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Reflections on Representation in Australian Superannuation Governance

Ronald B. Davis
Allard School of Law at the University of British Columbia, davis@allard.ubc.ca

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Reflections on representation in Australian superannuation governance

Dr Ronald B Davis *UNIVERSITY OF BRITISH COLUMBIA FACULTY OF LAW*

The size and importance of pension organisations around the world have grown to the point where they are crucial to the economic and social wellbeing of both individual members and their countries. At the same time, financial markets have grown more and more complex. Australia's mandatory contribution superannuation system has expanded tremendously over its relatively short lifespan. Scholars and commentators have portrayed some of Canada's largest defined-benefit pension plans as models of good governance based on their integration of accountability to stakeholders with expertise in their management structure.[1] One study of 81 pension funds from around the globe found that the financial performance of the best-governed funds exceeded those of the worst-governed by an average of 2.4% per year over the four-year period ending in 2003.[2] This study reproduced earlier study results showing a positive correlation between governance and financial performance.[3] This correlation and the important role of retirement savings institutions make the governance of superannuation funds a matter of public interest.

One of the tensions in pension fund governance design is that between accountability and financial market expertise. This is often expressed as concerns that the inclusion of plan member nominated/appointed trustee-directors in the governing body may lead to underperformance, due to an inability to react appropriately to financial market developments.[4] On the other hand, I have argued that the broad discretion exercised by the governing body, coupled with the potential conflicts of interest among stakeholders and between the service providers and plan members, makes some form of governing body representation or accountability to plan members necessary.[5] Joining the United Kingdom and Australia, along with most other countries belonging to the Organisation for Economic Cooperation and Development, the Canadian provinces of Quebec and Manitoba have made member-nominated pension trustees mandatory.[6] The benefits of representation are that it offers a cost-effective means of addressing conflicts of interest in an industry whose primary function is profitable investing of other people's money. Where there are such conflicts, the governance system in place must ensure that they are resolved in favour of those whose assets are invested in the scheme. In accumulation/defined contribution schemes such as those predominating in Australia, the assets are unambiguously those of the members. In addition, representation offers an alternative motivation to the financial incentives based on short-term performance offered to senior executives of the fund or service providers; provides an antidote to democratic deficit in our important institutions; and offers an avenue through which the interests of plan members in better environmental, social and corporate governance performance of investee businesses can be pursued through the investment activities of superannuation schemes.

With much of the world turning away from defined benefit and towards defined contribution pension plans, Australia has much to offer as a pioneer in the regulation of the governance of large-scale defined contribution plans. Canada's federal parliament and the legislatures of several provinces have embarked on a new form of defined contribution plan, the Pooled Registered Pension Plan, which will face similar governance challenges to those facing Australia's superannuation schemes. Many important regulatory lessons can be learned from its experience and the recent reforms implemented following the Cooper Review. However, one reform proposed in the Review seems to lack the usually rigorous analysis and justification offered for many of its other recommendations.

The Cooper Review's recommendations on the governance of superannuation fund boards of directors included fundamental changes. In the non-profit "industry" sector, it recommended the abandonment of mandatory equal employer and member representation, and the imposition of the requirement that one-third of the directors be non-associated ("independent"). It also recommended that a majority of directors in the for-profit "retail" sector be independent, although this recommendation was not at the forefront of debate in the run-up to the recent election. I have serious concerns about both of these proposals.

Implementing the recommendations in the industry sector will undermine member representation and accountability, a key factor enhancing the ability of trustee-directors to address the conflicts of interest inherent in mature superannuation schemes. In addition, the justifications offered for the change offer a weak, abstract explanation of its necessity; provide no elucidation of a concrete, measurable goal by which to determine whether the change has produced the desired result; and fail to generate a persuasive narrative about why independence offers value in the context of superannuation fund governance. Member representation is important in an accumulation superannuation system because it is the members' money that is being managed and they bear all of the risks. The choice of the trustee form of governance emphasises the importance of protecting the interests of members in its fundamental requirement that trustee-directors must manage their money in the best interests of members and never allow the interests of trustee-directors to conflict with their duties.

Conflicts with members' interests in Australia's mandatory accumulation scheme reside primarily in their relations with the for-profit advisers and service providers to the scheme, every dollar of whose profit reduces the members' benefits by the same amount. The trustee-directors' responsibility is to ensure that the return on these expenditures exceeds the cost to the members. Reaching this goal is a much more difficult project in the retail sector, where there are numerous associations between the majority of directors and the service providers.[7] In addition, the interests of members and managers can diverge — for example, with respect to the potential destruction of long-term value for short-term gain if management compensation is determined by short-term results; with respect to the appropriate scale of management compensation; and with respect to decisions to invest in order to shore up the financial position of the industry sponsoring the fund.

