

# **ACTU**

## **Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System**

**ACTU submission on Governance**

**21 October 2009**

**D No 18/2009**

## Summary of main ACTU views and recommendations

Issue	ACTU views / recommendations
5.1.2 Complexity	<p>ACTU recommends:</p> <p>a) Establish a single reporting channel through which funds can submit required documentation to APRA and ASIC. Those in receipt of the relevant papers would then be responsible for ensuring their correct distribution to APRA or ASIC.</p> <p>b) Establish a single point of contact for the purposes of co-ordinating meetings with and visits from APRA and ASIC officials.</p>
5.1.3 Trust model for super	<p>ACTU strongly supports the trust model, the not-for-profit business model, and boards that comprise equal numbers of employer and employee representatives.</p> <p>The Review Panel should acknowledge the advantages of these forms of fund governance and business organisation for members, and recommend to government they continue.</p>
5.1.4 UNPRI	<p>ACTU recommends:</p> <p>a) In common with practice in other countries, adoption of UNPRI should not be mandatory.</p> <p>b) APRA should recommend to funds that they actively consider adopting UNPRI on a periodic basis.</p>
5.2.2 Trustee knowledge, skills and training	<p>ACTU recommends:</p> <p>a) In relation to maintaining an appropriate Fit and Proper policy we believe paragraph 10(i) in APRA's PPG Draft on Fitness and Propriety should recommend reviewing the policy every year or whenever the composition of the trustee changes.</p>
5.2.3 Trustee performance	<p>ACTU recommends:</p> <p>a) Regular independent assessment of boards? Quality control?</p>
5.2.7 Conflicts in outsourcing	<p>ACTU recommends:</p> <p>a) Trusts should be required to remove embedded arrangements from their trust deeds and governing rules that require the trustee to outsource particular functions to specified service providers and/or only invest in financial products marketed by specified parties. Short of such a requirement, trustees should be given the explicit authority to remove or ignore such arrangements.</p> <p>b) Funds should be encouraged to develop a 'partnership approach' to their dealings with external providers that seek to balance cost efficiency with the need for adequate revenues to facilitate investment in service quality.</p> <p>c) Any proposals that APRA supervise service quality should be considered in the context of how we can encourage a growing market in higher quality external service provision.</p> <p>d) APRA, peak super bodies and the AASB should work together to develop forms of compulsory accounting and disclosure relating to all expenses, fees, charges and commissions relevant to outsourcing.</p>
5.2.8 Board Composition and succession planning	<p>The ACTU recommends:</p> <p>a) Appointments to trustee boards should be on a fixed term renewable basis.</p>

Issue	ACTU views / recommendations
5.2.10 Consolidation	<p>The ACTU would oppose any measures which would compel trustees to consolidate funds. To ease the voluntary consolidation process the ACTU recommends:</p> <p>a) For the purposes of meeting the requirements that allow bulk transfers, the SIS Act and Regulations should be amended to allow trustees to distinguish between 'core' and 'peripheral' member rights.</p> <p>b) Where trustees wish a consolidation to take place, but there exist what the trustees regard as unreasonable requirements imposed by a trustee deed, APRA should have the discretionary power to approve a Successor Fund Transfer.</p>
5.3.1 Fund involvement in pursuing broader public policy objectives	<p>The ACTU would oppose measures intended to mandate fund participation in public policy projects such as infrastructure. The ACTU recommends:</p> <p>a) The development of a framework of tax incentives and government-guaranteed investment vehicles that would secure both fund involvement in nation building projects and adequate long-term returns for fund members.</p> <p>b) Further exploration of how funds could become involved in economic and social infrastructure projects such as public rental housing. To this end, the Federal government should establish a working group comprising representatives from interested peak superannuation bodies with a time-limited remit to produce detailed recommendations on how this can be achieved.</p>
5.5.1 Investment time horizon	<p>The ACTU notes with concern the continuing tension between Member Choice and long-term fund management.</p>
5.5.2 Tilt toward equities	<p>The ACTU would oppose measures intended to determine how funds allocate their investments between asset classes. In common with arrangements in many other countries, this is a matter that trustees are best able to decide.</p>
5.3.5 PJC governance issues	<p>a) ACTU supports Recommendation 4 relating to compulsory accounting and disclosure.</p> <p>b) ACTU opposes Recommendation 6. Trustees are best placed to decide which services are tendered and how.</p>

