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Pat Brennan
General Manager
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Australian Prudential Regulation Authority
GPO Box 9836
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By email: superannuation.policy@apra.gov.au

Dear Pat

Subject: Consultation: Governance requirements for RSE licensees: proposed amendments

We are pleased to provide this submission in response to APRA's proposed supervisory changes – released by a letter to trustees dated 26 June 2015 ("APRA's letter") - in relation to draft legislation to improve governance arrangements in superannuation released by Treasury on the same date ("the draft legislation").

Towers Watson is a leading global professional services company that helps organisations improve performance through effective people, risk and financial management. With 16,000 associates around the world, we offer consulting, technology and solutions in the areas of benefits, talent management, rewards, and risk and capital management. In Australia, we provide consulting, actuarial and investment services to a broad range of defined benefit and accumulation superannuation funds including standalone corporate funds, industry funds, master trusts and master trust sub-funds, and a wholly owned subsidiary of ours acts as trustee to a number of corporate funds.

Towers Watson has provided feedback to Treasury (copy attached) on the concerns held by both ourselves and the superannuation funds we advise in relation to several aspects of the draft legislation, including in particular its unexpected and costly expansion to include non-public offer employer sponsored (or "corporate") funds. We would encourage you to read our submission to Treasury in conjunction with this letter. We also have significant concerns regarding several areas covered by APRA's proposed supervisory changes as they are proposed to apply to corporate funds, including:

- proposed requirements around independent directors on various board committees, in particular the Remuneration committee;
- fund operations more generally; and
- APRA's expansion of the proposed definition of "independent".

The potentially short time frame for trustees to develop their transition plan is also surprising, and is also discussed further below.

In this submission, we refer to "corporate funds". We have used this term to represent non-public offer standard-employer sponsored funds which generally operate under the direct election equal representation model.

Independent directors on board committees

The draft legislation will require all boards of APRA-regulated funds to have a minimum of one-third independent directors, including an independent chairperson. However, APRA proposes to extend these requirements to, among other things:

- require a majority of both the Audit and Remuneration committees to be independent directors; and
- require the chairperson of both committees to be independent directors.

APRA also appears to be contemplating additional requirements around nomination and risk committees, although such committees are not currently required under any prudential standard and there is insufficient detail in APRA's letter for trustees to form any view on the implications of these requirements.

We have significant concerns regarding the unnecessary and costly impact of these proposals on corporate funds. Non-public offer corporate funds have a number of differences to public offer funds, which are not recognised under the blanket approach of either the draft legislation or APRA's proposals. They do not compete for membership of the public, most retain defined benefit sections, albeit usually closed, and they may provide other benefits such as fee subsidies to employee members that are not provided to employees of the sponsoring employer outside the corporate fund.

Importantly, under the direct election equal representation model, directors of corporate funds are currently generally not remunerated for their services to the fund – although they may be allowed time from their regular duties to prepare for and attend trustee and committee meetings. We are aware that APRA supervisors have recently suggested to some corporate fund boards that they should record this time as remuneration on the fund's website, but this is actually misleading as the directors do not receive any additional remuneration when they commence on the board and do not suffer any reduction in remuneration when they cease to be directors. Therefore, typically the only directors who will generally be remunerated on corporate fund boards will be the independent directors. APRA's requirements that the Remuneration committee consists of a majority of independent directors, and that the chairperson of that committee be an independent director, will therefore result in the independent directors facing an immediate and irreconcilable conflict of interest in being a majority and chairperson of the committee that determines their own remuneration.

The additional costs that will be incurred merely in appointing independent directors are likely to be substantial. Further expense will be incurred in paying these directors to serve on and chair the required committees. Our submission to Treasury included estimates of the likely cost impact on corporate funds based on our discussion with such funds. For some funds, the extra cost burden imposed by these requirements, which will be financed from members' retirement accounts to the extent the sponsoring employer is not willing to meet them, will be significant and will not be matched by any material benefits to members.

Further, discussions with corporate funds and their employer sponsors indicate that they are concerned with the potential impact of this change on the relationship between the fund and the sponsoring employer. Imposition of independent committee chairs and majority independent directors on the Audit and Remuneration committees, none of whom will be permitted to have any recent material relationship with the employer sponsor, may further disengage that employer. In addition, the proposal that independent directors should form a majority on the committee that sets their own remuneration is of considerable concern to employers who might otherwise have considered financing the cost of the independent directors. It would not be to the benefit of the members if, as a result of these proposed changes, the employer decided instead to withdraw its support for the fund. Indeed, where the employer currently meets part or all of the fund's costs, the result is likely to be to the considerable financial detriment of the members as such subsidies *will not be provided outside the corporate fund*.

We therefore strongly urge APRA to recognise that directors of non-public offer corporate funds are currently generally not remunerated for their services to the fund, and grant an exemption for such funds from the proposed Remuneration Committee requirements.

Fund operations more generally

The governance arrangements for superannuation were significantly strengthened only two years ago with the commencement of the Stronger Super changes. APRA has stated, in its letter, that it intends to further expand the requirements in SPS 510, including in relation to nomination and assessment processes for candidate directors. APRA also proposes to "review, and in some cases extend" the guidance in Prudential Practice Guide SPG 510 in a number of areas, including the size of trustee boards, director tenure limits and the role of certain board committees. However, APRA has not, in our view, sufficiently articulated what inadequacies in the current arrangements these changes are intended to address or what specific additional requirements and guidance are proposed.

