CUSTOMER OWNED BANKING ASSOCIATION

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Manager
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The Treasury
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Dear Manager

Banking Executive Accountability Regime (BEAR) – July 2017

Thank you for the opportunity to comment on the BEAR consultation paper.

COBA is the industry association for Australia's customer owned banking institutions– mutual banks, credit unions, and building societies. Collectively, the sector we represent has $106 billion in assets and more than 4 million customers. These institutions make up more than 70 per cent of APRA's domestic ADIs.

The Government announced the BEAR as one of the 2017-18 Budget measures entitled "Building an Accountable and Competitive Banking System".

COBA welcomes measures to increase consumer confidence and accountability in the major banks.

This is a problem that was acknowledged by the House of Representatives Standing Committee on Economics *Review of Australia's Four Major Banks* (the 'Coleman Report'), which found that:

- there is an "accountability deficit" within the four major banks
- "the major banks have a 'poor compliance culture' and have repeatedly failed to protect the interests of consumers"
- "This is a culture that senior executives have created. It is a culture they need to be held accountable for."

However, we are concerned that the BEAR, as it currently stands, contradicts the Government's complementary intention to create competition in the banking system.

It is clear that we have a problem with competition in the banking market in Australia. The Coleman Report also found that:

- "Australia's banking sector is an oligopoly. The major banks have significant market power that they use to protect shareholders from regulatory and market developments"
- "Oligopolies are problematic when they are able to use pricing power to the detriment of consumers. Australia's banking system is such an oligopoly"

- "A lack of competition in Australia's banking sector has significant adverse consequences for the Australian economy and consumers"

The BEAR has been designed as a "one size fits all" approach, and will create excessive red tape on customer owned ADIs, whose behaviour was not the impetus of the BEAR measure. Red tape disproportionately burdens smaller institutions and will further restrict competition in a highly concentrated banking market.

COBA is concerned that the BEAR has been designed to solve a problem that exists in the major banks, not in the customer owned banking sector. The conduct of other ADIs was not examined and no case has been presented to apply the BEAR to other ADIs.

Customer owned banking institutions are different in that they are owned by their customers rather than a separate set of shareholders.

There is no case to apply the BEAR to customer owned ADIs because our business model ensures we have a built-in structural solution to conflict between customer interests and profit maximisation that plagues the major listed banks.

The community concern regarding recent poor behaviour by ADIs does not apply to our sector. There is no problem in our sector for the BEAR to solve.

Our sector is already effectively regulated by APRA's prudential framework which already includes standards covering many of the areas of the BEAR:

- culture: *Prudential Standard CPS 220 Risk Management* (CPS 220)
- remuneration & governance: *Prudential Standard CPS 510 Governance* (CPS 510)
- risk management: *CPS 220* requires an ADI to maintain a risk management framework that is appropriate to its size, business mix, and complexity; and
- fit and proper: *Prudential Standard CPS 520 Fit and Proper* sets out criteria for determining the fitness and propriety of responsible persons.

These standards apply in addition to the duties of directors under the Corporations Act.

APRA's existing regime is operating effectively for our sector. Additional requirements above and beyond what is currently in place are unlikely to lead to better prudential outcomes relative to the additional costs on smaller institutions.

The major banks have not only created the problem that the BEAR is intended to solve, but they are systemically important institutions (D-SIBs) and should be subject to greater prudential oversight, as noted in a speech on 21 July by RBA Assistant Governor Michele Bullock, "the systemic importance of the four major banks in Australia does mean that they need to have a proportionately greater supervisory focus."

COBA therefore seeks that the Government consider the following options in order to introduce a proportional approach and reduce the red tape created under the current BEAR proposal.

Options:

1. Exempt ADIs other than those with total liabilities greater than $100 billion from the regime
2. Exempt ADIs other than those with total liabilities greater than $100 billion from aspects of the BEAR.

In addition, the Government should introduce a materiality threshold for the deferral of income measure. While this measure may be appropriate for the major banks'

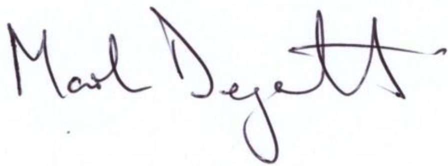
remuneration structures, it is not clear that it is appropriate for those seen in the customer owned banking sector.

Customer owned banking institutions were not the instigator for the BEAR and not the intended targets. Further our sector does not have the remuneration structures that create the incentives to undertake behaviour inconsistent with the BEAR.

COBA looks forward to engaging with the Treasury to ensure that the BEAR meet its intended outcome while ensuring that it does not place an excessive burden on smaller institutions.

Please contact Luke Lawler, Director - Policy at llawler@coba.asn.au or 02 8035 8448 if you wish to discuss any aspect of this submission.

