

4 August 2017

Manager
Banking, Insurance and Capital Markets Unit
Financial System Division
The Treasury
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PARKES ACT 2600

via email: bear@treasury.gov.au

Dear Sir / Madam

Banking Executive Accountability Regime – consultation paper

Thank you for the opportunity to provide a submission on the Australian Government's proposed Banking Executive Accountability Regime (**BEAR**).

The Australian Institute of Company Directors (**AICD**) is committed to excellence in governance. We make a positive impact on society and the economy through governance education, director development and advocacy. Our membership of more than 40,000 includes directors and senior leaders from business, government and the not-for-profit sectors.

The AICD recognises the critical role of Authorised Deposit-taking Institutions (**ADIs**) in the Australian financial system. We support effective efforts of the government, the Australian Prudential Regulation Authority (**APRA**) and the banking sector to support good governance of ADIs, positive consumer outcomes and financial stability. The AICD recognises that governance of ADIs is essential to good consumer outcomes and financial stability.

The AICD welcomes the BEAR's aim of strengthening accountability in the banking system. We are, however, concerned that the regime, as proposed in the consultation paper, risks confusing the fundamental governance role of non-executive directors with executive management functions, and does not adequately consider corporate governance principles in its application.

We are concerned the BEAR, as currently constructed, will not achieve its aims.

This submission outlines our concerns and urges further consideration of, and more meaningful consultation on, the BEAR proposals in order to achieve the regime's policy objectives and minimise the risk of unintended outcomes. We have considered the BEAR through a governance lens, drawing on the practical perspectives of our members.

Our submission is divided into the following sections:

- 1 Overarching observations and recommendations
 - 1.1 Allow adequate time for consultation and review
 - 1.2 Clarify reform objectives
 - 1.3 Appropriately recognise the role of non-executive directors
 - 1.4 Interaction with existing duties
 - 1.5 The need for a targeted regime
 - 1.6 Principles, not prescription
- 2 Responses to specific consultation questions

3 Conclusion

1 OVERARCHING OBSERVATIONS AND RECOMMENDATIONS

1.1 Allow adequate time for consultation and review

The BEAR is a significant and complex reform proposal. The consultation paper proposes that the regime will impact on all ADIs in Australia and their subsidiaries. Given the importance of these entities to the Australian financial system and economy, it is essential that the BEAR be appropriately crafted. This requires careful and considered policy development.

The AICD is concerned that the three-week consultation period provided for public comment is an inadequate period for stakeholder review on this complex reform. In the AICD's view, it does not provide enough time for interested parties to fully consider the implications of the reform proposal, engage with stakeholders and affected parties, and provide the government with an informed and useful submission. Our comments and suggestions on the BEAR proposals are necessarily constrained by this unreasonable timeframe.

We note that the initial consultation in the United Kingdom (**UK**) on its Senior Managers Regime (**SMR**) was around four months, with subsequent detailed engagement with the sector. The AICD encourages the government to give consideration to a similar approach to finalisation of an Australian regime, to support meaningful and effective reform that appropriately considers the impacts and options in the Australian legislative, regulatory and market environment.

1.2 Clarify reform objectives

In introducing the reform proposals, the consultation paper identifies 'growing community concern regarding a number of examples of poor culture and behaviour in banks and the financial sector generally'. It also acknowledges the integral role of ADIs in the financial system. While these observations provide important context for the reform initiative, we recommend that the BEAR more clearly identify the conduct it seeks to address, namely, egregious systemic misconduct compromising consumer outcomes, financial stability or market integrity.

As with all reform proposals and legislation, the policy objectives must be clearly defined to ensure the regulations are fit for purpose. This is particularly the case for the BEAR given the extensive range of laws and standards that already exist to address conduct and prudential matters.

Clarity of the reform intention could be assisted through an objects clause in the legislation or explanatory material.

1.3 Appropriately recognise the role of non-executive directors

The AICD is concerned that key aspects of the BEAR, as proposed, have the potential to undermine crucial corporate governance functions and expectations in the Australian context, and misapprehend the role of non-executive directors (**NEDs**).

NEDs fulfil fundamentally different functions to that of executive management. NEDs bring a critical, and necessarily cross-organisation and high-level, perspective to the firm's strategy, performance, risk and culture. They apply their expertise, which is often derived from a non-ADI environment, to this role on a part-time basis. Unlike management, NEDs are not involved in the day-to-day operations of the organisation. NEDs bring an independent and objective judgement to the governance function, working collectively as the board and committees of the board. NEDs apply an inquiring mind to board papers, and constructively challenge, oversee and monitor the management of the organisation.

