Board Governance of Not for Profit Superannuation Funds

Bernie Fraser

16 February 2017

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Dear David

Dear Tom

BOARD GOVERNANCE OF NOT FOR PROFIT SUPERANNUATION FUNDS

My report on this subject is attached.

For such a brief document it has been sometime in the making; as you know, this happenstance has a good deal to do with uncertainties flowing from the mid-2016 Federal election.

Should you wish it, I would be happy to participate in any discussions on the report with relevant stakeholders, including cross-bench senators.

I have appreciated the assistance provided by officers of Industry Super Australia in the preparation of this report.

Yours sincerely

Bernie Fraser

16 February 2017

GLOSSARY

ACTU	Australian Council of Trade Unions
AICD	Australian Institute of Company Directors
AiG	Australian Industry Group
AIST	Australian Institute of Superannuation Trustees
ATO	Australian Taxation Office
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities & Investments Commission
ASX	Australian Securities Exchange
EM	Explanatory Memorandum
Fintech	Financial Technology
FSC	Financial Services Council
FSI	Financial System Inquiry
GFC	Global Financial Crisis
IFF	Industry Funds Forum
ISA	Industry Super Australia
NFP	Not For Profit
PPG	Prudential Practice Guide
RSE	Registrable Superannuation Entity
SIS	Superannuation Industry (Supervision) Act
SMSF	Self-Managed Superannuation Fund
SPS	Superannuation Prudential Standards
The Bill	The Superannuation Legislation Amendment (Governance) Bill 2015

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BACKGROUND

The Superannuation Legislation Amendment (Governance) Bill 2015 (the Bill) was introduced in the House on 16 September and passed in that chamber on 20 October 2015. The Bill was introduced in the Senate on 9 November 2015. The stated purpose of the Bill was to raise the governance standards of all superannuation funds (including industry and other "not for profit" funds), primarily by mandating that their Boards of Directors comprise a minimum of one-third "independent" directors, including an “independent” Chair.

The appropriateness and motivation of these proposals were questioned by representatives of the not for profit (NFP) funds. Several of the then cross-bench Senators were unwilling to support the Bill and it was suggested that the interests of members of NFP funds might be better served by an appropriate code of Board governance, rather than the proposed mandatory requirements in respect of “independents”. This led to the deferment of further consideration of the Bill pending a report on a possible voluntary code. The Bill lapsed when Parliament was prorogued on 17 April 2016.

In early December 2015, I agreed to a request from Industry Super Australia (ISA) and the Australian Institute of Superannuation Trustees (AIST) to review the Government’s proposed changes as they related to NFP funds, and to suggest alternative arrangements for those funds.[1] In response to a request for public submissions some 22 submissions were received, almost all of which were released on ISA’s website.[2] Letters were sent to the major stakeholders [3] (and to the relevant Minister)[4] outlining the proposed approach of the review and requesting their cooperation.

Extensive discussions were held in the early months of 2016. These included meetings with several cross-bench senators, Australian Industry Group (AiG), Australian Council of Trade Unions (ACTU), Australian Institute of Company Directors (AICD), Australian Securities & Investments Commission (ASIC), Australian Prudential Regulation Authority (APRA), and the Boards of the two sponsoring organisations (ISA and AIST). A Review Team also met with several academics familiar with governance arrangements pertaining to local and overseas superannuation funds.[5]

The consultative processes and the finalisation of the report were interrupted by last year's federal election, which was announced on 8 May and held on 2 July. Given the uncertainties surrounding the election outcome, including the likely make-up of the new Senate and the priority the in-coming Government might attach to the earlier Bill, it made sense to hold over completion of the review until there was greater clarity on these issues; this decision was conveyed to major stakeholders on 3 May 2016.[6]

With the passage of time these uncertainties have been largely resolved. Most recently, in the course of an address at an ISA conference on 22 November, the Minister for Revenue and Financial Services announced the Government's intention to re-introduce its earlier Bill relating to governance arrangements, but did not indicate when this might occur. With this confirmation that the Bill remains “live” and would be reintroduced, the report has been completed and made available to interested parties.

OVERVIEW

It was generally understood that the central focus of the report would be to review the Bill's mandatory requirements for independent directors (and chairs), particularly as they might impact on members of NFP funds. The alternative arrangements covering independence issues for these funds was to be an integral part of the review.

Any review of this kind must start with some clarity about the benchmarks against which different proposals can be judged and assessed. In the view of the Government (and others) the proposals in the Bill represent “best practice”, based on experiences both of other financial institutions in Australia, and of comparable superannuation funds internationally. But are those the most appropriate benchmarks, particularly if there were significant differences between the funds targeted by the Bill and institutions in the benchmarks? Or, as some seem to think, is any benchmark really a secondary consideration alongside an unshakeable belief that “representative” directors of employers and members couldn’t possibly be as good as “independent” directors?

The start and finish point of this review is that what matters most in assessing the proposals in the Bill – and possible options – should be their likely consequences for the members of the funds directly in the firing line.

From that perspective, considerations other than how many of the directors sitting around the Board tables of NFP funds happen to be “independents” might be expected to be much weightier; the values and skills of those directors in particular. Fleshing out the case for concentrating on these really critical considerations is a major part of this report; in the process, its focus shifts from the “independence” thrust of the Bill to the values and skills of real Boards of Directors. 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) – but to argue that the priority from the perspective of members of NFP funds should be squarely on the latter. The limited recommendations in this report seek to promote members’ interests by elevating the sources of potentially greatest benefit to them – the values, skills and experience of their Boards – to top billing, ahead of independence as such.

WHY MANDATE MINIMUM INDEPENDENTS?

In the absence of any indications to the contrary, it has been assumed in preparing this report that the re-introduced Bill will mirror the original. As mentioned earlier, the major changes proposed in the Bill would require a minimum of one-third of Board Directors (including the Chair) of all superannuation funds to be “independent”. It would also repeal the current legislative provisions underpinning of the equal representation model of NFP funds (that is, equal member and employer representation on Boards).

In addition, the Bill proposes that APRA be given an over-riding power in determining whether a person viewed as a prospective director of a superannuation fund actually qualifies as “independent”.

Boards of Directors are ultimately responsible for the performance and behaviour of the funds which make up this country's substantial superannuation industry. Collectively, these funds manage more than $2 trillion of the retirement savings of nearly 12 million

Australians, of which roughly one third supports company investments, and infrastructure and property developments, in Australia. They are also tax-privileged institutions, with the value of revenue foregone through taxation concessions (or “tax expenditures”) estimated to be in the order of $30 billion annually. For all those reasons – of which the protection of members’ compulsory retirement savings rates most highly – quality Board governance of all superannuation funds – including NFP funds – is rightly an important policy goal of governments.

It is far from self-evident, however, that simply mandating minimum numbers of “independent” directors will deliver quality or “best practice” Board governance for all super funds: that case has to be made, not inferred or asserted.

The Government’s main arguments in support of mandated requirements – as distilled mainly from the Explanatory Memorandum (EM) accompanying the Bill and from related Ministerial statements – are canvassed briefly below:

(i) Independents bring "...an independent kind of thinking to boards ..." and provide "...an external dispassionate perspective enabling boards to benefit from a diversity of views...” They also "... ask the right questions ...” These and similar comments/quotations appear throughout the EM, which attaches considerable weight to “independence of mind” and its inferred attributes.