The Cooper Review cited the following rationale for equal representation by MP John Dawkins in 1992:

> One of the most important ways in which members are able to participate in the management and protection of their retirement savings is through representation on the board of trustees.

The Review then noted that:

- the replacement of single-employer defined benefit by multi-employer accumulation schemes and fund choice meant that an employer's legitimate interests and identification with funds was greatly diminished;
- representative trustee-directors were predominantly appointed by employer organisations and unions that did not represent everyone in the fund; and
- the current system left pensioners and non-union members unrepresented.[8]

However, instead of investigating means of enhancing member representation, the Review opted to recommend that non-representative trustee-directors be appointed based on the assertion that having independent directors was the best practice in corporate governance. While recent events at companies — such as Enron — with these best practices in place may raise questions about this assertion, the need for independent directors in superannuation can be questioned on another ground.

The Review ignored an important difference between corporations and industry superannuation. In corporate governance, the problem is that shareholders face severe collective action problems in monitoring and disciplining the directors and management through the ballot. In the industry funds, these collective action problems are reduced because representative union organisations have the resources and coordination necessary to protect plan members' interests in superannuation. To the extent that there is a concern that the union members' superannuation interests are significantly different from those of members outside the union, some alternative organisation could have been considered before determining that they, and other members, are better off with trustee-directors who are completely divorced from them and their representative organisations. Another crucial difference is that shareholders are able to elect and remove the independent directors, offering a degree of accountability that will be missing in the superannuation industry where the existing trustee-directors of trustee corporations will likely be those appointing the independent trustee-directors. I will discuss the problematic aspects of this factor further below.

The Review offered no concrete, measurable goal that its proposal for a fundamental governance shift would achieve, opting instead for the assertion that an "outside perspective" was vital for the industry funds by providing an "objective assessment of issues".[9] No illustrations of the failure of industry boards to objectively assess issues were offered, leaving one to wonder how this missing element had manifested itself in the 20 years prior to the Review. Indeed, the fact that industry superannuation funds have consistently outperformed retail funds (which are not required to have representatives on the governing body) over a long period of time ought to have raised this question: What is so fundamentally wrong with their governance structure that requires such a radical structural change in response?[10]

In the retail sector, while knowledgeable persons have recognised that the issue of directors' associations with the financial institution and service providers needs to be addressed, the appointment of non-associated independent trustee-directors, without a means of enhancing accountability, seems doomed to repeat the governance failures of institutions such as the US mutual fund industry.[11] There, lucrative compensation for directors, lack of available resources and information, and dependence on the incumbent directors for reappointment have combined to lead the Securities and Exchange Commission (SEC) to lament a "serious breakdown in management controls" and to determine that its 2001 amendments requiring a majority of independent directors on the funds' boards "do not go far enough". The SEC justified its decision to increase the number of independent directors to 75% and to require that an independent chair be appointed on the grounds that the fund adviser was in a position to dominate the board through its monopoly of information and control of the board's agenda.[12] In addition, concerns about relative performance in the North American mutual fund industry have been raised. Studies comparing Canadian and US mutual fund and pension fund performance — controlling for size, investment style and risk — find that mutual funds significantly underperform benchmark returns, while pension fund returns are very close to those of a benchmark portfolio.[13]

To summarise my concerns, these non-associated directors — adrift from all but the most formal legal ties to the scheme members — will gravitate towards those with the power of appointment, and be vulnerable to capture by the full-time management of the scheme, because of insufficient resources and lack of information necessary to act as an effective constraint on their actions. The lack of a robust system of accountability to members in the Cooper Review recommendations will compound these problems.

Member representation offers clear benefits in providing a cost-effective means of addressing both external and internal conflicts with the best interests of the members through the solidarity and accountability to the representative organisation. In addition, it increases the social legitimacy of an institution vitally important to both the present and future wellbeing of Australians. The case has not been made for such a substantial change, neither in the Cooper Review nor in the evidence about independent director effectiveness in similar settings. As a tool of corporate governance, it is designed to address a problem that is not present in industry funds. Reconsideration and further study seem more appropriate than immediate implementation of these recommendations.