Yours sincerely



MARK DEGOTARDI
Chief Executive Officer

Attachment A – a proportional approach to the BEAR

The disproportionate impact of a one size fits all approach

Under the BEAR, ADIs will have new ongoing reporting obligations and new conduct requirements.

The new conduct requirements, at first glance, are uncontroversial, e.g. an ADI must conduct its business with integrity, due skill, care diligence; deal with APRA in an open and co-operative way. Our sector does this now.

However, the BEAR will create a new world of regulatory risk, i.e. of breaching the BEAR. This creates a situation where an ADI could meet the conduct requirements, but risk breaching the BEAR by failing to meet excessive reporting obligations.

For example under the new ongoing 'accountability mapping' reporting obligations, ADIs will also be required to provide APRA with accountability statements to detail the roles and responsibilities of each accountable person. This process is likely to be excessively burdensome for smaller ADIs and disproportionate to their relative size and structure.

Imposing the BEAR on our sector will have no beneficial impact on consumers but will ensure that our businesses divert resources and scarce executive time to complying with the BEAR as well as proving to the regulator that we comply with the BEAR.

As APRA chair Wayne Byres commented to the Senate Committee on 30 May when asked whether the deferral of income measure would be straightforward to implement: "No. Like all of these things, the devil is in the detail."

The compliance costs associated with the BEAR will harm our competitive position. This will help the competitive position of major banks. Major banks can far more easily cope with new regulatory compliance requirements than their smaller competitors.

The BEAR will impose a massive new regulatory risk on our sector. To avoid any possibility of facing a $50 million fine, our sector's culture of regulatory compliance caution will inevitably mean that the BEAR will impost significant new costs.

Customer owned banking institutions will have to allocate significant time and resources to understanding and complying with a significant new regime with various new reporting and conduct requirements to avoid the risk of a $50 million fine. A fine of this size is crippling for all customer owned banking institutions and entirely disproportionate to the size of institutions in the sector.

For example, there are questions about what are "reasonable steps" to ensure that the 'expectations and accountabilities of the BEAR are applied and met'?

The consultation paper concedes ADIs "will need time to undertake changes to systems, structures, policies and contracts. In addition, ADIs will need time to register existing accountable persons with APRA and develop accountability statements for these individuals and accountability maps for the ADI group."

This will waste resources and harm the competitive position of our sector.

The only winners will be compliance lawyers and ultimately the major banks as the red tape burden weighs down their smaller competitors. It will place significant strain on human resources departments while providing marginal benefit above the existing prudential framework.

COBA proposes that Treasury take a proportional approach to the BEAR. This will reduce the regulatory cost on smaller ADIs and ensure that the BEAR appropriately

targets the largest institutions in Australia whose behaviour has led to these scandals and whose executives should be held accountable for them.

This does not mean that smaller ADIs are not accountable for their actions, as noted in both this submission and consultation paper, there are still significant existing prudential powers that can be used to hold executives to account.

COBA therefore seeks that the Government consider the following options in order to introduce a proportional approach and reduce the red tape created under the current BEAR proposal.

Proposals to introduce a proportional approach to the BEAR

Option 1: Exempt ADIs other than those with total liabilities greater than $100 billion

Under this option, ADIs below the $100 billion in total liabilities threshold are exempt from the BEAR regime. All other ADIs would be subject to APRA's existing regime under the current prudential standards.

This threshold appropriately captures the major banks that were the impetus for the House of Representatives Economics Committee findings that led to the BEAR. These are also the four ADIs identified by APRA as 'systemically important' institutions. This is also the threshold proposed for a 'large ADI' under the BEAR proposal.

Option 2: Exempt ADIs other than those with total liabilities greater than $100 billion from aspects of the BEAR.

Under this option, ADIs below the $100 billion in total liabilities threshold are exempt from certain aspects of the BEAR regime.

The Government would consult further with industry on the individual 'reduced' components of this regime, taking into account the relative costs and benefits of each measure.

Materiality threshold for the deferral of income measure

In addition to one of the above proportional approaches, the Government should introduce a threshold (say $500,000 in variable remuneration) below which variable remuneration does not need to be deferred. When setting this threshold, the Government should consider the role that shares or share-linked remuneration packages have in promoting short-termism, noting that these are not used in the customer owned banking sector.

COBA notes that one of the key drivers of poor behaviour is the remuneration structures evident in the listed banks, particularly the largest four banks. This has led to the BEAR proposal to defer part of an executive's variable remuneration.

The clear intent of this policy is to prevent short-termism from the large share-linked remuneration packages of major bank executives that can "incentivise a short-term focus or excessive risk-taking". It is not clear what benefit it will have on the smaller cash bonuses seen with customer owned ADIs.