The AICD is very concerned that, under the framework proposed in the consultation paper, the BEAR misinterprets the role of NEDs and the board, and fails to appropriately reflect the governance function of the board.

The application of BEAR to NEDs requires substantial re-working to adequately frame the role of the board and NEDs, and to apply expectations and accountabilities tailored to their governance role and responsibilities.

Of particular concern:

- As currently described, the BEAR appears to impose managerial or quasi-managerial expectations on NEDs who are classed as ‘accountable ‘persons’ (**AP**), blurring the line between NEDs and executive management and potentially compromising NED oversight of management.
- Wording that would require NEDs to ‘ensure’ certain matters that sit within the remit of executive management risk imposing an expectation that would be impossible to meet, without the board embedding itself in operational and compliance functions and compromising the governance task of independent judgement and oversight.
- In its current form, the BEAR framework does not adequately consider the collective governance function of the board and board committees. An unintended consequence of this could be that NEDs in prescribed roles are incentivised to mitigate individual exposures, impacting the collective oversight of culture, compliance and performance. The AICD believes this issue requires further consultation with ADI directors in framing the BEAR’s coverage and prescribed roles.

The AICD strongly recommends that the BEAR be designed to clearly reflect the role of NEDs and their governance responsibilities.

1.4 Interaction with existing duties

Directors are already personally accountable under the *Corporations Act 2001* (Cth) (**Corporations Act**) for breaches of duties, with potentially significant civil and criminal consequences. These duties already include the duty to act with due care and diligence (s 180), and the duty to exercise their powers and discharge their duties in good faith in the best interests of the corporation, and for a proper purpose (s 181).

In addition to these core Corporations Act duties, ADIs and their officers are subject to other regulations including detailed risk management, governance and propriety standards imposed by APRA, and the conduct-related requirements of Chapter 7 of the Corporations Act. There is now a well-developed body of judge-made law which considers the meaning and effect of many of these provisions.

We acknowledge that the intent of the BEAR is to impose even higher standards of expectations on ADIs than already exist.

However, we are concerned that the imposition of yet another layer of expectations may not meaningfully improve conduct in the financial sector and may unintentionally foster an inappropriate degree of risk aversion in our financial system.

Further, the BEAR expectations contain concepts which are unknown to the law. This could mean they will be inherently difficult to assess, comply with, and enforce.

For instance, we question how the regulator or a court could determine whether a director has acted with ‘integrity’, or dealt with regulator in an ‘open and co-operative’ manner. By their nature, concepts such as ‘integrity’, ‘openness’ and ‘co-operation’ are subjective and open to

interpretation. Further, the BEAR does not address the potential for these expectations to conflict with well-established principles such as confidentiality and legal professional privilege.

The legal duties imposed by the Corporations Act, and APRA's prudential standards, were developed after significant consultation and careful consideration. The duties imposed by the Corporations Act are well understood and judicially clarified. Given this, and given the inherent challenges associated with drafting laws which relate to appropriate standards of governance, the AICD considers it critical that the BEAR regime adopts approaches and principles consistent with these existing, extensive regimes.

To the extent the BEAR does impose additional expectations on directors and officers, it is critical that the defences, qualifications and relief available under the Corporations Act are consistent with those available under the BEAR.

The BEAR legislation should expressly acknowledge that it does not alter the duties imposed on officers under the Corporations Act or at general law, and applies only in relation to the new regulatory powers imposed under the BEAR.

1.5 The need for a targeted regime

The AICD is concerned that the scope of the regime will capture a large number of persons within an ADI group who are not necessarily in a position to influence 'systemic and prudential matters', despite the intention of the government in limiting the regime to these matters.

We understand that the BEAR is intended to apply to subsidiaries of ADIs, including non-ADI subsidiaries. It would also appear that the BEAR may apply to 'prescribed roles', as well as those persons who have a significant influence over conduct and behaviour, and whose actions could pose risks to the business and its customers.

To appropriately limit or control the scope of the BEAR, the AICD suggests a principles-based approach to the design of the regime, where senior individuals are appointed by the relevant entity to be primarily responsible for core functions of that entity.

