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Dear Sir/Madam

Banking Executive Accountability Regime - Submission of Henry Davis York

Henry Davis York has one of Australia's leading banking, financial and regulatory practices and has extensive experience in advising financial service providers on regulatory and governance issues.

We welcome the opportunity to provide feedback on the Consultation Paper issued by the Australian Treasury (**Consultation Paper**) in relation to the proposed Banking Executive Accountability Regime (**BEAR**) based on this experience.

1 Introductory remarks

Our initial and overarching comments in respect of the Consultation Paper are as follows:

(a) The objective of the BEAR is to apply a heightened responsibility and accountability framework to the most senior directors and executives of Authorised Deposit-taking Institutions (**ADIs**) in order to enhance culture and encourage behaviours that are consistent with achieving good prudential outcomes.

We are supportive of this objective but query the rationale for limiting the scope of the BEAR to ADIs and their subsidiaries. Achieving good prudential outcomes through enhanced accountability should be a universal aspiration for all financial institutions regulated by the Australian Prudential Regulation Authority (**APRA**) and we see no reason why the remit of BEAR should be limited in the way proposed.

We are also concerned that the limited scope of the BEAR will have the unintended consequence of giving non-ADIs a competitive advantage as they will not be subject to the more onerous accountability and governance framework introduced by the regime.

Further, one of the key criticisms levelled at the Senior Managers and Certification Regime (**SCMR**) was its uneven application to regulated entities within the UK financial sector. As a consequence, following consultation, the Financial Conduct

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Authority and Prudential Regulation Authority have recently announced that the SCMR will be extended beyond the banking sector to all regulated entities including insurers.

We encourage APRA to consider a more comprehensive application of the BEAR to other APRA-regulated entities to build on the learnings from the UK and avoid any unintended competitive bias within the industry.

(b) We note from the deliberations during the Senate Economics Legislation Committee on 30 May 2017 that the BEAR's focus is executive conduct as it relates to prudential outcomes, rather than as it relates to market conduct.

Whilst the Consultation Paper confirms that the BEAR will apply to poor conduct that is of a systemic and prudential nature, much greater clarity on the prudential complexion of the regime is required.

The BEAR seeks to regulate conduct of individuals but there is no clear demarcation between the role of APRA, as prudential regulator, and the role of the Australian Securities and Investments Commission (**ASIC**), as market conduct regulator.

Further, the Consultation Paper contains very limited guidance on how the BEAR will interact with existing obligations under current prudential standards (including *CPS 520 Fit and Proper*) and it contains no guidance on how the BEAR will interact with directors' statutory duties or AFS licensees' obligations under relevant corporations legislation.

Clarity on these issues is essential before an informed and comprehensive consultation process can take place.

(c) The guidance contained in the Consultation Paper regarding the BEAR is very high level and there is a pressing need for more detail on many aspects covered. The period allowed for submissions has also been relatively short given the importance of the regime and its potential consequences for the financial services industry.

We believe that all parties would benefit from a further round of consultation after additional guidance has been provided in response to the Consultation Paper submissions. In our view, this should precede any proposed consultation on the form and substance of the draft legislation and/or prudential standards.

Our responses to a number of the specific questions raised in the Consultation Paper are detailed below.

2 Specific response to queries raised in the Consultation Paper

2.1 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?

Our starting premise is that there should not be a principles-based element to the definition of accountable persons. Instead, the BEAR should prescribe the individual roles that will be subject to its requirements and we would consequently be supportive of a broader list of prescribed accountable persons.

This would facilitate greater certainty for individuals as regards their obligations and should reduce the inconsistent application of the BEAR by eliminating the need for a subjective assessment of whether an executive who is not prescribed as an accountable person falls within the principles-based definition.

(a) Question 1.1: Are there any other roles which should be included at a minimum?

