and employee representatives in public offer funds and in master trusts is diminishing as employers reduce their direct involvement and interest in this complex area. Employers now see the provision of superannuation as a requirement where there is reduced discretion for the employer and where the obligations are often more safely managed by outsiders and specialists. This does not mean that commercial interests should override the fiduciary obligations of the governing bodies. We see the interposition of a trustee relationship as imposing additional and very important duties on the body that runs the fund. A primary obligation is to act in the best interests of the members of the fund. This obligation can be lost sight of when an investment is run by an entity that manages without strong in-built fiduciary obligations, and that has investment fees and external shareholder profits as its primary focus.

The trustee model works best where trustee and member interests are aligned, and this occurs most readily in the not-for-profit funds sector. Research by Rafferty and others has statistically shown significant support for the proposition that the not for profit representative trustee out for perform for profit funds by up to 2.4% per annum, a margin larger than fee and charge differentials between the two models¹. APRA statistics also support consistently superior returns from the not for profit sector.

5.1.4 UNPRI

It should not be mandatory for funds to adopt UNPRI. Funds should be allowed to determine the investment strategy that best achieves retirement outcomes of their members relative to other superannuation funds. In focusing on those outcomes, long term investment decisions would normally take to account principles akin to those of the UNPRI, but UNPRI should not be mandated. Prime superannuation investment focus must be retirement income, and should not be bound by social or political issues. However, consideration of sound governance, ethical business practices and “clean products and services” not only achieves UNPRI goals but also good investment yields.

5.1.6 Best Practice

Principles based legislation and regulation should drive transparency, disclosure, conflict management and governance. Environmental and social issues should be fund driven, with market performance and segment competition ensuring appropriate practice. Member participation will be reactive, by exercise of fund elective choice

¹ Bryan D, Ham R, and Rafferty M,(2009) *Fund Performance in the Australian Superannuation industry* Workplace Research Centre, University of Sydney

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and market segment competition, rather than involving member proactive participation in fund governance.

5.2.1 Trustee duties

Given the evolution of superannuation funds into large bodies often owned by significant investment entities, and in any case with management less closely connected with and monitored by employer and employee stakeholders, there may need to be a reminder for trustees built into the legislation that their primary objective is to act in the best interests of members. This should not need to go so far as for codification of the duties mentioned. Similarly, provisions enabling trustees to override deeds that require them to invest or outsource in a restricted corporate group would be helpful in focusing trustees on their duties to act for and in the interests of members.

There is a strong case that a master trust operator or administrator should not be in a position to control a superannuation trustee, where that trustee acts for sub-plans that represent a number of disparate and unconnected employer sponsors (in this document we refer to these funds as “multi-employer funds”). In these circumstances we suggest that the trustee should have a majority of directors independent of the master trust operator and administrator. We also recommend that the Fund CEO, CFO, and CIO should not be members of the Trustee Board. Again in the multi-employer fund context, although independent Trustee Directors should not be current or former employees of a fund operator or administrator or related corporations, we would encourage but would not prescribe a fund membership requirement. Trustee board members would be permitted to hold additional directorships provided they did not hold directorships of companies with whom their trustee body had an operational relationship such as investment managers, consultants, administrators. Further, trustee board members should not serve on boards of other funds that compete for the membership in the same industry, as this will give rise to conflicts.

5.2.2 Trustee knowledge, skills and training

Trustees by nature are required to meet fiduciary standards, under the SIS Act and under trust law and precedent, exceeding those applicable to other company directors. This high standard is the essence of the role of a trustee, and a major source of strength for the trustee model. There is little evidence to suggest that the majority of trustees are other than adequately equipped. Indeed the licensing and monitoring regime under the SIS Act, administered by APRA, imposes a fit and proper test supported by prudential practice guides. The industry is served by three specialist training bodies, and many trustees, in addition to professional skills, also have formal superannuation training to a standard prescribed by ASIC. While not calling for a mandated superannuation qualification, we believe mandated compulsory continuing superannuation education for trustees is warranted. We would disagree with an approach requiring formal investment or other qualifications in individual trustees. It is important to avoid homogeneity in trustees’ skills. Better governance is achieved through diverse skills and experience, and through close contact with and representation of sponsor and members.