## Introduction

1. The Australian Congress of Trade Unions (ACTU) welcomes the decision by the Federal government to conduct a wide-ranging review of the governance, efficiency, structure and operation of Australia's superannuation system.
2. The ACTU represents nearly 2 million working Australians who are union members. Over the past twenty years, working closely with our affiliates and previous Federal governments, we have played a central role in the development and management of our current superannuation system. We know better than most that workers are concerned that they should have access to an adequate income following retirement. In addition to the aged pension and voluntary savings, the benefits that accrue from our system of compulsory retirement savings will play a key role in providing that income.
3. It is therefore vital that Australian superannuation funds, which held investments that totalled 105 per cent of our GDP in 2007<sup>1</sup>, are required and encouraged to manage their organisational and financial resources in a manner that prioritises the interests of fund members at all times. The negative investment returns experienced by all parts of the industry because of the Global Financial Crisis underlines that how funds are governed – by legislators, regulators and those appointed to manage particular fund entities – is of crucial and growing importance.
4. The ACTU therefore welcomes the opportunity to discuss and comment on some of the issues raised in the *Governance* consultation paper. We would be happy to meet with members of the panel to elaborate on this submission.

## Governing for Members

5. The ACTU believes the recent history of the superannuation industry in Australia clearly shows that funds operated on a not-for-profit basis, and which are managed by boards of trustees that comprise equal numbers of employer and employee representatives, offer a highly effective means of protecting and advancing the interests of fund members. This model has consistently performed well for members since its foundation and has proved resilient in the context of the current global financial crisis.
6. The distinction between for-profit and not-for-profit funds remains a relevant and important one for a number of reasons.
7. Firstly, for-profit funds are structured around a fundamental conflict of interest: between the duty to advance the interests of fund members, and the duty to shareholders in the parent financial institution. This conflict is

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<sup>1</sup> OECD (2009) *Private Pensions Outlook*, p. 158

fundamental to the structure of such funds and helps to explain why they typically charge higher fees to members than those charged by not-for-profits.

8. Secondly, recent research has shown, yet again, that not-for-profit funds on average perform better than the retail sector. According to research conducted at the University of Sydney, in the period from March 2004 to December 2008 for-profit funds with trustees appointed by the parent financial institution consistently underperformed other funds by up to 2.4 per cent per annum on a risk adjusted basis.
9. The research concluded that a key reason for this underperformance is the difference in fee levels and expenses. This conclusion is further supported by analysis by APRA which found that in the ten year period from 1996 to 2006 the main reason for differences in net returns between fund types was the higher expenses associated with for-profit funds.<sup>2</sup> Using a rule-of-thumb that every 1 per cent of sustained underperformance will translate into a cut in final retirement benefits of about 20 per cent, the Sydney University researchers concluded that tackling this persistent performance differential should be a priority for policymakers and regulators<sup>3</sup>. The ACTU shares this view.
10. In relation to equal representation on trustee boards the ACTU agreed with the Productivity Commission in 2001 when it concluded:

*'The equal representation rules for trustee boards of standard employer-sponsored funds provide balanced representation of employer and employee interests. They are conducive to active member interest in the prudent management of these funds. This benefit exceeds the cost of finding and appointing members who are capable of undertaking trustee duties.'*<sup>4</sup>
11. The ACTU is not aware of any substantial evidence base that has emerged in the past 8 years that would cause the Productivity Commission to revise that view or cause us to withdraw our endorsement of it.
12. We note, however, that there has been some discussion in the UK about the relative merits of trustee and contractual schemes<sup>5</sup>. In the latter model employers negotiate a scheme set-up with a commercial provider who then has a direct contractual relationship with each individual member. Such a model will appeal to those who like to view the world in

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<sup>2</sup> APRA (2009) *Insight*, issue 2.

