Submission on the Banking Executive Accountability Regime Consultation Paper

from

Dr Ann Wardrop, Dr David Wishart, and Associate Professor Marilyn McMahon, 3 August 2017

1. Introduction

1.1. Who we are:

1.1.1. We are academics interested in the regulation of the banking and finance industry. We have jointly published in the area and ran a Roundtable Conference on the topic in December 2015. Individually we have each written extensively on topics involved in this submission.

1.1.2. Dr Ann Wardrop is a Senior Lecturer at La Trobe Law School, La Trobe University whose main research interests are in banking and finance law and regulatory theory.

1.1.3. Dr David Wishart is also a Senior Lecturer at La Trobe Law School, La Trobe University. His main research interests are in corporation law and theory, competition policy and regulatory theory.

1.1.4. Dr Marilyn McMahon is an Associate Professor at the Law School of Deakin University. Marilyn's research areas are in psychology and the law, crime, criminal law and criminology.

1.2. Why we are submitting:

Our research focuses on organisational culture as a key point of intervention in the regulation of the banking and finance industry. We have investigated many differing mechanisms and strategies for increasing the responsibility and accountability of senior and influential directors and executives within authorised deposit-taking institutions (ADIs). We have also researched a wide spectrum of regulatory techniques aimed at ensuring the behaviour of institutions and personnel in the banking and finance industry is appropriate both in prudential and consumer protection terms. The Banking Executive Accountability Regime (BEAR) is an Australian articulation of one such technique and we are keen to make our expertise available to the Banking, Insurance and Capital Markets Unit of the Treasury in its development of the BEAR.

1.3. Our approach:

While there is much in the detail, the most intriguing aspect of the BEAR is its overall formulation. Accordingly, we first discuss this and then work through the specific questions posed at the end of Chapters 4 – 6 and through Chapter 7.

2. The overall design

2.1. The Bear aims to expand the existing prudential regulatory scheme applicable to ADIs by incorporating a requirement of a declared accountability framework. This would set out that 'accountable persons' are required to be registered with APRA as having accountability and responsibility in relation to risk, remuneration, and audit, and also require that lines of accountability and responsibility be 'mapped' in 'accountability statements'. Under the proposal, such registration and mapping would be leveraged to:

- require of 'accountable persons' limited personal accountability in relation to risk, audit and remuneration;
- impose corporate liability for failure to hold accountable persons answerable for failure to meet expectations set out in the BEAR;
- extend APRA's control over who is appointed to positions of responsibility within ADIs;
- extend APRA's control over remuneration;
- extend requirements on officers and ADIs to be open and cooperative with APRA;
- create new duties for ADIs; and
- extend liability to firms rather than just corporations.

While not entirely setting up self-regulatory systems, the proposal appears to balance organisational autonomy against enhanced regulation, focussing on requiring firms to enforce responsibility.

We welcome the proposal as a step towards ensuring that culture within financial institutions and banks does not prejudice systemic stability. We are less convinced that it will serve to mitigate reprehensible conduct in relation to consumers. Nor are we convinced that its *ex post* enforceability will do much in relation to creating an incentive to construct better cultures within ADIs. However, we are of the opinion that the requirement to map accountability and responsibility will make the governance of ADIs more transparent and in so doing encourage the formation of better cultures.

We also welcome the proposal as redefining what is expected of officers, in particular for placing a focus on their accountability. We are of the opinion that such redefinition would be usefully included in the *Corporations Act* directors' duties regime.

We are, however, concerned with a number of matters relating to the design, mostly to do with the functional separation between ASIC and APRA – the oft referred to 'Twin Peaks'. In our opinion, APRA's remit to deal with prudential matters confines the effectiveness of the BEAR. This is now considered.