    These characteristics no doubt contribute to the proper functioning of Boards, but they are hardly intrinsic to directors who count as “independent”, and absent in other directors. In terms of their ultimate value to fund members, the retail (“for-profit”) funds – which have majorities of independents on their Boards – consistently underperform NFP Funds.

(ii) Independent directors hold other directors and fund managements “more accountable” – to a greater degree, presumably, than non-independent directors.

    Again it is far from clear why this should be so; it is not demonstrated in the relative returns to members of retail and NFP funds, or in their respective behaviour report cards.

(iii) Independent directors avoid conflicts of interest that can cause non-independent directors to act – "either intentionally or unintentionally" – contrary to the best interests of members.

Conflicts can arise for various reasons in any fund, irrespective of the mix of independent and other directors, and all Boards are required by APRA to have procedures for handling them (including, for example, on disclosures, and on the non-participation of directors in decision-making on certain issues).

To the extent that potential conflicts of interest (and duty) are a function of the number of different "interests" in play around Board tables, it is reasonable to expect that the incidence of actual conflicts would be somewhat greater in the case of retail ("for profit") funds, which face the task of reconciling the interests of two powerful and somewhat aligned groups (shareholders and senior executives[7]), and of a third and generally less powerful group (customers/clients): compared with NFP funds which focus on their members alone. This point, which goes to the heart of the question of "independence", is elaborated below.

(iv) A variant of the previous point is the argument that as the membership of some funds expands and becomes more diversified – through, for example, amalgamations and "public offers" – this diversified membership is entitled to see more "independent" directors in these funds, and fewer appointees from particular union and employer groups which may have become less "representative" of today's membership than they were in the earlier times.
This argument supports the suspicion that industry super funds are a particular target of the proposed changes: their funds under management have grown rather faster over the past decade than those of retail funds (see Table 2).

The more substantive response is to repeat the comment on point (iii), namely, that the Boards of NFP funds are focussed inherently on advancing the interests of all their members, irrespective of any particular industry or other affiliations individual "representative" directors might have. The sustained growth of these funds is reflective of their good on-going performances: it hardly suggests a failed business model that is disadvantaging any of its members.

(v) More independents on the Boards of super funds would bring Australia into line with “international best practice”. The EM quotes from the Financial Services Inquiry (FSI) report which noted:

> “…. including independent directors on boards is consistent with international best practice ….”

Governance practices in other countries can be of interest and, at times, provide insights that help to improve practices in Australia - but they rarely come in ready-made and readily transferable packages. What turned out to be exceptionally bad behaviour and sloppy risk management practices on the part of many American and European banks and other financial institutions – of which the GFC is their continuing legacy – were widely regarded as “best practices”: fortunately, they were not practices which Australian institutions were pressed to import.

Governance structures of superannuation funds around the world exhibit considerable diversity, reflecting their different histories and cultures. The make-up of Australia's superannuation funds, including their structures, goals and governance, similarly reflect their peculiarly Australian histories and cultures: this should be remembered when assessing both the proposals in the Bill and possible alternative approaches. In other words, the search for improvements in current Australian practices is likely to prove most fruitful when it is based on an in-depth understanding of the domestic landscape, (including, for example, the different priorities of retail and NFP funds), rather than looking to lift particular models from overseas. That said, the proposal in the Bill to attack the equal representation model of NFP funds is contrary to the support shown worldwide for this model, including in a majority of OECD countries.

(vi) Independent directors can bring different skills and experiences, and expand the pool of talent available to the boards of all funds.

> There is no question that the mix and quality of the skills and experiences represented around the Board tables are major drivers of performance for all funds. The importance of skills and experience is elaborated later in the report, where it is argued that these attributes in Board members – particularly of NFP funds – far outweigh any appeal of their "independence" as such.

Many of these arguments for mandated minimum numbers of independents rely heavily upon assertion, rather than reason and evidence. Sadly, this has come to characterise so much public policy "debate" in this Age of Assertion. Whether driven by ideology, pressures from lobbyists, or something else, the assertion card is increasingly and shamelessly played to trump sound reasoning and solid evidence – even on a matter as far under the radar as Board governance of superannuation funds. Very much in this vein is the Minister's recent claim that "...governance standards for superannuation funds under the law are lower than for banks and life insurance companies ..."[8]

Some aspects of points (i) to (vi) are re-visited below. For the most part, however, the case for the main proposals in the Bill rely more on assertions than on hard evidence of either on-going problems in the governance of NFP funds, or of the necessity for mandated minimum independent requirements to be imposed on those funds. The thinking underlying the Bill ignores the diversity – between retail and NFP funds, and in the size, cultures and performance – within the industry. It also suggests that, to the extent the Bill really seeks to enhance members' interests through increased "independence" it is, by taking aim at NFP funds, attacking the wrong target.

SNAP-SHOT OF THE AUSTRALIAN SUPERANNUATION INDUSTRY

The following tables provide a quick snap-shot of the Australian superannuation industry, primarily to highlight its considerable diversity.

Table 1: Number of Superannuation Funds, by Sector

	June 2006	June 2016	Change (%)
Retail	251	135	-46
Not-for-Profit:	407	109	-73
- Corporate	295	30	-90
- Industry	68	41	-40
- Public sector	44	38	-14
SMSF	309,088	577,236	87

Source: APRA Annual Superannuation Bulletin, June 2016

Significant reductions occurred in the numbers of most funds over the past decade, and especially so for corporate not for profit funds (as employers have outsourced this “non-core” function) and in industry funds (driven largely by mergers). SMSFs have grown solidly over the period; nearly three quarters of these funds have two members and most of the remainder have only one member. These funds are administered by the ATO (rather than APRA) and are not affected by the Bill; they are included in the tables to highlight the rapid growth of the sector, to the point where it now represents close to one-third of the whole industry in terms of assets.

Table 2: Growth in Member Accounts and Net Assets, by Sector

	June 2006	June 2016	Change (%)	June 2006	June 2016	Change	Share Assets (%)
Retail	**14,991**	**12,978**	**-13**	**302**	**543**	**80**	**27**
Not-for-Profit	13,424	14,992	12	340	835	146	42
- Corporate	469	341	-27	42	53	26	3
- Industry	9,836	11,118	13	144	445	209	22
- Public sector	3,119	3,533	13	154	337	119	17
SMSF	594	1,088	83	203	622	206	31

Source: APRA Annual Superannuation Bulletin, June 2016
*Note: SMSFs assets refer to total assets *Data are not available on the number of superannuation fund members; changes in the number of member accounts is a very rough proxy, given the incidence of multiple accounts.*

Funds under management of retail ("for profit") funds increased by 80 per cent over the past decade, and represented approximately 27 per cent of the industry total at 30 June 2016. Retail funds are owned mostly by the major banks and life offices. Their trustee Boards were traditionally dominated by executive directors but from 2014 the Financial Services Council (FSC) has required the trustee Boards of their members to have a majority of independent directors and an independent Chair. Most retail funds are members of the FSC and comply with this requirement. Many of the appointed "independent" directors have had careers as finance executives. In addition, trustee boards for the major banks typically govern a number of separate super funds on behalf of the banks and their independent directors sit as "independents" on these multiple Boards. Perhaps a little ironically, compared with the current FSC requirement for a majority of independent directors, the Bill would reduce the minimum requirement for retail funds to one third.