<sup>3</sup> Bryan, D., G. Considine, R. Ham and M. Rafferty (2009) *Agents With Too Many Principles? An Analysis of Occupational Superannuation Fund Governance in Australia*, Workplace Research Centre, University of Sydney

<sup>4</sup> Productivity Commission (2001) *Report into the Superannuation Industry (Supervision) Act 1993 and certain other Superannuation Legislation*, p. 87

<sup>5</sup> For example see Altman, R. (2005) *DC Scheme Governance: trustee-based vs. contract-based*, NAPF discussion paper, London.

terms of firms competing in perfectly competitive markets for the custom of voluntary, perfectly informed, rational consumers. It will also appeal to those in the financial services industry who understand how profitable customer inertia, lack of knowledge and susceptibility to highly partial 'expert advice' can be.

13. However the market for superannuation in Australia is not remotely 'perfect' and is unlikely to become so. The real market is defined by the following characteristics:
  - a) Non-voluntary participation by most consumers with no control over the minimum extent of their participation;
  - b) Products and services which are viewed by many customers as complex, opaque and difficult to fully understand;
  - c) Persistently low levels of financial literacy and interest in the detail of retirement-related products;
  - d) Firms that compete primarily on the basis of product differentiation, marketing and advocacy by intermediaries, rather than price and performance.
14. In this real world context the market operates to generate a significant power imbalance between those who are compelled to make contributions and those who wish to profit from managing those contributions on their behalf. Given that imbalance, and the likely endurance of the factors that give rise to it, a priority of policymakers and regulators should be to support and help improve the modes of fund governance and business models that have consistently proven to be the most cost efficient and beneficial to members. The ACTU therefore believes the Review Panel and the government should use the opportunity of the current review to make clear that they support the continuance of the representative trustee mode of governance and the not-for-profit business model.

### **The composition, skills and requirements of Boards**

15. The regulatory and investment environments have become more complex in recent years. Levels of risk, volatility and uncertainty have all increased significantly in the context of the growth and deregulation of global capital markets. This means that funds, working with regulators and legislators, should be concerned to ensure trustees have the individual and collective knowledge and support needed to respond effectively to changing circumstances. This involves nominating people to Boards who are best able to represent members, ensuring they receive the training they need to access and evaluate expert advice, and dealing effectively with any instances of unsatisfactory performance.

16. With the APRA licensing regime now six years old it is appropriate to review its effectiveness.

In our experience the introduction of the 'fit and proper persons', and the 'adequacy of resources' obligations have seen funds formally and regularly evaluate the skills of their Boards, senior management and advisors, identify any skill gaps and implement strategies to fill those gaps.

Certainly the funds to which the ACTU nominates trustees have ensured that we are aware of their fit and proper policies. Many have responded to this regime by formalising policies to evaluate their Board performance, to entrench Director training and professional development into their Board agendas and formalising a process to remove directors. APRA encourages funds to adopt these procedures and funds have responded.

The ACTU has enhanced its process for appointing Directors. In filling vacancies the ACTU will typically meet with the fund Chair and Boards to ensure we are aware of the Board's requirements prior to making our nomination.

While the ACTU strongly defends the equal representation structure of industry funds, we have been supportive of those trustees who have decided to strengthen the decision-making processes of the funds by supplementing the composition of Board sub-committees with additional members who bring particular expertise.

17. The ACTU notes that APRA has issued draft revised guidance on fitness and propriety. Our view is that the existing guidance has performed well and significant change is not required. However, we believe the current draft guidance would benefit from the following amendment:

- a) In relation to maintaining an appropriate Fit and Proper policy we believe paragraph 10(i) in the Guide should recommend reviewing the policy every year or whenever the composition of the trustee changes.

18. In addition the ACTU believes the following measures would contribute to improving trustee performance:

- a) Training for trustees should include instruction on the importance of investment manager performance and asset allocation over the long term (10 years plus).

*Board assessment*

- b) APRA should recommend that all funds develop a robust process for assessing board performance on a regular basis. Boards should offer

APRA assurance that such a process has been developed and is being implemented in an appropriate manner.