Alternatively, we suggest that the government could revisit the existing concept of 'responsible person' contained in APRA Prudential Standard CPS 520 *Fit and Proper*. In this way, an ADI could work with APRA to identify the appropriate person who is in a position to control or materially influence systemic or prudential issues.

1.6 Principles, not prescription

We note that the Coleman Report, which is cited in the consultation paper, did not recommend an SMR-like regime in Australia. Indeed, the Coleman Report noted, *inter alia*, that such a regime has the potential to undermine businesses' internal accountability structures, and 'runs counter to traditional concepts of criminal and civil liability'.¹ We are concerned that the limited consultation period prevents detailed consideration of these threshold issues.

The BEAR model proposed in the consultation paper draws extensively on the UK's SMR. The AICD questions the appropriateness of the prescriptive UK model for the Australian context.

We understand that the SMR was primarily conceived and designed to target large UK banking institutions. Feedback we have received suggests that the SMR regime is complex, expensive to implement, and may be unsuitable for smaller institutions.

The AICD recommends that the government give further consideration to incorporating the principles and approach adopted in the Hong Kong Manager-in-Charge (**MIC**) regime. We have received feedback that this regime enables institutions to determine who is best-placed

¹ Coleman Report, 20

to be accountable for a particular *function* within an entity, rather than the more prescriptive approach of mandating prescribed roles.

We strongly recommend the government consider designing a regime which engenders flexibility for ADIs both large and small, so as to avoid interfering with existing governance structures which are appropriately determined by the board taking into account the circumstances of an individual organisation.

We understand that the UK is undertaking a public consultation regarding proposals to expand the SMR to all financial services firms (rather than just banks). One of the complexities associated with such a rollout is that the SMR's high degree of prescription inhibits its scalability across organisations of different sizes, structures and industries.

The AICD understands that the MIC regime may be more scalable. This may be more appropriate for Australian ADIs, given the variances in size from small credit unions to large, internationally operating banks in our market.

2 RESPONSES TO SPECIFIC CONSULTATION QUESTIONS

Question 1

Does the prescriptive element of the proposed definition of Accountable Persons capture the roles which, at a minimum, should be subject to enhanced accountability under the BEAR? Are there any other roles which should be included at a minimum? Should any of the roles be excluded?

As stated above, the AICD suggests that further consideration be given to the complexities and practical issues associated with the proposed definition of AP.

The AICD considers that a model that focuses on prescribed functions, rather than prescribed roles, may be more appropriate in the Australian environment. Subject to further consultation with the industry, we encourage the government to consider whether the approach adopted in the MIC regime would better meet the policy objectives of the BEAR, while limiting compliance complexity.

In this way, the BEAR could bring greater focus on functions which are performed in practice, rather than entities and structures which may not reflect the true lines of accountability.

If a model similar to the MIC was adopted, the ADI would appoint at least one 'fit and proper person' to be an AP for the core functions of the ADI. However, an ADI may appoint one individual to act as the AP for several core functions where appropriate considering its scale of operations and control measures. An ADI could also appoint two or more individuals as APs to jointly manage a particular core function.

If, however, the government pursues a model which prescribes particular roles to be APs, the AICD suggests these categories draw on the existing 'responsible persons' concepts under APRA's fit and proper regime. This is far more preferable to the development of an entirely new prudential concept of an AP.

In relation to the inclusion of NEDs in prescribed role categories, the AICD reiterates our concerns outlined in Section 1.3 of this submission (above).

The AICD is very concerned that, under the framework proposed in the consultation paper, the BEAR misinterprets the role of NEDs and the board, and fails to appropriately reflect the governance function of the board.

If managerial standards are imposed on NEDs, this risks undermining their important role in governance, as they would risk becoming entangled in operational matters and compliance concerns, with too much focus on managing the business.

NEDs are essential for the proper governance of an ADI. The board needs to have an appropriate number of non-executive directors who can challenge management and hold them to account, and also represent the best interests of the company.

The consultation paper does not give adequate consideration to these issues and further work and consultation is required to develop tailored descriptions.

Question 2

Does the principles-based element of the proposed definition of Accountable Person provide sufficient flexibility to reflect differences in business models and group structures?

The AICD does not support the proposed definitions in their current form.

As stated above, the current definitions are ambiguous, and would significantly expand the BEAR beyond the scope of the UK SMR or the HK MIC regime, potentially capturing middle-level or mid-senior level management.

