



17 May 2018

TO: ALL RSE LICENSEES

BOARD GOVERNANCE THEMATIC REVIEW

RSE licensees are responsible for the oversight of increasingly complex financial services operations in an environment of significant change. Robust governance practices that support sound decision-making are therefore essential for ensuring RSE licensees' business operations remain sustainable into the future and continue to meet the best interests of beneficiaries. APRA remains firmly committed to promoting the ongoing enhancement of governance practices across the superannuation industry.

Prudential Standard *SPS 510 Governance* (SPS 510) has set minimum requirements for RSE licensees since 1 July 2013. In December 2016, APRA expanded SPS 510 to require RSE licensees to formalise their governance framework. To assess how the superannuation industry has responded to SPS 510 and identify better practices and opportunities for improvement in targeted areas of governance, APRA undertook a thematic review into the board governance practices of RSE licensees. This review commenced in late 2016 and continued over the course of 2017.

The review covered 29 RSE licensees representing a cross-section of fund type and size, ownership structures and board composition. The review particularly focused on board appointment and renewal policies and practices, and board performance assessment approaches.

APRA's observations from the review, and recommendations for consideration by RSE licensees, are set out in the Attachment. Some high-level observations from the thematic review are:

- many RSE licensees, in seeking to comply with SPS 510 and Prudential Standard *SPS 520 Fit and Proper* (SPS 520), have adopted processes to ensure that individual directors meet minimum fit and proper requirements. However the majority do not go further to actively consider the optimal composition that is appropriate for the board as a whole, taking into account their strategic plan and the skills, capabilities and experience needed to effectively execute the plan;
- better governance practice was demonstrated by RSE licensees with clearly articulated policies on optimal board composition, which addressed a range of relevant aspects including achieving appropriate diversity, policies on multiple directorships and current and expected future skills and experience requirements;
- renewal policies and practices of some RSE licensees demonstrated a tension with the spirit and intent of SPS 510, for example by not requiring the board to take into consideration previous terms served on the board when assessing the period of tenure or not enforcing the tenure limits set out in the policy; and
- board performance assessments that move beyond self-assessment, to include more objective and independent review, often through the use of external experts, are viewed

by those boards as providing significant benefits through identifying means for improving the board's performance.

APRA expects all RSE licensee boards to review their existing governance arrangements against the practices outlined in this letter and Attachment and address any identified areas for improvement.

As part of its post-implementation review of the superannuation prudential framework, APRA intends to review and amend the framework where appropriate to reflect the findings of this thematic review.

The outcomes of this review, together with APRA's Related Party Arrangements Thematic Review (the findings of which will be communicated separately), complement APRA's policy proposals and supervision activities that seek to strengthen the focus of RSE licensees on enhancing the outcomes delivered for members.

Please contact your responsible supervisor if you wish to discuss any of the matters highlighted in this letter further.

Yours sincerely

A handwritten signature in cursive script that reads "Helen Rowell".

Helen Rowell
Deputy Chairman

ATTACHMENT

Governance practices vary considerably across the superannuation industry, and what constitutes good governance will continue to evolve as the industry itself evolves. From its broader supervisory work, APRA observes that RSE licensees with a strong focus on delivering quality member outcomes also tend to have in place robust governance practices that go beyond minimum regulatory requirements. They seek to meet the spirit and intent, and not just the letter, of the prudential requirements. APRA's observations and recommendations below, based on the Board Governance Thematic Review undertaken over 2016 and 2017, seek to identify better governance practices that APRA, and some of the boards that participated in the review, view as positively contributing to the delivery of enhanced outcomes for members.

1. Board composition

Prudential Standard SPS 510 Governance (SPS 510) requires the board to have a governance framework which includes among other things a charter that sets out roles, responsibilities and objectives of the board and policies and processes designed to achieve appropriate skills, structure and composition of the board. SPS 510 also requires a written policy for the nomination, appointment and removal of directors that supports appropriate Board composition and renewal on an ongoing basis.

APRA's objective in this area of the thematic review was to assess how a board determines that its composition, and that of its committees, is consistent with the complexity of its business operations and identifies the skills and experience needed by the board.

Board composition policy

Very few boards had formally documented, or were able to articulate, what their optimal board (and committee) composition should be, and how this might change in the future in light of their strategic plan and objectives. In particular, there was limited documentation of aspects of board composition such as the target size, optimal skills mix, ideal number of independent directors, workload considerations, or the connection between director skills and experience and the RSE licensee's strategy and business plan.

Link to strategic planning

Better practice demonstrated by some boards was consideration of the optimal composition for the board in a dynamic manner as part of their strategic planning process. These boards sought to ensure that the board as a whole possessed requisite skills, capability, and experience, rather than solely focusing on individual director skills and experience. This approach also provided these boards with appropriate diversity of perspectives, which APRA considers important to support better quality decision-making through appropriate review and challenge.