The NFP funds (more accurately described as "all profits to members" or just "profit to member funds") collectively grew by 146 per cent over the past decade (rather faster than retail funds) and currently make up about 42 per cent of the total industry. Within this sector, industry funds recorded the fastest growth over the past decade (more than 200 per cent), making up 22 per cent of the whole industry, followed by public sector funds (17 percent) and corporate funds (3 per cent). More than half of industry funds follow the "typical" equal representative trustee model, with an equal number of employer and employee directors nominated by employer associations and unions. A small number follow a similar structure, but their member representatives are directly elected. Others have a variety of arrangements, which include holding member elections for all directors, and Board/Committee involvement in nominating either member or employer directors (or all directors). Industry funds range in asset size from around $650 million in funds under management (with about 9000 members) to over $100 billion (and more than 2 million members).

Both public sector and corporate funds also broadly follow the equal representation trustee model. The predominant approach in respect of the former is for member directors to be nominated by relevant unions and employer directors by employer(s). Other approaches include Board nominations, member elections or direct appointments by Ministers. Some of the public sector funds are subject to federal or state laws, with their own legislative requirements. Several public sector funds have appointed independent directors. The employer directors on corporate funds are generally nominated by the employer, while member directors are elected by members from among the employees of the company, or nominated by the union covering those employees.

The best evidence that the NFP model is not broken is embodied in Table 3. This shows that the net returns to members of NFP funds – collectively and separately – have consistently and significantly exceeded returns to members of retail funds.

Table 3: Net returns to members, by Sector, to June 2016

	1 year	5 years	10 years	20 years
Not-for-profit	3.8	8.2	5.4	6.6
- Corporate funds	2.5	7.4	5.1	6.5
- Industry funds*	4.1	8.3	5.4	6.3
- Public Sector	3.6	8.2	5.3	6.8
Retail funds	1.6	6.4	3.6	4.5
Outperformance of NFP over Retail	2.2	1.8	1.7	2.2

*Source: ISA analysis of APRA Annual Superannuation Bulletin, June 2016 and APRA 2007-Insight-issue-2 celebrating 10yrs of Superannuation Data Collection 1996-2006. Note: Not-For-Profit net returns are assets weighted averages. *Note SuperRatings estimate that industry funds outperformed bank owned funds by 2.7 per cent on average in 2016; by 2.1 per cent over three years; 2.2 per cent over five years and by this same margin (2.2 per cent) over ten years.*[9]

Several factors contribute to the sustained outperformance of NFP funds. For a start, they are all structured to focus on their members' interests above all others: they are effectively "mutuals", where fund members are also the shareholders. The equal representation model also has meant that directors traditionally have had close ties with the industries their fund members worked in. The alignment of interests and loyalties arising from these ties have bolstered the "members first" focus of NFP funds, both to make good investments for members and to restrain cost increases (through, for example, a hard-nosed approach to the fees paid to managers and other service providers, and to staff remuneration relative to retail funds).

Other factors also contributed. From their early days industry funds, for example, benefited from a core of directors who were mindful of risks, but also prepared to be innovative, venturing into infrastructure and direct property investments well before these asset classes became fashionable, and "collective vehicles" were established to assist small and fledging funds to gain exposures to those longer-term assets. Over time the skill levels of NFP funds generally have risen in step with their investments, to the point where – as Table 3 suggests – their strategies, asset allocations and risk management processes are more than competitive. At the same time, the culture and values which reflect where they came from continue to define what they stand for today.

Clearly, the NFP model is not broken. It is, however, facing some challenges. As already mentioned, the Government's Bill would undermine the equal representation governance model which has contributed to outperformance. And, despite its less than stellar success in fairly reconciling the often conflicting interests of shareholders, management and customers, "corporatisation" has largely driven out the "mutualisation" – although not (yet) in the superannuation industry. Another challenge is the likely competition for people with special skills and experiences in the years ahead. With the globalisation of flows of not only goods and services and capital but also of people, technologies and ideas – with all their attendant geopolitical ramifications – investment and other risks are on the rise[10]. Good governance is largely about effective management of these risks, and all superannuation funds will require directors with the requisite skills – a wide diversity of skills, in fact, extending far beyond those that have to do with financial markets.

This snapshot highlights the diversity within the superannuation industry, and particularly the differences between the retail and the NFP sectors. It shows that the NFP sector – with the least number of independent directors (and Chairs) – consistently delivers better returns to members than the retail sector, which casts some doubts on the assumed "silver bullet" qualities of "independence". It also draws attention to what is at the heart of this whole debate: namely, the fundamentally different priorities of retail funds and NFP funds. To repeat this point: Boards of the former, owned by the banks and life offices, have three sets of interests to reconcile - those of shareholders, senior executives and fund members. By contrast, NFP funds have the clear focus of their members - they have no beneficial "shareholders" and their management teams are rather less powerful and less lavishly rewarded than their retail fund counterparts.

This difference in focus is reflected in current governance policies. The Superannuation Governance Policy of the FSC of March 2013 requires that its member retail funds "must" have a majority of "independent directors" on their Boards, and an independent Chair. The ASX Corporate Governance Principles and Recommendations (Third Edition) 2014 – which is applicable to all entities listed on the ASX but is not binding – recommends that these entities "should" have a majority of independent directors and an independent Chair.

The focus on “independence” is perfectly reasonable in respect of retail funds (and listed entities generally); the absence of such requirements for independents would likely see a continuation of the earlier prominence of executive directors on these Boards, with the risk that the distribution of benefits could be skewed against the interests of their members and customers. Or, in the words of the “Commentary” in the ASX Code, bias decisions of the Board “….towards the interests of management or any other person or group with whom a non-independent director might be associated”. Notwithstanding the moves towards greater independence of their Boards over recent years, the close alignment of interests of shareholders and senior executives has meant that many members of retail funds (like many customers of their parent banks and life offices) continue to be stuck at the back of the queue.

APRA’s recent Prudential Standard on Governance (issued 31 October 2016 and effective 1 July 2017) does not set any minimum requirements for the independence of directors or Chairs of NFP funds. In the non-binding “Guidance” which accompanied the Prudential Standard, APRA expressed its “views” that:

> “….a prudent equal representation Board would consider the appointment of at least one independent director.”; and
>
> “…. a prudent RSE license would consider whether the appointment of an independent as chairperson of the Board would benefit the Board’s fulfilment of its duties.”.

The Government’s proposals in its earlier Bill would, of course, go much further, mandating that all funds, including NFP funds, move to a minimum of one-third independent directors (including an independent Chair) within three years.