We suggest that the proposed list of accountable persons in the Consultation Paper be augmented to include the Chief Compliance Officer and the Chief Anti Money Laundering and Counter Terrorism Officer, or equivalent. Consideration should also be given to extending the proposed list to capture all executive members of the board of directors who do not hold one of the roles specified in the prescribed list of accountable persons.

(b) Question 1.2: Should any of the roles be excluded?

Given the intention that the definition of accountable persons encompasses individuals who have significant influence over conduct and behaviour and whose actions could pose risks to the business and its customers, we query whether the Head of the Remuneration Committee should be included in the list.

It is unclear whether the BEAR is intended to apply in relation to ADI executives who operate outside of Australia. If this is the intention, we consider that it will be particularly difficult to implement the BEAR in jurisdictions where ADI executives are also subject to local senior manager accountability regimes. There will need to be some flexibility in the application of the BEAR to ensure that internationally-based executives do not face conflicts between the BEAR and their local regime.

We also query whether non-executive directors (**NEDs**) should be expressly excluded from the proposed definition of accountable persons or the obligations imposed by the BEAR should be specifically tempered for NEDs to accommodate their distinct role. NEDs are, by their very nature, not involved in the day-to-day running of the business and should not be subject to the same obligations as directors and senior executives who are involved in day-to-day management and operational decision making.

2.2 **Question 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?**

We are not supportive of a principles-based approach for defining accountable persons. The principles-based definition outlined in the Consultation Paper is subjective and vague. If widely interpreted, the description of "individuals who have significant influence over the conduct and behaviour, and whose actions could pose risks to the business and customers" could extend to many middle management roles and lead to inconsistent application by ADIs, in the absence of much more expansive guidance.

If APRA is minded to include a principles-based element in the definition of accountable persons, it should be informed by APRA's mandate, which is to establish and enforce prudential standards and practices. This is distinct from ASIC's mandate, which is financial market integrity, business conduct and consumer protection in the financial system. Giving APRA the power to police behaviour that poses risks to customers seems to be straying into ASIC's territory. For this reason, we suggest that any principles-based element of the definition of accountable person should be amended to reflect the prudential nature of the BEAR i.e. individuals who have a significant influence over business behaviour and risk management and whose actions could *pose risks to the financial stability of the institution and cause financial losses to beneficiaries.* The word 'beneficiaries' could be defined to include customers and shareholders.

2.3 **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 Consultation Paper proposes that the BEAR will extend to subsidiaries of ADIs, including those that provide non-banking services. We have already outlined in section 1(a) above our view that APRA should consider extending the reach of the BEAR beyond ADIs.

We are not supportive of the proposition that all subsidiaries of ADIs should be captured by the BEAR as the application of the regime should not be determined by the corporate structure of a conglomerate. This would lead to the inconsistent application of governance standards across the industry solely based on the regulated activities undertaken by a parent company and would have the unintended consequences of introducing competitive bias.

Instead, the BEAR should expressly identify which APRA regulated-entities are within its remit based on the perceived need to ensure their business is conducted in a manner consistent with good prudential outcomes.

Extending APRA's regulatory powers under the BEAR to non-banking subsidiaries that are not otherwise regulated by APRA goes beyond its mandate. We do not consider this is appropriate, not least because the Consultation Paper suggests the BEAR builds on the regulatory framework contained in existing prudential standards which may not apply to these entities. These non-banking subsidiaries will necessarily be subject to other, specific legislation and their executives and senior management will be subject to various duties such as directors' duties under the Corporations Act 2001 (Cth).

We also consider that the legislation should prescribe the approach where foreign subsidiaries operating in Australia are exposed to a number of different accountability regimes.

2.4 **Question 4: Do the options canvassed for the expectations of ADIs capture the behaviours that should be expected under the BEAR?**

We consider that it would be duplicative to impose the proposed expectations upon ADIs, given the extent of other regulatory obligations on ADIs, and the fact that it is proposed to also impose these expectations on accountable persons (who would be responsible for ensuring that ADIs discharged their obligations under the expectations in any case).