Trustees already have a fiduciary duty to act in the best interests of their members and are subject to a range of governance requirements by way of legislation, and Prudential Standards. Prudential Standard SPS 510 specifically states at paragraph 8 that "the Board is ultimately responsible for the sound and prudent management of an RSE licensee's business operations." The breadth of APRA's expanded requirements and guidance potentially leave trustees with little scope to manage their fund in the way they consider most appropriate for the fund's circumstances and members' needs, especially in cases where APRA supervisors form different views to trustees as to the application of particular aspects of guidance to the fund's circumstances. We therefore suggest that trustees should, in practice as well as at law, retain responsibility for, and power to, establish the most efficient and appropriate committee structures for their fund's size, business mix and complexity.

APRA's expansion of the proposed definition of "independent"

As discussed in our submission to Treasury, APRA's proposal to include material professional advisors, consultants or suppliers as examples of material relationships could result in experienced professionals such as former fund actuaries, lawyers and auditors, insurance company executives and executives of investment management and administration firms being excluded from the pool of independent directors for the first three years after the relationship has ended. Whether there is a sufficient pool of appropriately skilled people to enable every APRA-regulated fund to expand or adjust its board to meet these requirements in a maximum of only three years may be problematic, and may result in the costs of such people increasing substantially from those discussed in our submission, due to the shortage in supply. This may be exacerbated by APRA's proposed guidance on board size and director tenure limits, although without further detail on APRA's proposals in this regard it is not possible to estimate the likely extent of the impact. The extra cost burden imposed by these requirements will be financed from members' retirement accounts to the extent the sponsoring employer is not willing to meet them.

Corporate funds only exist to provide valuable benefits to employees and their dependants. In such funds, under the direct election equal representation model both member elected and employer appointed directors already hold each other accountable for decisions and act in the best interests of all members, many of whom are their fellow employees. Any skill gaps can be met by training or sourcing assistance from professional advisers. The employer sponsor generally gains little benefit from the corporate fund beyond goodwill and the provision of a distinguishing employee benefit, and in many cases bears the risks of a defined benefit section and the costs of fee and/or insurance subsidies. Because of the two thirds majority already required of all trustee decisions, the employer representatives are not able to dominate trustee decisions and in well-run funds any such interference would not be tolerated.

The close working relationship between the employer sponsor and the trustee is one of the significant differences between non-public offer corporate funds and public offer funds. Imposition of an independent chair and a third of directors who will not be permitted to have any recent material relationship with the employer is likely to further distance the relationship from the employer's perspective and potentially disengage the employer. It is also likely to result in the replacement of directors with years of valuable experience with and knowledge of the corporate fund and its employer sponsor with directors with no experience with or interest in the fund and the valuable employee benefits it provides. It is therefore not at all clear what benefits members of corporate funds will gain from this change.

We therefore recommend that APRA reconsider – particularly in the case of corporate funds – the classification of material relationships in the definition of "independent" as including relationships with the employer sponsor.

The transition

The haste with which this change is being introduced is surprising. The FSI commissioned research to assess the cost effectiveness of certain regulatory changes implemented in the last decade, and its final report stated at page 30 that:

> *…although the assessment highlighted broad agreement with the policy that led to the intervention, it also highlighted shortcomings in how policy makers and regulators approach regulatory design and implementation. These included gaps in consultation processes and optimistic time frames for implementation…*

Given these comments and the potential significance of the changes for corporate funds, it is surprising that the only five weeks has been allowed for consultation on APRA's proposals. Further, APRA has indicated that drafts of the applicable prudential standards will not be issued for consultation until "later in 2015" with the final standards to be issued "before the end of 2015". No indication has been included in APRA's letter as to when its additional guidance will be finalised. Trustees must then have a transition plan in place by 1 July 2016 – only six months later – and this process will require extensive dialog with the employer sponsors. If these significant changes are indeed to be applied to corporate funds, we strongly recommend that a substantially longer period be allowed for development of the transition plan by trustees of such funds.

Summary

In our view there are differentiating features of non-public offer corporate funds that warrant different treatment to public offer funds. In particular, APRA's proposed requirements for Remuneration committees combined with the fact that directors of corporate funds are generally not remunerated will mean that the independent directors on that committee will be confronted by an immediate conflict of interest. The breadth and depth of APRA's proposed additional guidance potentially leaves trustees with little scope to actually manage their fund in the most efficient and appropriate way for their fund's size, business mix and complexity. The proposed extension of "material relationships" to include those with the employer sponsors of corporate funds will distance the relationship between the employer and the fund and cause the loss of years of valuable experience with the fund for no material benefit to corporate fund members.

Therefore, to impose these additional requirements on non-public offer corporate funds will reduce the retirement benefits for some members of these funds, and/or lead to the closure of the fund itself, which will be outcomes not matched by any benefits of the new regime.

Finally, given the significance of these changes if they are ultimately extended to non-public offer corporate funds, we urge APRA to allow such funds substantial additional time to develop their transition plans.

We would be pleased to discuss this submission or provide further information if required.

Yours sincerely

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