Dr Ronald B Davis
Associate Professor
University of British Columbia Faculty of Law
davis@law.ubc.ca

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Footnotes

1. G L Clark "Governing finance: global imperatives and the challenge of reconciling community representation and expertise" (2008) 84 *Economic Geography* 281 pp 295–6; C Lamoureux "Effective pension governance: the Ontario teachers' story (2008) 1 *Rotman International Journal of Pension Management* 6.
2. K Ambachtsheer, R Capelle and H Lum "The pension governance deficit: still with us" (2008) 1 *Rotman International Journal of Pension Management* 14 p 19, noting that performance was the excess return over the same asset mix, passively invested; the governance quality rating was based on the pension fund CEO's self-reported ratings; and, while the measures of fund performance were adjusted for expenses and differences in asset mix, they were not given active risk-related adjustments.
3. K Ambachtsheer, R Capelle and T Scheibelhut "Improving pension fund performance" (1998) 54(6) *Financial Analysts Journal* 15–21.
4. F Stewart and J Yermo "Pension fund governance: challenges and potential solutions" OECD Working Papers on Insurance and Private Pensions No 18, 2008, available at www.oecd.org; G L Clark "Pension fund governance: expertise and organizational form" (2004) 3 *Pension Economics and Finance* 233; G L Clark "Expertise and representation in financial institutions: UK legislation on pension fund governance and US regulation of the mutual fund industry" (2007) 2 *Twenty-First Century Society* 1; G L Clark, E Caerlewy-Smith and J C Marshall "The consistency of UK pension fund trustee decision-making" (2007) 6 *Pension Economics and Finance* 67; G L Clark, E Caerlewy-Smith and J C Marshall "Pension fund trustee competence: decision-making in problems relevant to investment practice" (2006) 5 *Pension Economics and Finance* 91.
5. R B Davis "Balancing competence and representation: trustees and fiduciaries in the era of financial engineering" (2011) 33 *Comparative Labor Law & Policy Journal* 49; R B Davis "The survival of the trustee model of governance in the era of

financial engineering" in *A Super Act — 2009*, proceedings of the Annual Meeting of the Superannuation Committee of the Law Council of Australia, 26–9 February 2009.

6. Pension Benefits Act (Manitoba), CCSM, c P32, s 28.1(1.2); Supplemental Pension Plans Act (Quebec), RSQ, c R-15.1, at s 147.
7. W Sy "Pension governance in Australia: an anatomy and interpretation" (2008) 1 *Rotman International Journal of Pension Management* 30 p 34.
8. J Cooper et al *Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System Recommendation Packages — Pt 2: Recommendation Packages* 5 July 2010 pp 53–8, available at www.supersystemreview.gov.au (last visited 15 August 2013).
9. Above, n 8, p 55.
10. Australian Prudential Regulatory Authority "Celebrating 10 years of superannuation data collection: 1996–2006" (2007) 2 *Insight* 1 p 14, available at www.apra.gov.au; M Pokrajac "Advisers urged to recommend industry funds" *Super Review* 23 September 2013, available at www.superreview.com.au. Pokrajac reports that SuperRatings figures show industry funds outperforming retail funds by 1.67 percentage points over a rolling seven-year period and by 1.84 points over 10 years.
11. See, for example, the discussion of this issue in N Davis "Independence vital for superannuation trustees" *Super Review* 14 May 2012, available at www.superreview.com.au.
12. US Securities and Exchange Commission, Final Rule 17 CFR Pt 270: Investment Company Governance, 2004, available at www.sec.gov.
13. Benchmark returns are typically the returns earned by a similar mix of assets in the stock or bond markets over the same period as those with which they are being compared. See, for example, R Bauer and L Kicken "The pension fund advantage: are Canadians overpaying their mutual funds?" (2008) 1 *Rotman International Journal of Pension Management* 64, which compares the returns of fixed-income pension investments (bonds and treasury bills) and fixed-income mutual funds in Canada and finds that mutual fund returns were lower than the benchmark, while those of pension funds equalled or slightly exceeded the benchmark returns; K P Ambachtsheer and R Bauer "Losing ground: do Canadian mutual funds produce fair value for their customers?" (2007) 20 *Canadian Investment Review* 8, which reports similar results for pension fund and mutual fund equity investments; and R Bauer, M Cremers, and R G P Frehen "Pension fund performance and costs: small is beautiful" Social Science Research Network Working Paper No 965388, 29 April 2010, available at www.papers.ssrn.com, which reports that US pension fund cost levels are substantially lower than mutual fund fees for similar-sized funds. The difference in cost means that the pension fund's returns are greater than a comparable mutual fund's by the difference between the costs and fees.