Major banks provide a much larger amount of their senior executive remuneration as variable remuneration (equivalent to 133 per cent of fixed remuneration as variable remuneration compared to up to 19 per cent for customer owned ADIs). Higher levels of variable remuneration provide greater incentive to undertake behaviour that contradicts the BEAR. Deferring part of these large variable remuneration packages make sense. In addition, while the ratio of variable to fixed remuneration for major

banks is significantly higher, it is also calculated on a much larger fixed remuneration base (on average is 2 to 4 times higher than customer owned ADIs).

COBA believes that major bank remuneration packages are likely to have already met, or be close to meeting, the 40/60 per cent thresholds for deferral of variable remuneration due to the use of deferred share-linked instruments. PWC supports this assertion noting that for "senior executives in the large Australian banks the impact may be minimal, with deferral rates typically being 50% of annual incentives, and higher if LTIs are included".[1]

Customer owned ADIs are unable to issue the ordinary shares that primarily comprise the deferred component of the major bank remuneration packages. This means the 40/60 per cent threshold is not appropriate for our sector given that we do not have access to the main tool to meet this obligation—the ordinary share. Any deferral of variable remuneration takes the form of deferred cash bonuses. While some COBA members defer these bonuses, it is not common practice.[2] Additionally, the value of deferred shares over time is different to the value of deferred cash bonuses. While shares can increase or decrease value over time, deferred cash bonuses can only decrease in value (in real terms).

While the rationale for deferring large variable remuneration packages is clear, the blanket application to all packages will lead to a situation where those whose behaviour drove the change (the major banks) have minimal transition costs, while those that did not (customer owned ADIs) will have to revamp their variable remuneration. This is not an equitable outcome.

Furthermore, not all customer owned ADIs currently provide variable remuneration packages. Under this blanket proposal, if they were to offer these packages they would need to defer part of this remuneration. This could deter ADIs from using performance-linked variable remuneration. This may not be a prudentially sound outcome.

Table 1: Indicative remuneration data for senior managers[3]

	Average fixed remun.	Total variable remun. to total fixed remun. ratio		Deferred variable remun. to variable remun. ratio	
ADI type (number)	$'000s	All ADIs	ADIs with variable remun.	All ADIs	ADIs who defer remun.
Major Banks (4)	612	133%	133%	62%	62%
Largest customer owned ADIs (10)	286	12%	19%	16%	32%
Mid-sized customer owned ADIs (10)	219	9%	11%	0%	0%
Smaller customer owned ADIs (10)	160	1%	3%	0%	0%

[1] PWC Perspectives on the new Banking Executive Accountability Regime, Page 2
[2] Note some COBA members do not defer bonuses but have scope within their remuneration policies to do so.
[3] COBA estimates based on a selection of most recent APS 330 remuneration disclosures to APRA (publicly available on ADI websites)

Attachment B – Additional comments

Chapter 4 – Individuals to be covered by the BEAR

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?

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?

The consultation paper notes that the "accountable persons" concept intends "to build on, rather than replace, existing concepts of responsibility and accountability, such as definitions of 'responsible persons', 'directors' and 'senior managers' under APRA's Fit and Proper framework."

COBA questions whether it is appropriate to create another layer for smaller ADIs and whether it would be more appropriate to utilise the existing responsible personnel regimes for smaller ADIs to avoid duplication.

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?

Customer owned banking institutions have subsidiaries that undertake a number of APRA-regulated and non-APRA regulated activities.

Any requirement to defer income for these subsidiaries could put these subsidiaries at a competitive disadvantage to other companies, such as insurance companies, that are not subject to the BEAR regime.

COBA also notes that the identification of accountable persons in these subsidiaries is likely to increase the number of accountable persons and create a significant amount of additional red tape.

Furthermore, COBA notes that it is not clear how APRA will be able to take action against any subsidiary or subgroup not regulated by APRA.

Chapter 5 – Expectations of ADIs and accountable persons under the BEAR

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

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

COBA notes that these expectations of behaviour could already be met under customer owned banking institutions' requirements under APRA APS 520 Fit and Proper Framework and the Corporations Act 2001 (Cth) as well as their general governance processes.

However, COBA notes that further clarification must be required as to the concept of "reasonable steps" to ensure that the 'expectations and accountabilities of the BEAR are applied and met'.

The introduction of civil penalties increases the need for these expectations and accountability to be clear. This is further enhanced in the case of customer owned ADIs that are likely to be threatened by the prospect of a $50 million dollar fine as a 'small ADI'.

Chapter 6 – Remuneration

6. Would deferring variable remuneration be likely to result in a shift from variable to base remuneration? Would this be problematic and, if so, can anything be done to prevent this outcome?