The Bill also proposed significant changes in respect of the definition of “independent director”. The definition in the SIS Act 1993 which currently applies to “equal representation” industry and other NFP funds is relatively straight-forward. It defines as independent:

> “… a trustee of the fund who:

a) is not a member of the fund; and
b) is neither an employer-sponsor of the fund nor an associate of such an employer-sponsor; and
c) is neither an employee of an employer-sponsor of the fund nor an employee of an associate of such an employer-sponsor; and
d) is not, in any capacity, a representative of a trade union, or other organisation, representing the interests of one or more members of the fund; and
e) is not, in any capacity, a representative of an organisation representing the interests of one or more employer-sponsors of the fund."

The Bill also takes a prescriptive, rather than principles-based, approach to the definition of "independent": it prescribes a number of ownership and other relationships between the director and the fund which, if they existed, would preclude the director being labelled "independent". The EM has three pages of illustrations of the kinds of arrangements that would "prevent independence". The Bill would also extend APRA's powers to potentially allow it to overturn a judgment of "independent" consistent with the terms of the proposed legislative tests if APRA was not convinced the person in question had "the ability to exercise independent judgement in performing the role of a director". These powers would go beyond what APRA currently possesses in respect of banks and life offices. This paraphernalia of definitions, rules and illustrations of the kinds of situations which might and might not satisfy tests of "independence" is a veritable playground for many lawyers but a challenging maze for many funds.

The debate about independence really comes down to the question: "independence from what?". To the extent that the answer is independence from executive management, this is hardly an issue for the governance of NFP funds, which effectively ban executive directors from their Boards. A broader – and arguably better answer – to the question is to view independence as a defence from all the dangers and obstacles that can get in the way of pursuing a clear and committed objective. Such independence is never absolute but it is inherently more substantial for member focussed NFP funds than it is for retail funds.

TWO OPTIONS

My remit was to review the Government's proposals to mandate minimum numbers of “independent” directors (including the Chair) on the Boards of all super funds, and to consider whether some alternative approach was potentially more beneficial from the perspective of NFP funds and their members.

Two options suggest themselves. One course would be for NFP funds to go along with the Government's proposals, perhaps after some wrangling to extend the three year transition period. Some might see this as a relatively easy option, particularly given that NFP funds themselves have been appointing more “independents” to their Boards over recent years.

Relatively easy it might be, but is it the best option for members of NFP funds? A little reflection suggests it is not. To mandate the same Board governance requirements for all super funds, as if they were homogeneous entities pressed from the same mould, would be to ignore the stark differences which exist within the industry (are canvassed in the report). That diversity is a source of competition and strength for the industry, and not something to be whittled away as the proposals in the Bill seek to do. More fundamentally, the Government’s proposals should be judged ultimately on whether they would deliver the best possible outcomes for fund members: even with some amendment the risks in the Bill for member benefits are all on the downside compared with a course of positive actions to enhance members’ returns.

The debate around the appointment of more independent directors is largely peripheral to the betterment of the benefits that flow to members of NFP funds: that has much more to do with sharpening and strengthening the values and skills on the Boards of these funds. To reiterate some of the points made previously:

(i) their “mutual” structure and the associated creed of all profits to members make NFP funds a notably distinct sector of the superannuation industry;

(ii) combined with their solid performance record they have become a trusted and respected brand, not only in superannuation but also across the whole financial industry – a real rarity these days;

(iii) the basic cultural and business model that has created this brand is not broken, but it is facing some challenges, not least in attracting sufficient directors with the values and skills critical to sustaining trust in the NFP brand;

(iv) the pronounced member focus of NFP funds reduces the potential for conflicts of interest compared with retail funds with multiple stakeholders, where conflicts for directors too often become conflicts over fairness and justice for their members; and

(v) over time more directors of industry funds in particular are likely to be appointed from outside the major sponsoring organisations, many of whom might be expected to satisfy reasonable tests of “independence” and to be counted as “independents” by those who like these labels – any such increments in “independents” would be positive for the funds concerned but it would delivered as the outcome of appointment and other processes weighted heavily towards values and skills, rather than the pursuit of “independence” as such.

While the number of independent directors on the Boards of NFP funds does not loom large as a pressing national policy issue, the members of these funds are likely to feel that the maintenance of governance arrangements akin to those which have proved notably beneficial in the past are worth fighting for, in preference to the Government's proposals. As a member of a well-performing NFP fund, would you prefer that your Board strive harder to strengthen the underlying drivers of that good performance – largely values and skills – or risk getting hung up on how many independents should sit around the Board table? The old notion of “mutuality” in financial and other activities is now less common but NFP funds continue to demonstrate that model is alive and prospering in the superannuation industry. They operate successfully in some of the most competitive markets in the world but their focus on and loyalty to their members remains undiminished.

The Government’s message that its proposals to raise the proportions of independents on the Boards of NFP funds to levels comparable with those of banks and life offices will deliver benefits to fund members is not persuasive. Many members and customers of financial institutions with majorities of independents on their Boards have felt let down in their dealings with those institutions over recent years, and left out of their profits.

Neither the NFP nor the for-profit superannuation sectors have escaped scot-free from the appalling governance practices which have dogged the banking sector over the past decade. In the NFP sector, relatively isolated and short-lived incidents (Cbus and MTAA Super come to mind) have attracted a certain possible notoriety which seems to be out of all proportion to the actual harm inflicted on members. In the retail sector the mention of just two words – "financial planners" – is sufficient to evoke visions of scales of harm and injustice that have heavily weighed down for-profit funds.

IMPROVING BOARD GOVERNANCE OF NFP FUNDS

Despite these regrettable lapses, in parts of both the for-profit and NFP sectors – and the damage to the members and brands of the funds concerned – the Australian superannuation industry overall has maintained relatively high governance standards. The industry has grown rapidly in a short period but has avoided the worst of the financial difficulties, bad behaviour and customer backlashes which have dogged many other financial institutions and sullied their brands.

Much of the credit for this outcome should go to APRA for its deft regulation of the superannuation industry to this time. In the governance area, APRA has issued numerous Superannuation Prudential Standards (SPSs), which funds must comply with; it has also issued Prudential Practice Guides (PPGs) outlining its views ("guidance") on what it sees as sound practice in respect of matters covered in its Prudential Standards, although these PPGs do not themselves create enforceable requirements for funds. For the most part, APRA's requirements in respect of Board governance specify broad principles and practices, with some flexibility to accommodate differences among the funds.

The governance arrangements and reviews for the Boards of superannuation funds are, in short, subject to considerable on-going regulation by APRA, ASIC and the provisions of the SIS Act. These processes result in mostly incremental changes – and improvements – in governance. The main changes envisaged in the Bill would not, however, be viewed as "incremental" (or as "improvements") in many eyes. A point not to be forgotten here is that a sound governance framework for superannuation funds is in place – and will remain in place in the event the proposals in the earlier Bill are not adopted.

Of relevance to this review is that the existing framework includes two important Prudential Standards issued by APRA which remain central to the consideration of the qualities of people to be appointed directors of superannuation funds, and how they might behave at Board meetings. One details APRA's requirements relating to the fitness and propriety of "responsible" people (SPS 520), and the second specifies requirements relating to the management of conflicts of interest (SPS 521). Both Standards remain important foundations for building better Boards; properly adhered to they would diminish some of the perceived problems with non-independent directors.