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We are opposed to the development of a pool of “professional” trustees along the lines of boards for publicly listed companies, where there is common membership across a range of boards. In the superannuation fund context, we believe this would fail to provide the diversity required to represent the interests of fund members.

However, there is also a place for “independent” (unconnected with fund, employer and member groups) directors on a representative board, as much to promote a broader and more diverse view as to provide specific expertise.

5.2.2 Trustee performance

It is suggested that each Trustee Board should be required to have an appraisal committee to measure the performance of their CEO on an annual basis, using standard guidelines laid down by professional governance associations or the regulator. Trustee Board members should be independently appraised by the Trustee Chairman, and key fund staff appraised by the CEO.

5.2.4 Apprehension about personal liability

We do not believe liability issues unduly influences more so than any other factor trustee practice or trustee nomination in the not for profit sector. We believe that Trust Deeds and appropriate indemnity insurance offer sufficient comfort for an honest and competent applicant.

5.2.5 Trustee independence

As indicated above, we consider that it enhances the strength of the trustee when members participate in the trustee board and in management of the fund. In the current climate it is hard to ensure that the old system of equal representation of employer and employees is achieved, but a mixture of skills and interests on a trustee board is a source of strength because diversity of outlook enables problems and conflicts to be examined in the round. We believe that it is desirable but not essential that a trustee should also be a member of a superannuation fund. The Sponsor deed of an equal representation fund normally prescribes that member representative directors be members, but in public offer funds this is more difficult to achieve. The overriding requirement is that trustees should be aware of their obligations to act in the best interest of members and to avoid conflicts of interest.

5.2.6 and 5.2.7 Outsourcing

We consider that it is for the trustees to determine the extent to which they outsource functions to experts and specialists. Given the complexity of investment management and administration, there is bound to be a variety of strategies adopted.

We do see it as necessary that relationships between trustees and providers be disclosed, and that there should be a transparent process in appointment of service providers. There should be an established process in each fund for declaration and ongoing management of conflicts of interest.

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One of the difficulties when services are outsourced is that the trustee rightly retains the same liability as if performing the services directly; however the trustee has difficulty in monitoring external performance despite prescribed contract conditions. There is a case for third party administrators to be prudentially licensed.

5.2.8 Board composition and succession planning

A governance model similar to those prescribed by ASX governance rules could be introduced. Where a fund chose to deviate from the principles the fund would be required to justify that deviation in annual member reporting. Funds should be required to discuss actual governance measured against the principles in the Annual Report.

Multiple Trusteeships should be permitted, but not in the retail sector, nor where a not for profit fund completes for same employment classification.

5.2.9 Stock lending

Stock lending should be permitted but subject to prudential and ASX controls.

5.2.10 Consolidation

We would oppose strongly any move to require trustees of small funds to merge with larger funds. If a trustee is meeting APRA's requirements under the licensing system, we cannot see an obstacle to continuing to operate. We note that a number of multinational companies are committed to providing their own fund in each local regime, even though this may involve a relatively small fund. We believe it would be subversive and destructive to force these carefully managed employee benefit plans out of existence.

5.3.1 Government policies

We believe that it would be destructive of trust and confidence in the superannuation system if the Government were to attempt to mandate investments which forwarded particular government policies. We believe that it is best if superannuation fund trustees pursue their investment strategies in a way that they believe will bring appropriate returns having regard to the considerations set out in the SIS Act. If the Government sees fit to provide incentives for investment in particular types of asset, then it may become rational for trustees to extend their participation in these investments, but this should be done in the context of the particular fund's established requirements and strategy.

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We agree that portability and, to a lesser degree, investment choice do affect the ability of trustees to make longer term investments. The principles of portability and choice of fund have become entrenched and we see little benefit in removing a member's right to move balances. However, we are concerned about the general availability of investment choice within funds. The hazards have been demonstrated in the recent financial crisis in that certain members have prejudiced their savings by changing to (for example) a cash position when the equity element in their portfolio has been at its nadir. We do not believe that most superannuation fund members have the expertise to make such calls. Much time and energy and disclosure space is wasted in offering varieties of investment choice to members, the majority of whom are bewildered by it and either do not exercise a choice or if they do, do so to their detriment. We would support a move to reduce or eliminate the availability of investment choice within funds, subject to a facility for providing older members of funds with access to shorter term investment strategies if they wish to lock in gains shortly before withdrawal. Even at this time, however, there is a continuing role for growth investments. We believe that not enough focus is placed on the continuing need for balanced investment strategy during the pension drawdown phase.

