27 March 2015

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NOT IN CONFIDENCE

Retail Employees Superannuation Trust's Submission to the Financial System Inquiry's (FSI) Final Report

Introduction

The Retail Employees Superannuation Trust (**REST**) is open to all Australians and is one of the largest superannuation funds by membership in Australia. It has over 2 million members with more than $35 billion of funds under management, approximately 150,000 employers and an average member account balance of $17,500.

REST is a public offer fund with an independent Chair on its Board of Directors with the remaining members appointed by the Board, comprising eight Directors, with employer and employee sponsors from the retail industry, each nominating four directors.

REST's submission

REST welcomes the opportunity to respond to the final report of the FSI, in particular to the following recommendations:

1. Recommendation 12 - choice of fund
2. Recommendation 13 - independent directors

Executive summary

1. Recommendation 12

APRA statistics as at 30 June 2014 note there are a total of 116 MySuper products offered by 93 RSE licensees, comprising 103 generic MySuper products and 13 large employer MySuper products[1].

Data from an APA (Australian Payroll Association) survey conducted in 2011 and presented to ASFA shows that 65% of employers offer a single default fund. The research also showed that smaller employers with 1-50 staff each pay contributions to eight funds on average. REST has many contributing employers which fit this description.

[1] APRA MySuper Statistics Selected Feature, June 2014 (issued 2 October 2014), page 4.

If this was opened up to all funds the costs to employers in both time and money spent administering their employees default fund choices not to mention ongoing compliance costs and audit related expenses could prove unbearable for many employers and an unnecessary drag on revenues for others.

A further advantage of the current structure is that employers are not forced to make ill-informed, unsuitable and costly choices from multiple categories of default fund as the workplace/enterprise agreement nominates the fund for them with legal protections following that agreement.

2. **Recommendation 13**

Further clarification is required in relation to the definition of "independent director."

REST holds the view a more principles based approach to the definition of "independence" is required, rather than an inclusive list of associations or factors.

The definition of "independence" should relate more to a distinct personal or professional attribute which arises from a director's qualification, skills or experience. It is a "state of mind" which every director, regardless of their mode of appointment, is legally required to bring to the performance of their duties and obligations which is the most important defining set of characteristics.

Recommendation 12

Provide all employees with the ability to choose the fund into which their Superannuation Guarantee contributions are paid.

The FSI recommended that the Government should remove provisions in the *Superannuation Guarantee (Administration) Act 1992* that deny some employees the ability to choose the fund that receives their SG contributions due to the exclusions given to enterprise agreements, workplace determinations and some awards.

The FSI argued that a significant minority of employees cannot choose the superannuation fund that receives their SG contributions. In particular, this affects both employees (and employers) with a superannuation fund nominated in an enterprise agreement, a workplace determination or a state-based award. As a general principle, the Inquiry believes everyone should be able choose the fund that receives their SG contributions.

Choice of superannuation funds (for members) and for default funds (for employers) is still available in many modern awards and workplace agreements, so the 'benefits' of competition are already present.

Opening up modern awards and workplace agreements to more funds **does not increase** any advantages perceived to be delivered by competition and in fact reduces effective default fund selection.

For instance, the introduction of *Choice of Fund* in the 1990s was predicted to have significant positive impacts for members by many commentators, but the eventual take up by Australians has proved to be much lower than originally anticipated. The outcome was that employees **either preferred to stay with their current super fund choices or were inactive and did not respond**. Consequently the alleged positive impacts did not eventuate or at least were not even close to the degree first thought.

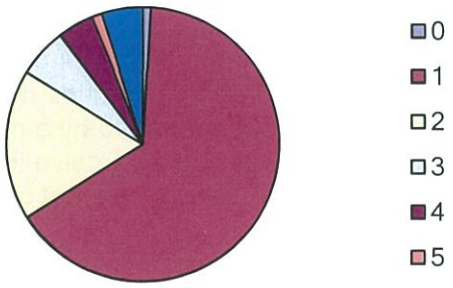
Impacts of default fund selection process on employers