The update of APRA's SPS 510 which is operative from July 2017, provides some additional blocks which NFP funds could build upon to emphasise their special attachment to values and skills in the appointment of directors. The particular requirements are that:

> "the Board must have a governance framework which includes, as a minimum, the Board's charter (or equivalent document) and policies and processes that achieve appropriate skills, structure and composition of the Board;" and

> "the Board must have a written policy which sets out requirements relating to the nomination, appointment and removal of directors that support appropriate Board composition and renewal on an ongoing basis"

These requirements – for a formal charter, and policies covering director nominations, appointments and removals – were elaborated in APRA's related PPG. Appropriately, neither the Prudential Standard nor the Guide makes any reference to the implications for these (or other) prudential requirements pending the passage or otherwise of the proposals in the earlier Bill. Overall, the requirements outlined in SPS 510, seem sound and conducive to achieving further incremental improvements in Board governance of superannuation funds. As is usually the case, the requirements are expressed in terms of principles and processes, leaving the way open for individual funds to add flesh to those bones to better describe their particular shape and any unique features. Some actions which NFP funds could take to highlight the importance of values and skills in their make-up are canvassed in the next section.

ENHANCING VALUES AND SKILLS

1. Boards and Directors

The behaviour and performance of all funds depends on more than their Boards of Directors. The calibre of senior management and staff generally are obviously important also, as are the relationships between the Board and management, and in the case of NFP funds, between the Board and the sponsoring organisations. These matters should be covered in some detail in the governance policies of individual funds, and in any “codes” applicable to sectors of the superannuation industry. In this respect the focus is Board governance, as it was in the Bill, albeit from a different angle.

Boards play vital roles: they set the strategic plans for their funds and monitor performance (including their own) against those plans. They are ultimately responsible – and accountable – for both good and bad outcomes. It is their role to steer their funds through sometimes tough environments and to effectively manage the investment, reputational and other attendant risks along the way. Good values, skill mixes and processes all assist Boards to safely navigate these risks. The suggestions on Board governance which follow would, if they were to be picked up by the funds, be reflected in the relevant comprehensive fund policy or industry code (see below).

Values

Issues relating to the values and cultures of different funds do not figure prominently in APRA’s Prudential Standards relating to Board governance, or in the Government’s Bill. But they do matter. As noted earlier, NFP funds have prospered in part because of the values encapsulated in their “mutuals” model and its creed of “all profits to members” and “members-first” – values generally absent in the corporate model. This has helped to make NFP funds a respected and trusted brand – a rarity in the financial sector these days.

Some measures which would help to enhance these values – and to sharpen their association with NFP funds – are canvassed below:

(i) Fund Charters. As noted earlier, APRA will require all funds to have formal "charters" of the roles, responsibilities and objectives of their Boards from 1 July 2017. These charters will provide an opportunity for NFP funds to declare that the maintenance of their traditional values would remain a clear Board objective in driving future growth. The potential for such a formal "charter" commitment – endorsed by all directors – in helping to keep Boards focused on these special values should not be under-estimated.

(ii) Nominations Committee. Part of the brief from Boards to the Nomination Committees charged with interviewing candidates for directorships should include a requirement for the Committees to undertake a comprehensive assessment of candidates' compatibility with the fund's values when weighing up their suitability as prospective directors.

(iii) Director Declarations. To formally re-enforce their commitment, newly appointed (and reappointed) directors should be required to confirm in writing at the time of their appointments that they understood the particular fund's values, were comfortable with them, and saw no conflicts with them.

Although modest, a package of such measures would help to highlight the member focus of NFP funds, and to strengthen public trust in the brand.

Skills

Strong brands also thrive on sustained strong performance, which requires appropriate mixes of skills and experiences, from the Board down. Reference was made earlier to the challenges which economic globalisation, political populism, and the outpouring of new technologies pose for the Boards of all super funds. The consequences of these developments are usually perceived as adding to risks and uncertainty in investment markets, which they do. But they might also open up some opportunities (in "fintech" for example) which could help to improve the ways members and their funds communicate and transact business. Perhaps the single most important determinant of the future performance of all funds (and their members' future benefits) is how well their Boards collectively understand and handle these diverse challenges.

APRA's Prudential Standard SPS 510 includes the following paragraph which is relevant to those challenges:

> "The Board must ensure that the directors and senior management of the (fund), collectively, have the full range of skills needed for the effective and prudent operation of the (fund's) business operations, and that each director has skills that allow them to make an effective contribution to Board deliberations and processes. This includes the requirement for directors, collectively, to have the necessary skills, knowledge and experience to understand the risks of the (fund's) business operations, including its legal and prudential obligations, and to ensure that the (fund's) business operations are managed in an appropriate way taking into account these risks. This does not preclude the Board from supplementing its skills and knowledge by engaging external consultants and experts."

This quote highlights both the large risk management component of Board governance and the critical requirement for "the full range" of relevant skills and experiences to be represented around Board tables. As to the last sentence of the quote, it is understandable that complexity should increase the demand for specialist skills. Several funds are already recruiting specialists to both their management teams and Board Committees dealing with increasingly complex investment, taxation, technology and other matters. Such recruitments, however, do not necessarily reduce the pressures on Boards or their responsibilities: being ultimately responsible and accountable for their fund's activities, Boards collectively – large and small – are obliged to maintain strong skill sets of their own. Larger funds need more directors – and a wider range of skills – on their Boards than smaller funds but all funds need directors who can not only ask the right questions but also can make sense of any complex or "technical" issues raised by specialist advisors (whether within the internal management teams of larger funds or by the external consultants of smaller funds), and reach sound judgments on their implications for members.

Views might differ on how best to deliver the quality and depth of the skills and experience required by funds. The approach favoured here is to directly target and attack specific gaps in Board skill sets, rather than rely on these gaps being met through the blunt ideological instrument of mandating minimum numbers of independent directors on Boards. The focus in this report is on the "skills" of incoming directors as against their "independence"; in quantitative terms on-going Board actions to address skill gaps in the existing cohort directors through, for example, skill matrix processes, and professional development courses are arguably more important.

Some specific suggestions for enhancing the skill sets of Boards of NFP funds are canvassed below:

(i) Fund Charters. As with "values", a fund's charter should emphasise the importance which the Board attaches to relevant skills and experience in generating superior returns to members, and formally record its commitment to maintaining an appropriate mix of skills and experience on the Board at all times.

(ii) "Agreed Skill Experience Profiles" for New Directors. Given their responsibility for monitoring of fund performances and changes in business environments, Boards should be well placed to spot particular gaps (current and prospective) in their collective skill sets. Because of these insights, whenever a director vacancy arose (or a new directorship was created), it would make sense for the whole Board to meet to agree a detailed skill/experience profile tailored to the vacancy in question.

This "Agreed Skill/Experience Profile" would constitute the first step towards filling a director vacancy; it would highlight particular requirements in respect of skills, qualifications and experience, having regard to gaps in the Board's existing skill matrix, and to possible future pressure points.

(iii) Selection Processes. APRA requires all funds to have "robust" processes for the nomination (and appointment and termination) of directors. Funds are also required to have policies in place to deal with situations where a sponsoring organisation nominates or appoints a director who the Board considers unsuitable for appointment. The suggestions which follow are consistent with "robust" selection processes in pursuit of the best possible mix of skills and experience on the Boards of NFP funds.