#### *Terms of appointment and removal of directors*

- c) The ACTU opposes a limit on the terms that a trustee may serve. Union nominees to funds derive their authority from the democratic wishes of the members of the fund, and that mandate should be respected.

More practically, arbitrary restrictions can lead to perverse outcomes. We are aware of a number of Boards where, as a consequence of resignations by less experienced trustees, a time based disqualification would have left the Board without any Trustees with corporate knowledge of the fund.

We are amenable to a requirement that appointments to trustee boards should be on a renewable fixed term basis (e.g. renewable every 5 years). This approach allows for the periodic replacement of board members when appropriate and would promote regular review of the composition of trustee Boards while retaining those who continue to contribute valuable knowledge and experience. It would also facilitate holding board members responsible for long-term investment decisions.

We are aware that APRA has required funds to develop an explicit policy for dealing with individual board members whose competence may be in doubt. We are also aware that from time to time APRA has expressed concern that the ultimate decision to remove a trustee rests with the nominating organisation, not with the Board. If a trustee's competence is in doubt the chairman of the board should formally approach the sponsoring organisation to find a replacement.

### **Conflicts of Interest**

- 19. Actual or potential conflicts of interest are not limited to the for-profit sector of the superannuation industry. But, for the reasons outlined above, it is in this sector that the conflict between the interests of members and funds is most pronounced and of potential long-term public policy significance. Given the negative association between fee levels and performance/final benefits, our view is that conflicts of interest in the for-profit sector require special attention and action by legislators and regulators.
- 20. Earlier this year APRA issued guidance on how funds should manage conflicts of interest when they arise<sup>6</sup>. While we welcome much of the guidance we do not believe it is sufficiently robust in some important respects. Given the size of the for-profit sector, and the profoundly

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<sup>6</sup> APRA (2009) *Prudential Practice Guide Draft: SPG 521 – Conflicts of Interest*. Canberra.

imperfect nature of the market in which it operates, more needs to be done to protect and advance the interests of fund members.

21. In their Guide APRA discuss issues related to the embedding of certain commercial arrangements in trust deeds (paragraphs 13-17). Such arrangements may require the trustee to outsource particular functions to specified service providers and/or only invest in financial products marketed by specified parties. Such embedded arrangements clearly constitute a significant potential threat to the interests of fund members and beneficiaries.
22. APRA offers the following guidance on this issue: 'If, in such circumstances, the trustee has power to initiate an amendment to the deed, the trustee will need to consider exercising it with a view to widening the choice of investments or service providers....If not, it may be appropriate for the trustee to approach the Court, for example for an order conferring power to invest in a wider range of products' (paragraph 17).
23. In our view this approach is not sufficiently robust. We believe trusts should be required to remove any such embedded arrangements from their trust deeds and governing rules. Short of such a requirement, trustees should be given the explicit authority to remove or ignore such arrangements.
24. In the view of the ACTU decisions relating to outsourcing should be made entirely on the basis of what is of most benefit to fund members. This is the approach taken by those industry funds that wholly or partly own separate commercial entities that are contracted to supply services to the funds.
25. Research by The Institute of Chartered Accountants in Australia and Deloitte<sup>7</sup> has found that the superannuation industry in Australia is heavily reliant on external service providers. However, sustained pressure on service providers to lower costs has, in some cases, resulted in a decline in service quality. Less revenue has resulted in some service providers finding it difficult to recruit and retain skilled staff. Investment in new processes and technologies has sometimes been delayed or cancelled. The research concludes that funds should be prepared to pay for quality services and recommends that the industry develops a 'partnership approach' to external providers. The ACTU supports this recommendation.
26. An important means of managing conflicts of interest in areas such as outsourcing is to maximise transparency via the disclosure of appropriate and comparable accounting data. The ACTU supports Recommendation 4 made by the 2007 Parliamentary Joint Committee Inquiry that called for

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<sup>7</sup> Institute of Chartered Accountants in Australia & Deloitte (2008) *The Governance of Superannuation Funds – the industry three years on from trustee licensing*. Sydney.

the formation of compulsory accounting standards and disclosure by all funds for promotional advertising, sponsorship expenses and executive remuneration. We further recommend that such an approach is also applied to all expenses, fees, charges and commissions relevant to outsourcing.