5.3.2 APRA regulation

We see no need to provide APRA with a prudential standards setting power or with a power to give directions in relation to superannuation. We believe it is helpful for the role of setting of law and standards to be separated from that of regulator. To place these powers in the same hands can give rise to confusion and lack of perspective on the part of the regulator. We welcome published interpretation of the law by the regulator. Where the regulator acknowledges that it does not make law, but provides clear indication of the way in which it interprets and administers the law, this is helpful to the public.

We do not support an extension of APRA's powers beyond prudential matters.

We see a case for reducing the number of regulators for superannuation to one specialist regulator. This has worked well in the past. We would propose that a body with an exclusive focus on superannuation and its very specialist issues would have an easier path and a clearer focus. The confusion and difficulties attendant on fitting superannuation into regulatory moulds designed for insurance companies and banks have caused many problems for regulators and for funds. Similarly, disclosure regulation has entered a new era of unnecessary complexity resulting from the transfer of the disclosure regime from the SIS Act to the Corporations Law.

5.3.5 2007 PJC inquiry

Recommendation 4: Promotional advertising, sponsorship expenses and executive remuneration

We have no objection to disclosure of the above; however we do not believe that mandating via Accounting Standards will achieve the desired objective of transparency.

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Receipt of full financial statements is at members' option, and traditionally few current or prospective fund members request financial statements. Appropriate disclosure should be in the fund's annual report. We are not convinced that the recommended disclosure of sponsorship and promotional costs is more relevant than any other line item.

Recommendation 6: Public tender of key service provision agreement

We are concerned by this proposal, which would result in significant additional administration expenses for funds, which would be required to deal with applications from an indiscriminate range of entities, some without the necessary skills to perform the services. We believe that trustees should be left with discretion to draw up shortlists of suitable service providers. If the proposals are considered necessary for public offer funds, non-public offer funds, where conflicts of interest are less likely to arise, should be spared.

5.4.1 Accountability to members

The policy committee structure lacks teeth, given the lack of powers and responsibilities awarded to policy committees under the SIS Act provisions, and consequently does not result in adequate member representation. Many policy committees are either unable to meet due to lack of participation, or if they do meet, merely fulfil the legislative requirements of meeting. When they do meet, the dialogue is usually 'top down' from trustee to policy committee, and there is little opportunity to make recommendations to the trustee board, or indeed to reflect on whether the existing trustee continues to be the appropriate service provider. The Policy Committee in its present format should either be given legislative teeth, which we believe would undermine the role of a Trustee, or be abolished and replaced with a regime along lines as follows.

- The employer should be mandated to meet with the Trustee twice annually to review performance against the contract KPI's. APRA should monitor Trustee observance of this rule.
- The employer should be required to review regularly (every 3 years is suggested) the existing arrangements for the employer sponsor's participation in the fund or sub-fund of the master trust, or other outsourced trustee arrangement. The review panel should comprise employer sponsor and fund member representatives.

We do not believe another member representation advocacy body is required. This would be an added regulatory cost with no perceivable added benefit.

A members' representation advocacy body would not have the power to override trustee decisions, hence would be powerless and would merely complicate the trustee's execution of its duties. We note the formal arrangements under the SIS Act and related legislation for handling complaints from members, without cost to the member. This is a practical approach to dealing with member queries and complaints in the trustee context.

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Governance bodies are increasingly questioning the appropriateness of annual general meetings. It is difficult to see the benefit of such a meeting of members unless the meeting was able to pass binding resolutions and appoint directors. As a concept this would also suggest trustees could be directed. Where a trustee is breaching the law or regulations, there are appropriate mechanisms for their removal. We are concerned in general by implications that shareholders and fund members are similar entities, with similar rights and concerns. A fund member has very different rights and interests from a shareholder, and this distinction should be observed.