In the case of an existing vacancy, where a relevant sponsoring organisation has the opportunity to nominate its candidate (under the equal representation arrangements) to fill that vacancy its nominee could come from within its own ranks or, if no such suitable nominee was available, it could nominate an “outsider”as its representative director. That appointment would proceed if a majority of the Board agreed the nominee satisfied the skills and values requirements. In the absence of a majority – an unlikely situation if the agreed skills profile and other requirements reflected appropriate consultations and were followed conscientiously – the required disputes resolution policy would be called into play. This might provide for the sponsor organisation to try again, and to try harder.

At the end of the day, if agreement on a nominee could not be reached through these processes, the policy should provide for the Nominations Committee to assess a wider field of candidates (again paying particular attention to the skills and other requirements). The policy should provide the opportunity in such situations for a limited number of representatives of the sponsoring organisations to attend the Nominations Committee’s proceedings. While these situations are likely to be rare, it would make sense, as APRA expects, for Boards to have agreed policies in place to deal with them should they occur.

Where a new director position was being created by the Board to fill a particular – and possibly urgent – skill gap, it would seem appropriate to activate the Nominations Committee at the outset, armed with the Board’s guidance regarding skills and values. Again the process would be facilitated if the fund’s policy was to provide for (limited) representation by interested sponsoring organisations at the Nominations Committee’s proceedings.

It seems reasonable to expect that, over time, the demand by industry funds in particular for directors with special skills would outrun the supply available from within their sponsoring organisations. In that event more directors would be recruited – including by the sponsoring organisations themselves – from outside those organisations; some of these directors would likely qualify as “independents” under the current SIS Act definition. This is already happening: currently about 50 directors of industry funds (or closer to 15 per cent) are independents[11]. Industry funds should be able to cope with this evolving situation: the potential pool of skilled and committed people to draw upon will be larger, while the relative attractiveness of the NFP brand might also be expected to appeal to more prospective directors, as it has to members.

It might, however, pose some questions for the “equal representation” model of industry and other NFP funds. As noted earlier, this model provides for equal representation of employees and members in respect of “standard employer-sponsored funds” and is presently guaranteed under the SIS Act. That situation would cease if the repeal provisions in the Government’s original Bill were to be adopted. If the changes proposed in the Bill were not adopted the legal underpinnings of the current arrangements would remain. In its November 2016 Guide, APRA expressed the following comment on this status quo position:

> “… APRA’s view is that a prudent equal representation board would consider the benefits of the appointment of at least one independent director.”

The likely appointment overtime of more directors who might qualify as independents could be viewed as potentially disruptive by some but the overall impact on fund members would be beneficial if it resulted in the best available directors (in terms of skills and values) being appointed to Boards. The recommendations in this report are intended to help deliver that outcome: if NFP funds were to agree to adopt processes along the lines suggested in the report all the sponsoring organisations involved would need to be firmly committed to making them work, even if this caused some disruption of the “pure” equal representation model.

While on the subject of the skills of prospective directors, suggestions are sometimes made that setting some minimum entry qualifications for directors might contribute to better governance outcomes, presumably by making it harder for “rogue operators” to slip through the net. Casual observation, however, does not point to any positive correlation between credentialism and integrity: a lot of skulduggeries are hatched under mortar boards. (This is not to denigrate current efforts to establish appropriate standards of qualification and ethical behaviour in the financial planning industry, which has been crying out for reforms of this kind). So far as directors of NFP funds are concerned, many do have some tertiary qualifications but are generally appointed more for their track records of performance and judgment in relevant fields, than for their qualifications as such.

Effective selection and reference checking processes (incorporating the refinements suggested here) are likely to offer the best protection against serious mistakes occurring in the appointment of directors. Once appointed, of course, the delivery of high quality induction courses to new directors, (including on their legal and prudential requirements), and the provision of appropriate on-going opportunities and encouragements for them to hone their skills as a Board member are (or should be) major responsibilities of all Boards.

2. Appointment of Board Chairs

The Government is proposing to mandate that the Chairs of all super funds be “independent”, presumably in the belief that this aura of independence will help to deliver outcomes beneficial to fund stakeholders. Again, however, it is not clear why this belief should bear fruit for members of NFP funds.

As well as having a good measure of the values and particular skills expected of all directors, Chairs are required to possess some extra qualities. Important among these is the ability to facilitate open and informed debates on many issues, culminating (more often than not) in decisions acceptable to all directors. These extra skills are not easily defined: they can be exercised in different ways or “styles”. It is reasonable to believe, however, that from their contacts and interactions at Board meetings over a number of years individual directors would come to discern who among their fellow directors were “Chair material”, and who were not. When the time came to appoint a new Chair, directors collectively would have a pretty good idea about who among them was best equipped to lead the Board – and if none of the existing directors was judged to be up to the mark – to advocate an outside appointment. In such matters, considerable weight should be given to the collective Board judgments, and:

- if there was general agreement on a standout candidate in the ranks of current directors that view would be hard to override; but
- if there was no such standout the prudent course would be for the sponsoring organisations to agree processes for recruiting an “outside” Chair.

In the interests of their members, NFP funds should always appoint the best available candidates as Chairs, whether or not they were “independent”, and irrespective of any rotational arrangements that might have operated in the past. To the extent that “independents” were to become more conspicuous on the Boards of NFP funds in the years ahead, this approach means that, at least for those funds, independent directors would obviously be considered for Chairperson (in line with the view expressed in APRA’s SPG 510). More over, the chances of selecting the best possible person for the position would be enhanced if the field of candidates were to comprise all the directors, not just the mandated minimum one third envisaged in the Government’s proposals.

The appointment of independent directors and Chairs across all superannuation funds is the primary focus of the earlier Bill and, therefore, of this report. As important as these particular aspects of Board Governance are, they represent only part of the very comprehensive governance policies which individual funds are obliged to follow because of legal and regulatory requirements, and through their participation in particular industry codes (such as the ASX and FSC codes – mentioned above – and the AIST Code – see below) Only two elements of these comprehensive policies/codes are touched upon here – Board Renewal and Member Communications.

3. Board Renewal

In their own interests – and those of their members – Boards are required to have policies for “renewing” Boards to stay abreast of changing operational environments. The earlier emphasis on policies to recruit new directors with valuable skills, and to upgrade the skills of existing directors, are obviously relevant here also. Two additional policies worthy of mention, because they can affect the mix of skills and experiences represented around Board tables, relate to tenure and gender balance.

(i) <u>Tenure Policy</u>. This is one of those areas where reasonable discretion is likely to deliver better outcomes than rigid rules, partly because of size and other differences across funds but partly also because it makes sense to extend tenure where a director’s continued engagement and contributions were demonstrably valuable to the fund. Boards are required to regularly evaluate the collective and individual performance of directors and, in practical way, all directors are “on show” at every Board meeting. These arrangements provide reasonable opportunities to assess whether or not the contributions of individual directors were falling off as their terms grew; that can happen but the real possibility of a positive correlation should not be ruled out!