This would also appear to exceed the scope of the BEAR, which is focussed upon executive accountability, not ADIs' responsibilities more broadly. We note that the SMCR does not impose equivalent expectations such as those proposed in the BEAR on regulated entities (though it does on individual Senior Management Functions).

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

The intention of the BEAR is to regulate executive conduct as it relates to prudential outcomes although the behaviours listed for accountable persons do not specifically refer to prudential outcomes. Prudential regulation focusses on the behaviours of the entity, rather than the impact on consumers. Whilst APRA focuses on failings in governance, risk management and internal controls, the key issue is how these failures impact the financial stability of the entity. The prescribed behaviours for accountable persons should therefore align with the prudential objectives of the BEAR.

There is no guidance on if, how and when an ADI may be required to inform APRA of any breaches of these expectations. Given the potentially severe consequences for any accountable person notified to APRA, and in the interests of procedural fairness, we are strongly of the view that the obligation to notify APRA should not be triggered until the matter has been fully investigated and substantiated and any formal disciplinary action taken against the individual has concluded.

2.6 **Question 7: What are the complexities in defining variable remuneration, including in relation to non-cash remuneration?**

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?

We are broadly supportive of the deferral of variable remuneration as a means of dis-incentivising short-term focus or excessive risk taking. However, the definition of variable remuneration must be sufficiently flexible to accommodate the differing remuneration structures and practices across the financial services sector.

We note that larger ADIs already defer a significant proportion of short-term incentive (**STI**) outcomes. STIs are usually based on both financial and non-financial measures, with the latter reflecting risk management outcomes and progress on the strategy implementation. The board usually has a discretionary power to reduce or forfeit an STI payment in the event of a material issue or financial misstatement.

A portion of the STI can be deferred as restricted equity, ensuring that incentive payments are better aligned with the interests of shareholders, as the ultimate value of the deferred portion is tied to the share price at the end of the vesting period. We consider that the definition should specify that deferred non-cash remuneration in the form of shares should be the share price at the end of the vesting period rather than being tied to "the delivery of results in excess of that required to fulfil a job description". This is one way of achieving good prudential outcomes through deferred variable non-cash remuneration.

2.7 **Question 9: Is the proposal for deferring 60 percent of the variable remuneration of certain executive accountable persons appropriate?**

The proposal to defer 60 percent of the variable remuneration of certain executives for a minimum period of four years is broadly consistent with the current practice in Australia's largest ADIs although we consider its application should be limited to the Chief Executive Officer.

We query whether it may be necessary to analyse whether this proposal has a disproportionate impact on smaller ADIs and their ability to attract talent.

2.8 **Question 10: Are the proposed enhancements to APRA's remuneration powers appropriate?**

Further guidance is required in respect of the enhancement of APRA's remuneration powers. It is proposed that APRA will be given enhanced powers to review and adjust remuneration policies where it believes those policies are producing inappropriate outcomes although there is no guidance around what might constitute an inappropriate outcome.

Having said that, we are broadly supportive of the enhancement of APRA's remuneration powers. Given the purpose of the BEAR, the granting of enhanced powers should be limited to circumstances where APRA finds that the remuneration policy of an ADI is encouraging behaviour which is inconsistent with appropriate risk-taking and prudent management of the entity (rather than, for example, conduct or compliance failures which do not impact the financial viability of the entity).

If an accountable person contravenes the BEAR and/or is removed or disqualified by APRA, it would be appropriate for APRA to have enhanced powers to reduce that person's variable remuneration. Furthermore, consideration should be given to extending APRA's powers to include clawback provisions, enabling the recovery of variable remuneration of an accountable person if matters come to light which could affect the prudential viability of an APRA regulated entity outside of the 4 year vesting period.

2.9 **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?**

We are supportive of accountability mapping and consider that it will provide clarity for individuals on their role and responsibilities within their organisation.

Prescribing a set of responsibilities which must be allocated to accountable persons will help with consistency and ensure that key areas of responsibility are covered. We consider that

each prescribed responsibility should be able to be allocated to one or more accountable persons given the overlapping nature of many roles.