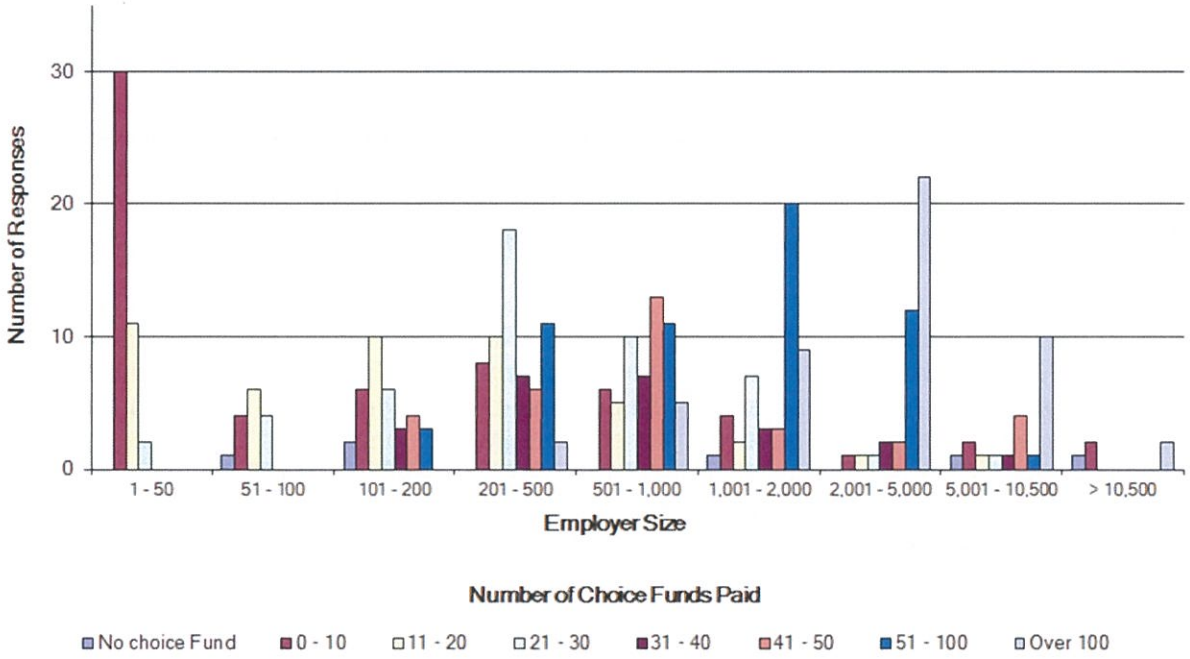
One of the advantages of the current structure is that employers do not need to be forced to make ill-informed, unsuitable and costly choices from multiple categories of default fund as the workplace/enterprise agreement nominates the fund for them.

An increase of funds from which to choose would involve increased processing costs for employers. Data from an APA survey conducted in 2011 and presented to ASFA shows that 65% of employers offer a single default fund. The research also showed that smaller employers with 1-50 staff each pay contributions to eight funds on average. REST has many contributing employers which fit this description.

If this was opened up to all funds (APRA statistics as at 30 June 2014 is that there are a total of 116 MySuper products offered by 93 RSE licensees, comprising 103 generic MySuper products and 13 large employer MySuper products[2]) the costs to employers in both time and money spent administering their employees 300+ default fund choices not to mention ongoing compliance costs and audit related expenses could prove unbearable for many employers and an unnecessary drag on revenues for others.

Number of Default Funds offered by Employers





Number of Choice funds Paid by Employer Size

Major retail employers have commented to REST that the use of clearing houses and efficient processing of superannuation contributions are key to supporting selection of funds. Clearing houses themselves are a critical component of efficient superannuation administration across larger employers. With large numbers of employees and many of these entitled to exercise choice of fund, the number of default funds which are required can be significant. Without the use clearing houses, larger employers would be overwhelmed. A clearing house is usually used for all non-default payments, which results in

[2] APRA MySuper Statistics Selected Feature, June 2014 (issued 2 October 2014), page 4.

at most two remittances being required. However, this is assuming that there is only one default fund to pay to.

Changes to the nominated default superannuation fund would cause substantial, additional ongoing costs to employers as a result of the need to materially change payroll systems and record configuration; the volume and complexity of disclosure material to employees and associated material to all recruitment locations, as well as the need to liaise with additional parties for contribution reconciliations and insurance claims. Of the 170,000 employers who currently make contributions to REST for a total of 1.2m employees, there is a turnover of 40 % per annum which results in approximately 243,000 employees per annum becoming members of REST. This process itself is already highly complex and expensive. The consequences of an "open" default nomination would incur major additional costs in identifying, recording and allocating contributions, especially for our 130,000 employers who employ fewer than 20 employees, many of whom have limited payroll system functions and resources to meet multiple default fund contributions.