Composition of committees

APRA observed a lack of clear criteria in both training and fit and proper policies in respect of the skill levels needed on committees. While documentation often indicated the key skills that are desirable for committee members to possess, it was rare for an RSE licensee to identify minimum collective skill requirements that each committee was required to have (e.g. that there must be at least one director with expert skills, one director with intermediate skills or an intermediate level of skills, on average, across all committee members).

Examples of better practices included RSE licensees taking steps to ensure the alignment of skills of individual directors to the committee that best suited their expertise and also setting tenure limits for terms on committees, in addition to board tenure limits.

Recommendations – Board and board committee composition

- 1.1 *That RSE licensees consider, determine, document and regularly review the optimal composition for the board and board committees in the context of the RSE licensee's business operations and strategic plan.*

2. Board committees

While SPS 510 sets out the composition requirements for remuneration and audit committees, it is common for other committees to be formed to assist the Board with overseeing the RSE licensee's business operations. These may include member services, marketing, investment, insurance and claims, risk, compliance, board governance and nomination committees. Although some RSE licensees combine audit, risk and compliance oversight under a single committee, a significant number of RSE licensees have recently created separate committees (for audit, and for risk and compliance respectively) to allow greater focus on these important areas.

Appointment of independent experts

APRA observed considerable engagement of independent experts and consultants to support RSE licensee board committees, with over one third of the sample population engaging at least one independent expert. Independent experts and consultants were either appointed as formal committee members, or attended committee meetings to provide input into decisions as non-voting advisors.

RSE licensees that engaged independent experts and consultants viewed their impact on the governance practices and decision-making of the committees as positive. Engagement of such experts allowed boards to supplement committee members' knowledge with more specialist skills and deeper experience in the particular area of expertise. This was most prevalent for equal representation boards, and the engagement of independent experts and consultants was most common for investment committees.

Whilst the appointment of independent experts is standard practice across industry, APRA has observed through its supervisory activities that, in some situations, the appointment of independent experts to board committees has indicated a skills deficiency on the board.

Recommendation – Board committees

- 2.1 *That RSE licensee boards consider the extent to which the use of independent experts signals a skills deficiency on the board that would be more appropriately addressed through appointment of a director with the requisite skills and experience.*

3. Board renewal

SPS 510 requires an RSE licensee's governance framework to include a board renewal policy, which details how the board intends to renew itself in order to ensure it remains open to new ideas and independent thinking, while retaining adequate expertise. An objective of the thematic review was to understand and evaluate board renewal processes, including processes for the appointment and removal of directors.

To achieve and maintain optimal board composition, a renewal policy should support the appointment of appropriate candidates, and also the identification and training of potential future candidates, as part of sound succession planning.

Role of the board and nominating organisations

Where boards have an equal representation structure, it is common that a nominating organisation is given the power to veto an appointment or reappointment of a director of a board (via their respective constitutions and charters). The thematic review indicated that some boards had experienced challenges in appointing quality candidates with the necessary capabilities (particularly superannuation and financial expertise), in part due to the limitations imposed by constitutions. To address such limitations, examples of better governance practice included boards developing strong collaborative relationships with their nominating bodies to ensure that these organisations had a good understanding of the board's strategic direction and plan, and the skills, capabilities and experience needed of potential candidates to effectively execute it.

Tenure policy

As required by SPS 510, APRA observed the inclusion of a tenure policy in the governance framework across the sample population of RSE licensees. However, in a number of cases, the effectiveness of the policy was undermined by weaknesses in aspects of the policy, or in its implementation. These included:

- overly long tenure limits;
- transition arrangements that appeared to unduly delay steps towards board renewal; and
- inconsistency between the constitution and the policy which impeded the policy's implementation.

Examples of better practice included boards with staggered appointment terms. The policies of approximately half of the RSE licensees covered as part of the review acknowledged the value of staggered director terms to ensure an appropriate balance between ensuring appropriate continuity through retaining adequate experience and corporate knowledge, and achieving renewal through bringing diversity, fresh perspectives and additional skills and experience onto the board.

Maximum tenure limits

Most renewal policies included a maximum tenure limit of at least nine years, with the majority having a maximum tenure limit of 12 years, consistent with APRA's expectations in *Prudential Practice Guide SPG 510 Governance* (SPG 510). Better practice included setting maximum tenure limits which specify the length of each term as well as the maximum number of terms e.g. a maximum 12 year tenure comprising three terms of four years.

The review identified examples of RSE licensees introducing a maximum tenure for directors but resetting the commencement of the director's term from the date of the (revised) policy rather than the date of original appointment of that individual to the board. This allowed existing long-term directors to remain on the board for another maximum term of up to 12 years, demonstrating a tension with the spirit and intent of the prudential framework.