27. Some in the superannuation industry have called for APRA to directly supervise external providers to ensure minimum levels of service quality. The ACTU has no objections to APRA undertaking such supervision. However, we are concerned that some making this call may be doing so in the hope that if the question of maintaining service quality can be effectively delegated to APRA, funds can then focus on placing yet more pressure on providers to keep cutting costs. This approach is not conducive to the development of a larger market in high-quality external service provision. The ACTU therefore believes that any recommendations from the Review Panel that APRA directly supervise the quality of service output should form part of a broader analysis of the structure, performance and future of the external provider industry. Such an analysis should consider measures for promoting sustained and long-term investment in staff training and skill formation.

### **Fund Consolidation**

28. The available evidence strongly suggests that fund size, in terms of membership and assets, is associated with significant scale economies in relation to administration and investment costs<sup>8</sup>. These lower costs will, ceteris paribus, contribute to generating higher retirement benefits for members.
29. Scale can bring other benefits: greater capacity to compete for investment opportunities at home and abroad; more resources to implement efficiency strategies; more resources to offer a wider range of products and services; the ability to attract and retain high quality employees; resilience in the context of national and global economic instability.
30. These are among the reasons why, when it can be clearly shown to be in the interests of members, the ACTU supports the consolidation of funds. However, we believe care should be taken to ensure that consolidation preserves the specialist industry knowledge and skills that smaller funds often possess and which play an important role in serving particular groups of members.
31. Trustees are best placed to judge if, when and how fund consolidation should take place. The ACTU would therefore oppose any measures intended to render consolidation mandatory.

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<sup>8</sup> Deloitte (2009) *Investment performance and scale: an analysis of Industry Fund performance 2004-2008*. Sydney.

32. However, while consolidation should be a matter for trustees to decide, because scale can deliver important benefits to members there is a role for government and regulators in helping to encourage and facilitate the process should trustees believe consolidation would be in the interests of their members.
33. ACTU Congress 2009 adopted a detailed policy on superannuation. In this policy we welcomed the Federal government's temporary partial relief from capital gains tax to encourage consolidation. Our Congress called on the government to extend the life and scope of the scheme and to 'remove other tax and regulatory impediments to fund consolidation'.
34. To this end the Review Panel should recommend that government simplify and clarify the Successor Fund Transfer (SFT) provisions of the SIS Act and Regulations in two respects.
35. Firstly, the Act allows for the bulk transfer of members and assets to the new fund without requiring individual consent where the rights of members are maintained. In practice, there may be instances where every right of some members may not be maintained after the transfer. For example, a specific range of investment options available pre-transfer may not be available post-transfer. There is clearly a reasonable distinction to be made between core and peripheral rights in such a context. However, that distinction is not currently made and it could lead to fund consolidations that are otherwise of potential benefit to most members in most important respects being blocked, delayed and/or rendered very costly.
36. Secondly, there may be instances when a trustee deed cannot be amended to allow an SFT or which requires the consent of all members – including those who are lost. We believe APRA should have the discretionary power to approve SFTs that fall outside the explicit provisions of the Act and that would otherwise be prevented by terms of deeds that trustees regard as constituting an unreasonable barrier to a beneficial consolidation.