As we understand it from the consultation processes thus far, the scope of the BEAR is intended to be targeted at senior levels of executive accountability. To achieve this aim, the AICD encourages a principles-based approach to identifying APs that focusses on core functions within an ADI, rather than broad and potentially vague notion of a person who has a significant influence or control over conduct and behaviour within the ADI group. By focussing on core functions, the BEAR would capture those persons who, in practice, do have significant influence or control, without the unnecessary confusion caused by a 'catch-all' definition.

This would also enable APRA and the individual entity to determine who is best-placed to be appointed as an AP, and design any accountability mapping accordingly. A prescribed list of individuals, rather than functions, fails to reflect the diversity of structure and accountability-lines found within ADIs, particularly subsidiary ADIs of foreign banks. Again, we reiterate the strength of the MIC regime in this respect.

Question 3

Should the definition of Accountable Persons apply to individuals in the subsidiaries of a group or subgroup with an ADI parent, including where the subsidiaries are not regulated by APRA?

The AICD recommends that the BEAR only apply to the individuals that perform core functions within the ADI group. In combination with a principles-based approach to identifying individuals to be appointed as APs, this would appropriately limit the BEAR to those persons who are sufficiently senior to have relevance to APRA's prudential supervision over the ADI Group.

One practical consideration of the approach proposed in the consultation paper is that within a large, complex ADI group, the number of individuals in prescribed positions (such as roles on subsidiary group boards) could be considerable, despite potentially exercising little control or influence in the context of the ADI overall. This appears counter to the aim of a targeted regime focused explicitly on senior executive roles with significant executive accountabilities.

Question 4

Do the options canvassed for the expectations of ADIs capture the behaviours that should be expected under the BEAR?

4.1 Are there any other behaviours which should be included?

4.2 Should any of the behaviours be excluded?

Question 5

Do the options canvassed for the expectations of accountable persons capture the behaviours that should be expected under the BEAR?

5.1 Are there any other behaviours which should be included?

5.2 Should any of the behaviours be excluded?

The AICD is very concerned that, under the expectations proposed in the consultation paper, the BEAR misinterprets the role of NEDs and the board and fails to appropriately reflect the governance function of the board.

The application of expectations to NEDs requires substantial re-working to adequately frame the role of the board and NEDs.

As currently described, the BEAR appears to impose managerial or quasi-managerial expectations on NEDs, blurring the line between NEDs and executive management and potentially compromising NED oversight of management.

Wording that would require NEDs to 'ensure' certain matters that sit within the remit of executive management risks imposing an expectation that would be impossible to meet, without the board embedding itself in operational and compliance functions and compromising the governance task of independent judgement and oversight.

If NEDs are to be captured by the BEAR, then the expectations applicable to them must be consistent with and tailored to the governance role. In the AICD's view, the consultation paper's formulation of proposed behaviours fails to do this and BEAR would require the development of a separate statement of expectations for NEDs. We consider that this requires further thought and consultation with the AICD and other stakeholders.

In addition to this central concern, we make the following remarks:

- To the extent possible, the AICD supports drawing on existing legal obligations which are imposed on ADIs and their directors and officers, rather than imposing new obligations which are either overlapping with existing obligations or importing concepts which are not already known in law and meaningfully understood.
- The AICD strongly supports the inclusion of defences which mirror existing concepts in law. An appropriate example might be to ensure that liability is not imposed where the AP took 'reasonable steps, in the circumstances, to meet all of APRA's requirements'.
- The AICD recommends that the legislation specifically provide that the BEAR does not modify or override the existing duties under the Corporations Act, and limits any new duties so that they only apply insofar as they relate to APRA's powers under the BEAR.
- The consequences which flow from a breach of expectations under the BEAR should not apply for single breaches which are not reflective of the overall culture or risk management of the ADI. BEAR should only apply where there has been a systemic failing which has resulted in a serious prudential risk to the ADI or the ADI Group.
- The concept of 'integrity' could be replaced with 'honesty', which is a well-established legal concept. A duty to act 'efficiently and honestly' could be imposed on APs, drawing from s 912A(1) of the Corporations Act.

- The concept of being ‘open and cooperative’ with the regulator should be replaced with an expectation on an existing legal concept.
- To the extent that any new duties are included, the AICD supports the inclusion of appropriate defences which enable persons to establish that they took ‘reasonable steps’.