Exceptions to maximum tenure limits

APRA considers it reasonable for RSE licensees to put in place arrangements to allow for a smooth transition between directors, including providing for an additional term in exceptional circumstances. These exceptions, however, in accordance with SPG 510 should be well defined and limited.

APRA observed that some RSE licensees had implemented renewal policies that enabled exceptions which appeared designed to enshrine the current composition of the Board or enable some directors with long tenure to continue. Examples included renewal policies that permitted:

- use of average tenure for the board as a whole, rather than individual director tenure limits;
- indefinite tenure, without a specified maximum tenure or number of terms;
- permanent tenure for directors who hold a senior position in a stakeholder organisation; and
- extended tenure for special circumstances that were not specified in the policy and did not limit the extension to only one additional term.

Succession planning

Some boards recognise the importance of carefully considered succession planning as part of their tenure policy. This ensures that boards do not only look to fill a vacancy at the point when it arises, but rather put in place an ongoing renewal planning process that considers the skills and experience that will be required as each director's term is likely to end. Most notably, for example, recent appointments to some boards added cyber and digital skills, enhancing board capability to provide appropriate review and challenge in this rapidly evolving area.

Recommendations - Renewal

- 3.1 *That RSE licensees have a director selection process that provides a clear role for the board (and not just nominating bodies) in the appointment of candidates, with a view to ensuring that candidates with the necessary skills and capabilities are appointed.*
- 3.2 *That RSE licensees have sound renewal and succession planning processes that include policies in relation to tenure limits and reappointment that strike an appropriate balance between ensuring continuity and bringing diversity and fresh perspectives, where the criteria for any exceptions to tenure policy are clear and limited, and the policy is demonstrably implemented in practice.*

4. Assessing board performance

SPS 510 requires the board to have procedures for assessing, at least annually, the board's performance relative to its objectives and the performance of individual directors. An objective of the thematic review was to understand and evaluate the process by which objectives are set for the board, how the board and individual directors' performance is assessed, and how the board responds to the outcomes of the assessment, including any identified issues.

The assessment of board performance was a notably weaker area of governance practice. A number of the boards covered by the review undertook an assessment of board performance as a whole, in terms of skills, experience and the way the board functions, rather than only conducting an assessment of directors individually. APRA identified some examples of inconsistencies between the formal policy for board assessments, typically set out as part of board charters, and the implementation of performance evaluations in practice. There was an absence of clearly articulated objectives on which to base the performance assessment, beyond meeting fitness and propriety criteria. There was also little evidence of setting key performance indicator metrics or measures (such as relative to business plans) to assist in reviewing board effectiveness. Almost half of the sample population covered by the review did not consider assessment of performance against the overall strategy of the RSE licensee, as suggested in SPG 510.

A framework to address board underperformance was also commonly lacking across the sample population. Almost two thirds had no evidence of a process for dealing with underperformance beyond steps for removal of a director for breaching fitness and propriety criteria. APRA expects that boards would consider as an initial remedial step, for example, whether training and education programs may address the reasons leading to the underperformance at board and individual director level. It is essential that areas for improvement identified through board performance assessments are addressed in a timely manner.

APRA observed that a number of assessments focused primarily or solely on relatively subjective assessment of the skills and capabilities of individual directors. Better practice performance assessments also included behavioural aspects, such as quality and level of contribution, collegiality and directors' approach to teamwork.

Assessment methodology

Self-assessment was often the sole method for assessing board performance. Some weaker assessment approaches primarily involved collating individual director self-assessments. Stronger assessment processes included greater depth of analysis, such as interviews of individual directors by the chair, and input from senior management. Better practice also included use of external independent consultants.

In APRA's experience, the effectiveness of assessments is enhanced when an external review is undertaken. External assessments are commonly much broader in scope, using self-assessment in conjunction with a suite of other assessment tools. Most of the external assessments used by RSE licensees were based on surveys and questionnaires completed by board members. Some external reviews also involved an external consultant reviewing board papers and decision-making processes, interviewing board members and executives and attendance at board meetings. The effectiveness of the external reviews is also dependent on the value placed on the process by the RSE licensee, which determines the scope of the evaluation undertaken by the external party and subsequent follow up by the RSE licensee.

Consideration of how to achieve sufficient objectivity in board performance assessments, as suggested in paragraph 47(b) of SPG 510, was not addressed by many of the sample population.

Frequency of assessment

The majority of boards met APRA's expectations set out in SPG 510 to undertake annual performance reviews and an external assessment every three years.

Boards that demonstrated better practice undertook external assessments of the board and individual directors more often than the timeframes recommended as better practice in SPG 510. This practice, and the rationale for doing so, was generally reflected in the governance charter.

Recommendation – Board performance assessment

4.1 That RSE licensees have a robust and objective board assessment process that considers the performance of the board as a whole, as well as performance of individual directors, and identifies recommendations to improve performance that are effectively implemented.