Yes. Deferring variable remuneration into the future will reduce the perceived value of that particular reward, and the overall concept of variable remuneration. This is likely to lead to potential employees perceiving this variable remuneration with a 'hair cut'. This is likely to lead to remuneration flowing from variable sources to fixed remuneration. This will reduce the board's ability of the offer performance incentives to senior executives.

As noted in Attachment A, COBA believe that in order to minimise the impact of this change that the Government should exempt variable remuneration below a certain threshold from deferral requirements.

Not all customer owned banking institutions currently have senior executives with variable remuneration packages. However, they may need to pursue this option in future in order to attract the necessary talent and the forced deferral of variable remuneration is likely to reduce the flexibility in designing these remuneration packages.

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

No. As noted in Attachment A, COBA does not believe that neither this nor the 40 per cent deferral is appropriate for customer owned banking institutions who pay lower levels of variable remuneration and do not pay executives in share-linked instruments that would predominately be used to meet deferral requirements at listed banks.

COBA believes that the Government should introduce a materiality threshold for the deferral of income measure below which variable remuneration would not be deferred. This approach is taken in the UK.

COBA members also note that there are likely to be issues about how to treat deferred income when executives leave the ADI, interactions with fixed term contracts and whether APRA will receive approval rights over payment of deferred bonuses.

Chapter 7 – Implementation and transitional issues

Registration and accountability mapping

COBA notes that there are concerns about APRA's register of accountable persons not being publicly available. COBA members regularly check the ASIC and APRA disqualifications registers as part of due diligence processes before making an appointment. It would be valuable for ADIs to have access to this register for transparency purposes. Furthermore, individuals on this register must be notified if their name is on the register.

One member noted that it costs about $60,000-$80,000 to hire a senior executive which includes the use of the services of an executive search agency. If this recruitment process identified a candidate that had previously been removed by APRA, the ADI may be forced into a position where it would have to incur these costs again.

COBA does not support any blanket requirement where ADIs must inform APRA when individuals have been subject to internal disciplinary proceedings. COBA notes that there is the potential for vexatious claims that can impair current and future employment prospects. In addition, not all internal disciplinary proceedings are related to the prudential mandate of APRA and the policy intent of the BEAR.

As noted in our response to Chapter 4, there is already an existing framework for identifying and registering responsible persons (under CPS 520, and the corresponding RF 520 Responsible Persons). COBA has concerns that a parallel framework could result in the duplication of registration for the same individuals currently notified to APRA as responsible persons. It would be beneficial to streamline and align these requirements.

Removal and disqualification

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

The consultation paper notes that a potential approach is to allow APRA to "to disqualify a person without applying to the Federal Court". APRA currently has the power to disqualify an individual from an ADI by applying to Federal Court. The case has not been made that APRA requires enhanced powers beyond its current disqualification powers. In any case, COBA believes that there must be an independent appeals mechanism to ensure that there is proper legal process.

Civil penalties

15. Is the proposed definition of large ADIs appropriate?

Yes. COBA agrees that the proposed threshold for a 'large ADI' is appropriate. This has been reflected in our proposed proportionate approach to the BEAR.

COBA also notes that the maximum $50 million fine for a 'small ADI' is going to have significantly different impacts for an ADI with $90 billion, $1 billion or $100 million in liabilities and that in addition to the noted seriousness of the contravention that the courts exercise proportionately relative to a small ADI's relative liability size.

General implementation

16. What would be a reasonable period of time after the passage of legislation for ADIs to implement the BEAR?

COBA notes that given the absence of detail, short consultation period and COBA's request for proportional approach that it is difficult to ascertain a reasonable time for ADIs to implement the BEAR. The timing required is also dependent upon the extent to which individual ADIs have already undertaken the required processes, or similar exercises, and the relative staffing of the relevant business units (particularly human resources departments). One certainty is that without a proportional approach, the BEAR will have a disproportionate impact on smaller institutions.

In terms of timing between implementation and legislation, COBA notes that the legislative framework underpinning the UK Senior Manager Regime, the Financial Services (Banking Reform) Act 2013, was passed on 18 December 2013. The Senior Managers Regime came into force on 7 March 2016.[4] A minimum two-year time frame could be appropriate for the BEAR.

17. How significant are the costs associated with implementing the BEAR? How can these costs be mitigated consistent with the policy intent of the BEAR?

As noted in Attachment A, COBA believe that the most effective way to mitigate costs is to implement a proportional approach that exempts smaller ADIs from all or some of the BEAR requirements.

This is consistent with the policy intent of the BEAR which seeks to minimise ensure that there is greater individual accountability within the major banks that have led to the creation of the BEAR.

The relative resourcing required will depend upon the extent to which ADIs have already undertaken the required processes, or similar exercises, and the relative staffing of the relevant business units (particularly human resources departments).

[4] Bank of England, News Release - New accountability regime for banks and insurers comes into force, 7 March 2016