APRA has not quite set a rigid rule but it has indicated its expectation that there would be “limited circumstances” when it would be appropriate for total periods of tenure to exceed 12 years. For the reasons indicated in the previous paragraph, it is recommended that NFP funds should adopt a pragmatic approach to tenure, and be prepared to argue strong cases on occasions for “exceptional circumstances”.

(ii) Gender Balance. This issue usually surfaces as part of a fund’s “diversity” policy but it is also germane to the need for NFP funds to access the widest possible pools of skills and experience when selecting directors (and staff generally). At present, on average about 1 in 4 directors of industry funds is a woman, with the average higher for larger funds (about 1 in 3) than small funds (about 1 in 5). Some progress has been made over the years but the average numbers remain below the earlier AIST aim of achieving a minimum of 40 percent of each gender on NFP Boards 2017.

The Boards of NFP funds are generally closer to gender balance than corporate Boards but can do better. Conscious and unconscious biases against women on Boards are both unfair and an avoidable constraint on the size of the talent pool accessible to funds. One area where a firm target could help to improve Board governance is gender equality. Differences in the sizes and industry orientations of funds argue against every individual fund quickly achieving equality. But concerted action on the part of each fund could be expected to produce “unders” and “overs”, which would make a sector wide target meaningful and achievable. With its new mandatory Governance Code (which has a considerable emphasis on “diversity” policies) expected to be implemented shortly, AIST would seem to be well placed to adopt and monitor such a target – and equal gender representation on Boards on average across the whole NFP sector in 5 years’ time would seem a perfectly reasonable and fair target to aim at.

4. Member Communication

Funds communicate with many parties, including regulatory bodies, sponsoring organisations and their members, and on many topics: it is an essential part of being transparent about, and accountable for, what they do. As the funds with the "members first" culture, NFP funds should – and probably do – lead the way in this field.

Some of the larger funds hold "live" meetings where members have opportunities to meet Board members and ask challenging questions. On-line facilities are often attached to these meetings to enable other members to follow the proceedings and to send in questions of their own. The high costs of these "AGM-type" meetings limits their feasibility for smaller funds which tend to focus more on workplace meetings between fund officers and members. All funds report to their members at best annually and often more frequently on fund performances and returns, product and policy innovations and other matters of interest.

Members generally appreciate reports on how their funds are performing – and behaving – relative to other funds. Many would likely be interested also in being better informed about the skills and experience strengths of their Boards, and in having more transparency on the processes for appointing and removing directors, and policies for addressing gender imbalances – all the issues, in short, which it is argued in this report have a substantial bearing on the security and growth of members' retirement savings. To this end the Boards of NFP funds should commit to explicitly addressing governance issues of these kinds in their annual reports to members – and proactively at other times and in other ways (such as member conferences and workplace meetings) as appropriate.

5. Implementation Options

If NFP funds were of a mind to take actions along the line proposed in the recommendations, the question arises as to how they might best commit to doing so. AIST is now close to finalising a new, revamped version of its Code which is intended to promote the highest possible standards of governance across the whole NFP sector.

There is considerable common ground between what is proposed in the present draft of the AIST Code and the recommendations in this report. The Code is dedicated to the NFP sector – what it calls the “profit for member” sector; it is based on “a member first” culture, and emphasises “competence and commitment” in the selection of directors; and it refers throughout to “non-representative” – rather than “independent” – directors, thereby avoiding the definitional uncertainty surrounding the latter description.

The Code is planned to take effect from 1 July 2017. It would be mandatory for AIST member funds, with an obligation for them to report annually to AIST on their compliance (on an “if not why not” basis). AIST also proposes to engage an independent body to review members’ compliance with the Code, and to suggest possible amendments to it. AIST’s Code is comprehensive in its coverage and goes well beyond the relatively narrow Board governance issues and the targeted recommendations contained in this report but the processes currently underway to finalise the Code represent an appropriate and timely opportunity for NFP funds to consider those particular recommendations.

Reflection of the recommendations in the final version of the AIST Code would be a good outcome. A Code dedicated exclusively to the NFP sector not only highlights the distinctiveness and maturity of that sector (which now represents over 40 percent of the whole superannuation industry): it also represents a clear reaffirmation of the commitment of NFP funds to governance standards intended to protect members’ retirement savings.

If for any reason the recommendations in this report were not picked up in the final AIST Code, NFP funds could – if they were so inclined – incorporate them in their individual governance policies as they considered appropriate.

RECOMMENDATIONS

From their beginnings NFP funds have been decidedly member focussed and, in a relatively short period, have established an enviable reputation for delivering strong performance and quality services to their members. The close collaboration between sponsoring organisations and their Boards has been a major contributor to this success and the development of a unique culture. From their Boards down, they have exhibited consistently good values (encapsulated in "all profits to members"), a low cost/high value philosophy and competitive skills in managing investment and other risks, all of which have helped to underwrite their reputation. Values, skills and experience are as critical today as ever but maintaining an edge in them is proving more challenging than ever.

The thrust of this report is that Board governance of industry and other not-for-profit funds could best be improved – that is, best help to deliver superior outcomes for members – by continuing to build on their strengths in values and skills, rather than through mandated minimum numbers of independent directors on their Boards. This is what the recommendations of this review seek to achieve, through their reflection in the constitutions of the funds' governing structures, and the Board governance policies of the funds.

The report debates, from the perspective of members of NFP funds, the relative attributes of the mandated independence approach and direct action to strengthen values and skills. It comes out clearly in favour of the latter but does not speculate on how NFP funds might react in the event that the provisions in the re-introduced Bill were adopted.

During the course of the consultations with them, the two major sponsoring organisations for industry funds – AiG and ACTU – indicated broad support for the thrust of the report, without necessarily endorsing all the individual recommendations.

<u>Boards of Directors</u>

1. Members of NFP funds would be best served by strengthening the values, skills and experience of Boards of Directors. To this end, Boards should agree:
   a. Values/Selection Processes
      i. to make clear in their informal "charters" (which APRA will require of all Boards by 1 July 2017) that the unique commitment of NFP funds to their members (encapsulated in "all profits to members") was unshakeable and should be embedded in the fund's processes wherever appropriate (the extent to which such measures – including those which follow – require changes to constitutions will be a matter for each fund to consider)

ii. to require Board Nominations Committees to include a comprehensive assessment of candidates' compatibility with the fund's values when reporting on their suitability as prospective directors
iii. to require newly appointed (and reappointed) directors to confirm in writing at the time of their appointments that they understand the fund's values , are comfortable with them , and see no conflicts with them

b. Skills/Selection Processes
    i. as with "values", to re-enforce in their "charters" the central importance of relevant skills and experiences in generating superior returns to members, and commit to maintaining an appropriate mix of skills and experiences on the Board at all times
    ii. as a first step towards filling a director vacancy, the whole Board should discuss and agree a detailed skill/experience profile tailored to the vacancy in question, having regard to current and prospective gaps in the Board's skill set
    iii. in equal representation funds, where the relevant sponsoring organisation puts forward a nominee to fill a vacancy (either from within its own ranks or from "outside" those ranks) that nominee shall be appointed if a majority of the Board agrees that the nominee satisfies the Agreed Skill Profile (and other relevant requirements)
    iv. policies should be developed (and approved by the Board) to deal with rare but possible situations where the Board and sponsors are unable to reach agreement on the proposed appointment; this should include the Nominations Committee process being activated to assess a wider field of candidates (again paying particular attention to the Agreed Skills Profile), and make its recommendations to the Board
    v. where a new director position has been created to fill a particular - and possibly urgent - gap in the desired skill mix the Nominations Committee process should be activated at the outset, with relevant inputs from the Board in respect of the Agreed Skill Profile, experience and any other requirements
    vi. the Board should have effective processes to liaise as appropriate with sponsoring organisations on these recommendations in respect of values, skills and selection

processes; this should include the opportunity for limited representation of sponsoring organisations at meetings of the Nominations Committee.