5.4.2 Corporate governance of underlying investments

The current arrangements relating to voting on shares held by superannuation funds come as close as is practicable to representing the interests of the fund members. There is of course a huge number of shares in the portfolio of a fund of any size, and so the task of representing member's views directly on each type of share held would simply be impracticable. The approach typically adopted by our funds is as follows. Each investment manager engaged by the trustee is required to provide a stated and agreed policy on voting shares. The trustee needs to be happy with this policy, and needs to monitor conformity with the policy through regular reports from the manager. The manager may in turn delegate the voting task to a specialist outside organisation which collates and exercises the principles in accordance with which it should vote on the fund's block of shares. This principles based approach is the most feasible approach whereby the corporate governance principles favoured by members can be conveyed to shareholders' meetings. We note that the corporate governance principles of fund members will most effectively be represented and conveyed by trustee boards on which member and employer interests are most effectively represented through equal representation.

5.4.3 Responsibility for investments

See comments on 5.3.1 above. We are concerned about the increasing role of member investment choice and its impact on uninformed members.

5.5.1 Investment time horizon

As indicated above under 5.3.1, problems have been created by choice, portability and internal Member Investment Choice. Unfortunately, rather than encouraging true competition, Choice of Fund gives rise to conservatism, herd behaviour and focus on short term results. Compulsory reporting on long term results, and mandated content in the PDS and in reports, encouraging a view of superannuation as a long term investment, may help.

5.5.2 Tilt towards equities

The investment strategy adopted by Australian regulated funds is set under a process mandated by the SIS Act. The section 52(2)(f) of the SIS Act requires funds:

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... to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity, including, but not limited to, the following:

- (i) the risk involved in making, holding and realising, and the likely return from, the entity's investments having regard to its objectives and its expected cash flow requirements;
- (ii) the composition of the entity's investments as a whole including the extent to which the investments are diverse or involve the entity in being exposed to risks from inadequate diversification;
- (iii) the liquidity of the entity's investments having regard to its expected cash flow requirements;
- (iv) the ability of the entity to discharge its existing and prospective liabilities;

Thus a fund is required to set, implement and monitor an investment strategy having regard to the above specific requirements. The asset allocation decision is made in this context, and is not arrived at frivolously. There is a focus on probabilistic achievement of the outcomes required under the SIS Act. The equity percentage exposure, as with the target ranges for other types of investments, is driven by the fund's time horizon and the desire to achieve the investment objectives. Government interference is neither appropriate nor desirable.

5.5.3 Portfolio re-balancing

Again, the policy on portfolio re-balancing emerges from the trustee's objectives and strategy set according to the requirements under the SIS Act. These processes will be monitored, documented in trustee documents and in the fund's information provided to the members and the public. Given the context, we believe general mandating of approaches to re-balancing would be out of place

5.5.4 Leverage

Leverage is an issue which should be encompassed overall by way of the fund's investment strategy, which takes into account the risk profile of investments, singly and as a composite, in the context of the fund's objectives and liquidity requirements. Set in this context, it is interesting to note that there is no control over investment in entities which in their turn adopt leveraged positions. Almost all companies have considerable debt, because this is a cheaper form of finance than equity, and a balance is achieved between cost and leverage risk. Unit trusts and other funds, particularly property funds, use considerable leverage, and hedge funds are a famous example of the use of leverage. Given the indirect risk exposure associated with all investments, it is interesting to note the overall SIS Act ban on trustee leverage. In simple terms, it is the trustee's responsibility to monitor investment risk in aggregate, and in logical terms this should encompass any direct leverage adopted by the fund itself (if this were permitted). We certainly see the arguments for protecting unsophisticated trustees from irresponsible borrowing, but in the now well established context of APRA licensing for trustees with its intrinsic focus on risk, we see leverage, in whatever form and at whatever level, as an area of trustee risk which is sufficiently monitored and reported and which need not therefore be subject to additional controls.

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5.5.5 Tax governance

Trustees should, and do, in common with other decision makers in today's world, take into account the after tax return on investments, rather than the pre-tax return. The tax considerations in each investment regime are taken into account in designing investment arrangements and manager mandates.

We look forward to further discussion.

Yours faithfully



Mark N Cerché
Chairman
Corporate Superannuation Association