### **Socially Useful and Secure Investment Strategies**

37. When it benefits members the ACTU supports funds choosing investments in assets, such as economic infrastructure, that help to generate broader benefits for our community. Many workers and union members in Australia want to see their contributions invested in ways that support our sustainable economic and social development, and which will also generate returns conducive to receiving an adequate retirement income.
38. The ACTU would oppose measures intended to mandate fund participation in public projects such as infrastructure. The key to securing participation is a public policy framework that establishes incentives for funds to undertake the appropriate investments. To this end our 2009

Congress called for the ACTU to adopt a number of priorities which include the following:

- a) supporting new forms of flexible long term Government bonds and other Government guaranteed investment vehicles that facilitate the investment of workers' capital in nation building and other nationally significant infrastructure and industry development investments and provide options for funds at different points on the risk/return spectrum;
  - b) exploration of opportunities for fund investment in social infrastructure, such as public rental housing, which could address areas of need while ensuring a reasonable return for workers' retirement savings.
39. The Review Panel should recommend to the Federal government that it establishes a working group comprising representatives from interested peak superannuation bodies with a time-limited remit to produce detailed recommendations relating to how these and other related social investment aims can be realised.
40. The ACTU supports the principles contained in the UNPRI. However, we note that no national regulatory framework presently requires funds to adopt the principles. We do not therefore believe their adoption should be mandatory in Australia. This should be a matter for trustees to decide. However, we believe APRA should recommend to funds that they actively consider their adoption on a periodic basis.

#### *The tilt to equities*

41. A further aspect of investment strategy concerns the 'tilt to equities' evident in many Australian funds and the related reduction in returns during the worst of the Global Financial Crisis. The OECD has estimated that Australian funds suffered the third largest absolute fall in returns, following those in America and the UK<sup>9</sup>. Understandably there has been some public discussion about the risks posed by the exposure of funds to equities and if government should intervene to minimise such risks.
42. While we understand these concerns it is important to remember that in Australia the returns from equities, and other investments managed by fund trustees, do not provide the sole source of retirement income. The age pension plays an important role for many retirees and must continue to do so. In our view recent equity market volatility underlines the importance, not of regulating how funds manage their asset allocations, but of a long-term commitment by government to an adequate age pension.

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<sup>9</sup> OECD (2009) *Private Pensions Outlook 2008*. Paris.

43. Furthermore, equity values have recovered since the end of 2008. As the OECD have noted, many of those who chose to move into cash and government securities in search of safety have not benefited from the subsequent recovery in equity markets in 2009. Despite recent volatility it remains the case that in the long-run equities are likely to continue to provide the returns that funds and their members will need in the coming decades.
44. The ACTU would therefore oppose measures intended to determine how funds allocate investments between asset classes. We believe such decisions are best made by trustees in the context of the specific size, composition and performance of the funds they manage.

#### *Member Choice and long-term investment*

45. The ACTU has long held the view that the Member Choice policy introduced by the previous Federal government is inappropriate given the structure of the market for superannuation products that exists in Australia. There is clearly a tension between the duties of trustees to safeguard the long-term interests of fund members as a collective and the obligation to facilitate individual choice regardless of the impact on the fund. While switching between investments and funds remained relatively low during the peak of the Global Financial Crisis, we remain concerned that some fund members will suffer long-term detriment because of poorly informed choices made during periods of heightened uncertainty and volatility. We welcome the decision by ASIC to allow funds to give limited advice to members about the nature of the investment options available to them. However, this does not resolve the more fundamental problem of members exercising choice in the context of low levels of financial literacy and the cost-barriers to obtaining high quality independent advice.

### **Governance Complexity**

46. Undue complexity generates additional administrative costs for funds and potentially lower final benefits for members. Regulators and legislators must be alert to the costs that the changes they implement can create for funds and be receptive to calls to reform and streamline laws, regulations and administrative processes. But there is a balance to be struck. Stability, compliance, transparency and probity are more important to the long-term interests of fund members than short-sighted and politically-motivated efforts to 'slash red tape'.
47. The ACTU believes that, in general, the present system of fund regulation works well. However, one area of concern relates to the time and related costs that funds expend in dealing separately with APRA and ASIC. These bodies perform important distinctive functions. We do not believe there is a strong case for merging them. However, there are measures which could be taken to simplify and streamline how funds deal and communicate with APRA and ASIC:

- a) Establish a single reporting channel through which funds can submit required documentation. Those in receipt of the relevant papers would then be responsible for ensuring their correct distribution to APRA or ASIC;
- b) Establish a single point of contact for the purposes of co-ordinating meetings with and visits from APRA and ASIC officials.