Board Chairs

2. In the interests of their members , NFP funds should always appoint the best of the available candidates (from within the existing Board or , if necessary , from outside) as Chairs , whether or not that person was " independent " , and irrespective of any previously established rotational arrangements .

Board Renewal

3. All funds are required to have policies for regularly evaluating the performance of Boards, and for "renewing" Boards to stay abreast of changing operational environments. Given the critical role of skills and experience in the performance of NFP funds, Boards of these funds should pay particular attention to renewal policies, including:
   i. "tenure" policy - this is one of those areas where reasonable discretion is likely to deliver better outcomes than rigid rules , partly because of size and other differences across funds but partly also because it makes sense to extend tenure where a director's continued engagement and contributions were demonstrably valuable to the fund; for these reasons Boards should adopt a pragmatic approach to tenure, including a preparedness to argue for extended periods of tenure in “exceptional circumstances”.
   ii. gender balance – one area where a firm target could improve Board Governance is gender equality and AIST should establish and monitor a target to achieve gender equality on Boards across the NFP sector as a whole by mid-2022.

Member Communication

4. As part of their on-going policies to improve communications with members, Boards of NFP funds should commit to addressing a range of Board governance issues in their annual reports to members and at other times and in other ways (such as member conferences and workplace meetings) as appropriate.

Implementation of Recommendations

5. AIST members (who cover the whole of the NFP sector) should give consideration to these recommendations (including 3 (ii) above) in the course of finalising their draft Governance Code.

Notes

[1] Bernie Fraser was an independent director of several large industry super funds for approximately 15 years, and the "independent" chair of Members Equity Bank (owned by Industry Super Funds) for a similar period.

He has been the Chair of two independent Australian Government statutory authorities – the Reserve Bank of Australia (7 years) and the Climate Change Authority (3 years).

[2] Public submissions made to the review are available at www.thefraserreview.com – The submissions include comments on the kinds of issues canvassed in this report and have been helpful inputs into it.

[3]Letter of 17th December 2015

Dear Senator,

Good Governance and not-for-profit superannuation funds

You might like to know that the proposed Review of governance arrangements in relation to not-for-profit super funds is now underway.

From tomorrow the attached paper will be available online, which briefly outlines the nature of the Review, and invites comments/submissions from interested individuals and organisations. The issues mentioned in the paper pick up many of the thoughts expressed by cross bench senators in relation to this Review. It remains to be seen what this invitation will elicit by way of material responses but we thought it appropriate to provide the opportunity for "interested parties" to participate.

It is expected that the most substantial inputs to the Review will emerge from the rounds of consultations which we plan to initiate with major stakeholders - including of course relevant cross bench Senators - as soon as practicable after Christmas. We will keep you informed of these arrangements and of the progress of the Review more generally. If in the meanwhile you should have any particular queries in relation to this Review please feel free to contact me at any time.

I am writing in similar terms to other relevant cross bench Senators.

Kind regards,

Yours sincerely,

Bernie Fraser

Cc: *Senator Lambie, Senator Lazarus, Senator Madigan, Senator Muir, Senator Wang, Senator Xenophon*

[4] Letter of 17th December 2015

Dear Minister,

Good Governance and not-for-profit superannuation funds

I think you are probably aware of the Review which I have been asked to lead into governance arrangements pertaining to not-for-profit super funds.

I am writing to inform you that from tomorrow the attached paper will be available online, which briefly outlines the nature of the Review and invites comments/submissions from interested parties. We are not expecting a great deal by way of material responses but we did want to at least provide an opportunity for interested individuals and organisations to participate if they were so inclined.

The most substantial inputs to the Review are likely to emerge during the course of the consultations we are planning to initiate with major stakeholders after the Christmas break. I would like to think that, as those consultations develop and particular positions emerge, you might see your way clear to engage in a general discussion around some of these issues.

I would like to pursue this possibility with you a little further down the track.

Kind regards,

Yours sincerely,

Bernie Fraser

[5] The review committee met with an Expert Panel comprising of Professor Gordon Clark – a Governance and investment academic based in the UK with postings in the UK, US and Australia, Mila Justine Hoekstra – Author of the Code of the Dutch Pension Funds and secretary of the Monitoring Committee that oversees compliance with the Code, Claire Keating – Long-serving partner at PwC with extensive experience in financial services and governance, Chris Lovell – Chairman of Holding Redlich with extensive experience in corporate governance. The panel discussed best-practice governance of Australian and overseas superannuation and pension funds. 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 specific purpose.

[6] Letter of 3rd May 2016

Dear Senator

Re: Board Governance of Not For Profit Funds

As you know, over recent months we have been consulting with relevant stakeholders to develop an appropriate governance code for boards of not for profit superannuation funds.

This work is quite well advanced but, in the light of the upcoming election, I think it makes sense to defer our envisaged further discussions until that election is out of the way.

I look forward to resuming our discussions on governance arrangements for not for profit funds that will best promote and protect the interests of members of those funds after the election.

Kind regards,

Yours sincerely,

Bernie Fraser

Cc: *The Hon Adam Bandt, The Hon Jim Chalmers, Peter Kell - ASIC, Senator Lambie, Senator Lazarus, Senator Madigan, Greg Medcraft - ASIC, Senator Muir, Helen Rowell – APRA, The Hon Bill Shorten, Pauline Vamos - ASFA, Senator Wang, Senator Whish-Wilson, Senator Xenophon*

[7] The key performance indicators for bonus payments to senior executives are very heavily weighted to outcomes which also increase shareholders' wealth (such as increases in profits and in share prices); if they exist at all, measures of customers' satisfaction and trust receive very modest weights

[8] Kelly O'Dwyer, Speech to Industry Super Australia Conference, 22 November 2016 http://kmo.ministers.treasury.gov.au/speech/017-2016/ The brief quote includes the curious phrase "under the law" which is open to different interpretations, none of which helps the case that the governance standards of banks and life offices (whether "under the law" or in practice) should be the benchmark for superannuation funds.

[9] ISA analysis of SuperRatings Fund Crediting Rate Survey, December 2016

[10] *See for example, the speech by Mike Carney, Governor of the Bank of England in the court room of the Bank of England, 30 June 2016*

[11] ISA estimates that about 50 directors of industry super funds currently satisfy the SIS definition and are called "independents" by the funds involved. ISA also estimates that at least this number of "represented" directors of industry funds would also qualify as "independents" if the relevant tests were applied to them.