2.2. According to the *Consultation Paper*, the BEAR is directed at prudential regulation. Thus, it is stated that 'The BEAR will apply where there is poor conduct or behaviour that is of a systemic or prudential nature' (p.7). It is a part of a package of reforms that seek to strengthen accountability and competition in the banking system (p 1). Notably, these reforms are directed at poor corporate cultures in banks and

financial institutions which have both prudential and consumer impacts. However, by maintaining the separate silos of APRA's prudential and ASIC's behavioural regulation the proposal obscures the fact that the behaviours comprising poor culture are inextricably linked. Consequently, to propose an accountability and responsibility regime covering both but which is subject to the limitations of prudential regulation represents a missed opportunity to meet the broader objectives of dealing with ADI culture in relation to fair treatment of consumers. It is noteworthy that the title of the *Consultation Paper* and the proposed regime make no express distinction between prudential and conduct regulation. Moreover, the Introduction to the *Consultation Paper* actually suggests that the regime is directed at serving the interests of consumers rather than systemic stability, acknowledging that 'recent poor behaviour in the provision of insurance and financial advice by the subsidiaries of ADIs has raised community concerns' (p.4). Yet, because of the distinction that is maintained between prudential and conduct regulation, this poor behaviour will not be caught by the BEAR, unless it is so widespread as to pose a systemic financial risk. Once established as a matter for APRA, it would be difficult to transition the scheme to being partly or totally a matter for ASIC.

Accordingly we suggest that either the scheme be explicitly limited to prudential regulation and be acknowledged to not cover other implications of bad conduct (such as impacts on consumers) or that it be remitted to the *Corporations Act* to be considered a part of general regulation – even if in certain aspects directed at the banking industry.

2.3. A regulatory requirement to 'map' accountability and responsibility is welcome as a useful regulatory technique. We note that attention is being given to the form and coverage of the maps. There is a danger in a prudential regulation that a failure to adhere to the map can be dismissed as insufficient to trigger systemic risk and thus to be *de minimis.* Further, the 'expectations' of ADIs do not appear to specifically address how the maps are to be utilised in the regulatory process, other than identifying 'accountable persons'. We recommend that the civil penalty regime sheet liability home to duties as provided for in the Map, that the Map be subject to approval processes, and that there be a compliance regime for registration. If the Map is to be a matter of more general conduct regulation of ADIs, we recommend that it be a matter for the *Corporations Act* and be integrated with the directors' and officers' duties regime.

2.4. The distinction between the roles of APRA and ASIC is maintained in the claim that the scheme does not make it an offence *per se* when an accountable person fails to live up to their responsibilities. Notwithstanding personal criminal liability under s 11CG(2) of the *Banking Act 1959* (Cth) of an officer of an ADI for failure to take reasonable steps to ensure an ADI complies with a direction by APRA under s 11CA of that Act, the paper states that to impose this type of liability would be conduct regulation and this, the paper states, is a matter for ASIC.

2.5. Moreover, while the proposal specifically excludes 'accountable persons' from civil penalties for non-compliance with personal expectations, it simultaneously allows APRA to remove them from their positions, thereby allowing the imposition of

severe consequences. It might be reasonably expected that such a removal would also be taken into account in the 'fit and proper' person regime. It would allow for the claw-back of excessive variable remuneration. APRA can also penalise the ADI for a failure to remove. The 'expectations', then, are indirectly enforceable. It cannot therefore be said to be a matter of leaving conduct to ASIC. This raises the possibility that the expectations may conflict with, rather than operate beside, the ASIC duties regime for directors, officers and employees.

2.6. The expectations of an accountable person (p 8) are phrased in terms of s 180(1) of the *Corporations Act 2001* (Cth) ('the Act'), with the addition of requirements to 'be open and co-operative with APRA', demonstrate 'integrity', and appropriately and effectively control delegation of responsibilities. Demonstrating integrity under the BEAR reprises ss 181-184 of the Act (which impose fiduciary duties on officers) and control of delegation is dealt with under ss 189-90. This raises significant issues about how the new BEAR duties will interact with nearly identical duties imposed under the *Corporations Act*. Some examples will illustrate this problem:

- Duties imposed under the BEAR will exist in conjunction with the duty of care and diligence in the *Corporations Act;* the latter is subject to the business judgement rule in s 180(2) of the Act, and limitations on responsibility in relation to delegation and reliance is already well articulated. Will the limitations and qualifications on these duties under the Act apply to those under the BEAR?
- While the BEAR imposes obligations on ADIs to ensure that accountable persons comply and implicitly penalises accountable persons for non-compliance, compliance with requirements such as the BEAR is already required and failure to prevent non-compliance is addressed in s 180 of the Act. The two regimes might have differential impacts for the same events.
- The duties in the *Corporations Act* apply variously to directors, directors and officers and directors, officers and employees, with officer defined in s 9 of the *Corporations Act*. Section 5 of the Banking Act already defines 'senior manager' for various purposes and refers to 'officer' (referring to the Corporations Act definition) in s 11CG(2); the definition of 'accountable person' under the BEAR seems to be consistent with the definition of 'officer' although there could well be differences in the detail of tests. Given the overlapping nature of the duties, this is likely to confuse implementation.