Ultimately, employers would prefer to leave the responsibility for selecting default superannuation funds to those for whom it is core business. If this were to change, employers would need to make a choice of default fund which would provide them with an onerous and potentially challengeable duty of care to select the appropriate fund. It is also counter intuitive that employers "choose" a default fund. It is possible that they will nominate a fund based on brand recognition such as one managed by a major bank unrelated to the relevance of the fund's product and benefit design. They could perceive the bank's strength and financial security to be important factors (even though this is independent of the fund's strength and performance).

Employers could come under pressure from groups of employees or from external marketing and promotions from other funds. Evidence of this short term impact is clear.

Employers are not necessarily qualified to make such decisions and it is possible that many employers would select a fund which is not geared to their employees' expectations – to the detriment of their employees. REST believes that employers would not want to be in the position where the selected funds in the awards are not tailored to the relevant demographics of the industry their employees work in. These employers may also find themselves acting as "de facto advisors" whereby they must choose the default fund from a very large pool and be challenged by their choices for their employees. If the fund is subsequently shown to not be suitable for their employees, then this may create disharmony in the workplace.

If the employer is in the retail sector and does not choose REST, it may still have a significant number of employees using REST. We expect many will already be members of REST when they began their careers and they will not perceive a need to change just because the new employer has a different default fund. Ultimately, the employer will have significant numbers of its employees as members of REST and in its chosen default fund. This would result in potentially significant variations in member insurance coverage, costs and fee levels, as well as investment risk and return strategies and outcomes within the same workforce and over numerous workplaces.

Employers may also use clearing houses to solve multiple fund contributions but it is also important to note differing insurance options from fund to fund some of which may be more generous than others and/or more expensive. This will put a "moral hazard" decision making process on the employer who would be at risk of not making the appropriate default fund choice in relation to death, TPD and IP insurance.

Recommendation 13

Mandate a majority of independent directors on the board of corporate trustees of public offer superannuation funds, including an independent chair; align the director penalty regime with managed investment schemes; and strengthen the conflict of interest requirements.

The FSI has proposed that the Government should amend the Superannuation Industry (Supervision) Act 1993 (SIS) to mandate that public offer APRA-regulated superannuation funds have a majority of independent directors on their trustee boards, with an independent chair. The proposed definition of "independent" is that it should be at "arm's length."

REST wishes to highlight the following areas regarding this proposal:

1. Further clarification is required regarding the proposed definition of "independent".
2. Use of indicative definitions of "independent" directors.
3. The necessity to amend SIS should include a principles based definition rather than a prescriptive definition.
4. A proposed approach to definition of "independent directors".

1) Further clarification required for the proposed definition of "independent"

The FSI proposes that an "arm's length" definition of independence apply to directors. No other detail is given in the report and REST welcomes the opportunity to consult with the Government on this definition.

There are a number of different definitions of "independent director" (APRA, SIS, ASFA and the ASX). Depending on which definition of "independent director" is used, the criteria ranges from excluding persons who are a member of the fund (SIS, section 10) to excluding those associated directly or indirectly with a material supplier to the fund (ASFA).

In particular, REST proposes that the SIS definition[3] is too prescriptive. REST does not support a "tick a box" approach to determining independence. Further, REST makes the following points in relation to the definition of "Independent Directors" under SIS:

(a) being a member of a fund of which they are a director means that the director "has skin in the game" which is useful in assisting with decision making and understanding members' needs. It is incorrect to assume that being a member will see that Director acting inappropriately in order to serve their own interests rather than that of members. This is because of Director's obligations arising under SIS, including acting in the member's best interests as well as the no conflicts covenants, which override any perceptions of personal bias.

Directors must be "fit and proper" under the APRA requirements regardless of relationships relating to how and from where they are identified for appointment.

Superannuation governance frameworks are underpinned by long standing statutory, regulatory and common law corporate and trust regulation principles. There are no lesser standards of duties, responsibilities or governance, nor lower level of liability imposed on directors across all corporate models, within or outside superannuation.

Further, the Stronger Super legislative changes introduced in 2013 have imposed higher trustee director legal standards and exposure to direct liability specifically for directors of trustee entities than for all other directors of Australian corporate entities, including those who are responsible for the governance of major publicly listed entities

[3] The SIS Act at s 10(1) sets of the following definition of "independent director", vis:

"Independent director, in relation to a corporate trustee of a fund, means a director of the corporate trustee 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."***

In relation to non-association with employer sponsors or union, the distinction should more properly require that current or immediate past employment in the nominating organisations or the Fund's major suppliers and advisors to be the **guiding** factors contributing to a principles based judgement, as opposed to **determinative** factors. Otherwise, the current SIS definition contradicts the ASX Principles of listed public company directors which encourages shareholding by directors. The rules regarding being a member of a super fund of which you are a director should be consistent with the rules regarding being an ASX shareholder.