Question 6

Would deferring variable remuneration be likely to result in a shift from variable to base remuneration?

The AICD does not have a comment at this time.

Question 7

What are the complexities in defining variable remuneration, including in relation to non-cash remuneration?

The AICD does not have comment at this time.

Question 8

Does the proposed principles-based definition of variable remuneration provide sufficient clarity as to the application of the BEAR to current and potential future remuneration structures?

Question 9

Is the proposal for deferring 60 percent of the variable remuneration of certain executive accountable persons appropriate?

Question 10

Are the proposed enhancements to APRA’s remuneration powers appropriate?

The AICD considers that the structure of remuneration of CEO and senior executive positions is a matter for the board of an ADI, within the guidance of prudential standards.

We note that APRA’s standards already require risk incentives to be considered in determining remuneration structures and provide powers to the regulator to supervise such policies.

The AICD has received feedback that the variable remuneration requirements could have the potential to cause significant practical difficulties for ADI boards, including:

- The proposed remuneration powers may not align with existing remuneration contracts, in the sense that while they may reflect the broader principles of deferred variable remuneration, they may not precisely align with the BEAR prescriptions. For instance, it is not clear whether a remuneration package which partly defers remuneration on a three-year basis, and partly on a six-year basis, would be compliant with the BEAR. We urge the government to ensure the regime is flexible, so that the policy intent is achieved without interfering with sensible remuneration packages already in existence; and
- It is not clear from the consultation paper what effect the BEAR will have on early-exit arrangements. These issues need further consideration by government.

Question 11

Should ADIs be required to map the allocation of prescribed responsibilities, similar to the approach under the Senior Managers Regime in the United Kingdom?

11.1 Are there any other prescribed responsibilities which should be included?

11.2 Should any of the prescribed responsibilities be excluded?

The AICD supports accountability mapping. We note the significant resources and time it will take an ADI to prepare and continually update these accountability statements and maps. We understand that accountability mapping in the UK experience involved significant consultation with executives. Existing employment contracts and position descriptions may also need to be updated to ensure the agreed accountabilities are consistently and clearly documented.

Accordingly, to the extent that the process could be minimised or streamlined, the AICD would support such measures. Targeting the BEAR's scope will assist with this.

Question 12

Should ADIs have discretion to add to the prescribed list of responsibilities?

Yes.

Question 13

Are the options canvassed for enhancing APRA's removal and disqualification powers appropriate?

We expect that the proposed disqualification powers would reflect those which ASIC presently has under the Corporations Act to make banning orders in respect of individuals.

Accordingly, should the government choose to adopt this proposal, the AICD strongly urges the government to ensure that there is a clear and consistent due process, and a right of appeal to the AAT / Courts.

Question 14

Are the proposed circumstances in which the civil penalties should apply appropriate?

The AICD considers there is a significant risk that the same conduct by an ADI or a subsidiary could result in a breach of an ADI's responsibilities under the BEAR and contravention of a range of other civil penalty or other provisions to which the ADI or subsidiary is subject, including FOFA and Corporations Act provisions.

Accordingly, the AICD supports the inclusion of provisions analogous to those in the Corporations Act that prevent a person from being held to be both criminally and civilly liable.

However, precisely how the civil penalties in the BEAR will interact with any regime of criminal responsibility – including, for example, under the Corporations Act – remains to be seen.

In addition, the AICD strongly supports the principle that any civil penalty be imposed by a court, and opposes the introduction of any infringement notices regime akin to that within the Corporations Act.

Further, the AICD urges the government to design the regime so that a civil penalty is only imposed where the impugned conduct is egregious, systemic and has a prudential effect. The BEAR should only respond to misconduct that cannot be appropriately dealt with under existing laws and regulatory powers.

Finally, the question of insurance should be resolved in a way that is consistent with the ordinary principles applied to liability in the context of the Corporations Act.

3 CONCLUSION

We hope our comments will be of assistance to you. If you would like to discuss any aspect of this submission, please contact Lysarne Pelling, Senior Policy Adviser, on (02) 8248 2708 or lpelling@aicd.com.au, or Matt McGirr, Policy Adviser, on (02) 8248 2705 or at mmcgirr@aicd.com.au.

Kind regards

A handwritten signature in blue ink, appearing to be 'Louise Petschler', written in a cursive style.

LOUISE PETSCHLER
General Manager, Advocacy