2.7. It is likely that the BEAR will impact on the definition of *Corporations Act* duties. This could be beneficial to the *Corporations Act* regime by clarifying the responsibility to supervise beyond s 190 and carelessness under s 180. However, because these duties are already limited in a variety of ways (e.g. through the Business Judgement Rule, the persons who are liable, the various requirements of being 'reasonable') that impact would be diluted. That dilution could then circumscribe the interpretation a Court might apply to the duties as set out for APRA.

2.8. A requirement for officers and ADIs to be to be 'open and cooperative' with APRA is troublesome. Although apparently benign, the requirement is uncertain in scope yet has significant penalties attached for breaches. *The APRA Supervision Blueprint*

(2015) sets out APRA's current expectations concerning regulated entities and their representatives (p.8). The *Blueprint* states that they are expected to be 'open and transparent in their dealings with APRA' and to be 'honest, candid, professional and courteous'. It specifies that 'Opacity or failure of a regulated entity to cooperate with APRA will require APRA to adopt a more intrusive level of oversight'. The *Blueprint* threatens without identifying overt penalties. While this is reasonably normal for regulatory authorities and consistent with regulatory practices on the Ayres and Braithwaite model, the penalty regime set out in the BEAR for ADIs and the implicit punishments for 'accountable persons', taken in conjunction with requirements to be 'open and cooperative' are much more troublesome. It is uncertain how the requirement of being 'open and cooperative' will be operationalised. Moreover, there is no identified link between the obligation to cooperate and the purpose for which information obtained through such cooperation may be used. Indeed, disclosures under threat of sanction could well lead to enforcement breaking down.

2.9. The BEAR seeks to impose on ADIs requirements to 'conduct [their] business consistently with good prudential outcomes' including 'conducting business with integrity, due skill, care and diligence and acting in a prudent manner'. The expectations are that an ADI is expected to 'conduct its business with integrity' and 'due skill, care and diligence', 'deal with APRA in an open and constructive way', and 'take reasonable steps to act in a prudent manner', 'organise and control its affairs responsibly and effectively' and apply all these across the whole firm (p 7). Not to live up to these expectations could give rise to liability for a civil penalty (p 14).

The context of these proposed requirements and their apparent source is the definition of 'prudential matter' in s 5 of the *Banking Act*. This refers to a prudential matter as a matter relating to the conduct of an ADI or its group of bodies corporate in such a way as to maintain a sound financial position and so as not to cause instability in the financial system, and conduct by an ADI and its group of its affairs with integrity, prudence and professional skill.

It is quite clear that a provision such as the definition of 'prudential matters' defining the ambit of powers of a body such as APRA is quite a different beast from enforceable expectations of performance. Generally, throughout the Banking Act, APRA is empowered to regulate in respect of prudential matters by means of conditions on registration, directions and other instruments setting out particular requirements with which ADIs must comply. This extends to appointing fit and proper persons and so forth. The BEAR's requirements are generalised and appear to be designed to fill in the interstices of those particular regulations.

An extension of liability to a generalised set of standards appears to be unobjectionable. However, even in the context of a civil penalty regime, requirements that are the subject of enforcement proceedings need to be explicit and clear. This, in the situation of liability in the carrying on of a business, even if banking, is not the case for the proposed civil penalties in the BEAR. The following are examples:

- The requirement to conduct its business with due care, skill and diligence is actually entirely novel for a firm. Usually, firms are disciplined by capital markets to be careful, which renders the stricture redundant in the normal course of events. The market signals any failure well before any regulatory intervention. A penalty may not add to the incentives to be careful etc, and as a punishment is of little effect.
- Further in relation to care, skill and diligence, it is unclear how the appropriate standard against which a firm's conduct will be measured would be determined. Standards of conduct are notoriously difficult to define even for individuals; typically, the standard of a reasonable person in that position in that type of company is used (as in s 180(1) of the *Corporations Act*). Consequently, rather than imposing a vague obligation on firms to be careful, a preferable approach would be to set out more precisely the required standards of behaviour for corporations as is the form of conditions and directions issued by APRA under the *Banking Act*. For instance, this could be done by referring to the standard of behaviour expected of a reasonably prudent ADI (perhaps not so particular as capital adequacy ratios etc, but certainly referring to something that is measurable and breach of which can be determined). This is not to say that specific areas of liability should not also be provided. For instance, failures to hold persons accountable and failures to register responsibility maps are specific behaviours by ADIs that could give rise to liability.
- The BEAR would also insist on 'integrity' on the pain of penalty. Where breach is contemplated, it is better to specify exactly what is contemplated. Even in the situation of directors' duties to avoid conflicts of interest, the general law has a degree of difficulty in pinning down what represents a conflict. That is even in the case of loyalty of a person where the interest of that person is clear. It is not at all clear what the equivalent would be for a corporation in a competitive environment – noting that the *APRA Act* in s 8 requires APRA to maintain a competitive industry in the context of maintaining systemic stability.
- As adverted to above in relation to individual responsibility, to require 'open and constructive cooperation' is vague. Consequently, it is unclear what firms must do to conduct themselves to the appropriate standard. This is not an issue if it is merely an expectation of APRA.

3. Individual Questions

Chapter 4 Questions

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?*

Response: Yes.

1.1 *Are there any other roles which should be included at a minimum?*

Response: We are concerned that the prescribed list does not include senior executives who may have responsibility for areas of the ADI that focus on the retail

side of an ADI's business. While such executives could be caught under the principles-based element of the proposed definition below, given it is generally the retail community that was a substantial factor in highlighting cultural problems within ADIs, specific reference to such senior executives should be made e.g. Head of Retail or Consumer Banking Services (or equivalent).

1.2 *Should any roles be excluded*?

Response: No

2. *Does the principles-based element of the proposed definition of accountable persons provide sufficient flexibility to reflect differences in business models and group structures?*

Response: While no definition is explicitly set out, we assume that the definition when formulated will cover 'individuals who have significant influence over conduct and behaviour, and whose actions could pose risks for the business and its customers' (p 5). It appears that the definition would be limited to persons who meet these requirements and who were 'responsible for the management of a significant proportion of the ADI business or activity based on its proportion of total gross assets, revenue or profit'. We think a definition based on these two factors is sufficiently flexible to reflect differences in business models and group structures. However, in relation to consistency with the Corporations Act, see para 2.6.

3. *Should the definition of accountable persons apply to individuals in the subsidiaries of a group or subgroup within an ADI parent, including where the subsidiaries are not regulated by APRA.*

Response: Yes.

Chapter 5 Questions

4. *Do the options canvassed by the expectations of ADIs capture the behaviours that should be expected under the BEAR?*

Response: We think there are significant problems with the expectations as drafted; see paras 2.6-2.9 above.

4.1 *Are there any other behaviours which should be included?*

Response: See paras 2.6-2.9 above.

4.2 *Should any of the behaviours be excluded?*

Response: See paras 2.6-2.9 above.

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

Response: See paras 2.6-2.9 above.

5.1 *Are there any other behaviours that should be included?*

Response: See paras 2.6-2.9 above.

5.*1 Should any of the behaviours be excluded?*

Response: See paras 2.6-2.9 above.

Chapter 6 Questions

We make no comment in relation to the questions relating to remuneration.

Chapter 7 Questions: Implementation and Transitional Issues

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

Response: Yes, but see para 2.3

11.2 *Should any of the prescribed responsibilities be excluded?*

Response: No

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

Response: Yes

Chapter 7 Questions: Removal and Disqualification

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

Response: Yes.

Chapter 7 Questions: Civil Penalties

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

Response: See para 2.9.

15 *Is the proposed definition of large ADIs appropriate?*

Response: No comment.

Chapter 7 Questions: General Implementation and Transition Issues

16 and 17 – *we* make no comment in relation to these questions.

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