Any assumptions that Industry Fund directors are perceived to be not free from relationships that could materially interfere with their judgement are incorrect as this would contravene the SIS, Corporations Act and APRA requirements which bind them. Such an assumption misunderstands and potentially misrepresents the nature of industry Fund director's legal and ethical duties and obligations to their members and suggests that, by such directors being allegedly amenable to such interference and lack of objectivity, they may well have breached their legal obligations.

2) Indicative factors regarding independence definition.

REST holds the view a more principles based approach to the definition of "independence" is required, rather than an inclusive list of associations or factors. The definition of "independence" should relate more to distinct personal or professional attributes, as well their contribution to Board decision making, which arises from a director's qualification, skills or experience. It is a "state of mind" which every director, regardless of their mode of appointment, is legally required to bring to the performance of their duties and obligations.

This means that ultimately a director's independence cannot be assessed strictly against a list of characteristics of independence, but the definition should be more principles based, see point 3 below.

3) A principles based approach to independent director definitions.

The ASX has an "if not, why not" approach regarding independent directors as set out in their Corporate Governance Principles and Recommendations. This approach is appropriate as it recognises that there is no one model of good governance and provides flexibility for each Board to consider their own circumstances.

Certainly the ASX recognises that independent directors should not be mandatory, but constitute best practice. The ASX definition adopts a more "principles based" definition[4].

REST submits that any definition adopted in relation to "independence" should be principles based, as opposed to prescriptive. Accordingly, it should be based on adherence to a set of principles supported by factors determined by the Board in the relevant circumstances.

4) A proposed approach to definition of "independent directors"

It is appropriate that the description of independence will involve attributes of the existing or prospective director. Consistently with our comments above:

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[4] The ASX definition ie:

"A director of a listed entity should only be characterised and described as an independent director if he or she is free of any interest, position, association or relationship that might influence, or reasonably be perceived to influence, in a material respect his or her capacity to bring an independent judgement to bear on issues before the board and to act in the best interests of the entity and its security holders generally." page 16, and 37, ASX Corporate Governance Council, Corporate Governance Principles and Recommendations, 3rd Edition, 2014.

(a) REST submits that the attributes should be principles based and a not a check list of items that could support orchestrated outcomes; and
(b) the assessment of independence should critically include objective evidence supporting the "independence of mind" that the director brings (or would bring) in the discharge of their duties.

An essential feature of this approach is that the process should involve judgement by the persons appointing the director (probably the Board), with those persons being accountable for that judgement and with consequences for breaching their duty in this respect. This is materially different to being accountable for compliance with a mechanical check list.

This can be achieved by enforcing more strict standards on the pre-appointment qualifications required to be or become a superannuation director. For instance, an APRA accredited qualification would emphasise the legal and ethical standards required of superannuation trustee directors and would be objectively assessed. It is, or should be manifestly clear to all current trustee directors that their duties and obligations have been significantly increased under the Stronger Super legislation and APRA Standards and Guidelines.

The Government's focus should be to ensure Trustee Boards mandate a procedure which would be placed on all trustee directors being required to meet the new qualification standards and ongoing performance which would be supported by an independent expert consultant review and report to the Board, on a three yearly cycle, of the continued performance by each individual trustee director and by the Board as a whole, as part of the APRA Standards such as SPS 520 *Fit and Proper* and SPS 510 *Governance*.

As a consequence, the initial establishment of a minimum standard of knowledge and skill together with the ongoing independent testing as to the performance to the minimum standards, would provide a higher level of assurance to APRA and to superannuation fund members as to the level of skills and knowledge and the commitment to superior performance by those entrusted to govern their superannuation fund.

In relation to using tenure as a further delineator of independence, it is also important to remember that any benefits gained from regular turnover of directors through maximum tenure may be outweighed by loss of experience and knowledge from the Board.

Whilst APRA already recommends a maximum tenure period in its APRA Prudential Guide, a more appropriate measure of individual director effectiveness is by way of a regular, say three yearly, reviews of each director's contribution by an independent expert consultant whose report would be provided to the whole Board for action, if necessary, to remove or improve directors not achieving the required standard. APRA would monitor these reports and any follow up actions.

Further, the ASX holds the view[5] that the mere fact that a director has served on a board for a substantial period does not mean that he or she has become too close to management to be considered independent. However, the ASX suggests that the Board regularly assess whether that might be the case for any director who has served in that position for more than 10 years.

Yours sincerely

Damian Hill

Damian Hill
CEO

[5] Ibid, page 17.