The completion of accountability statements and accountability maps will represent a vast amount of work for ADIs, particularly if the BEAR extends to the subsidiaries of ADIs. It will be critical to ensure that the process is streamlined to the greatest extent possible and provides for easy amendment given the fluid nature of executive teams and their responsibilities.

Without commenting on the appropriateness of each proposed prescribed responsibility, where appropriate, the prescribed responsibilities should replicate the responsibilities outlined in APRA's required prudential standards, such as responsibility for risk frameworks, governance frameworks and capital adequacy.

2.10 **Question 12: Should ADIs have discretion to add to the prescribed list of responsibilities?**

ADIs should have discretion to add to the list of prescribed responsibilities to accommodate different business structures. Allowing ADIs to add to the prescribed list of responsibilities where relevant for their organisation will also contribute to the aim of the BEAR in ensuring executives and senior managers are aware of their responsibilities.

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

We are broadly of the view that the proposal to enhance APRA's powers to disqualify an accountable person is appropriate.

However, we do not feel that it is appropriate for APRA to have the power to disqualify a person without having to apply to the Federal Court given the significant consequences it could have on the individual, their future employment prospects and the ADI as a whole. In this respect, we query whether it is appropriate for APRA to determine if someone is a fit and proper person and/or has failed to comply with the BEAR since that role may be perceived as quasi-judicial in nature.

Further guidance on the proposed operation of this process is critical, especially with regards to any appeal process and the onus and standard of proof that will be applied. Given the potential financial, employment and reputational consequences of a removal or disqualification order, it is essential that appropriate review and appeal mechanisms be built into the regime to ensure procedural fairness.

It is appropriate that an ADI is required to inform APRA where an accountable person, senior manager, director or auditor has been dismissed or their variable remuneration had been reduced due to a contravention of the BEAR. However, we reiterate our comments above that in the interests of procedural fairness, the requirement to report should only arise when the ADI's investigations have concluded and the individual has been found to be responsible. ADIs should not be required to report all internal disciplinary proceedings, including suspensions, since the individual may subsequently be absolved of any contravention.

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

In our view, it is presently unclear how the civil penalty regime relates to the expectations outlined for accountable persons and further guidance is required in this respect. Will, for example, the expectations be set out in a prudential standard and APRA be given the power to enforce the standard through civil penalty proceedings?

Furthermore, we do not support the expectations which the BEAR proposes to place on ADIs themselves. ADIs and other APRA regulated entities are already subject to prudential standards. The proposed expectations for ADIs are duplicative and do not align with the purpose of BEAR to increase individual accountability of executives and senior managers.

It is suggested that APRA may seek a civil penalty where an ADI fails to hold accountable persons to account under BEAR. However, it is unclear whether this means that the ADI failed to discipline, suspend or dismiss the accountable person. It is also proposed that a civil penalty may be sought where an ADI does not appropriately monitor the suitability of accountable persons, however it is not clear what this requires of the ADI or how this relates to the need for an accountable person to take reasonable steps to meet the expectations of the BEAR.

Finally, we are concerned that the proposed expectations of accountable persons are cast very broadly, increasing the risk of adverse findings in civil penalty proceedings and potentially leading to private and class actions.

2.13 **Question 15: Is the proposed definition of large ADIs appropriate?**

We support the proposal to vary the maximum amount of the civil penalty according to the size of the ADI. However, in order to ensure fairness amongst ADIs of various sizes, we suggest that the maximum amount of the civil penalty could vary depending on a qualitative measure specific to the ADI from time to time, such as a proportion of the ADI's total assets.

2.14 **Question 16: What would be a reasonable period of time after the passage of legislation for ADIs to implement the BEAR?**

ADIs will require a significant amount of time to implement the requirements of the BEAR.

In particular, even if the allocation of prescribed responsibilities and accountability mapping only extends to a small number of directors and executive management, it will have significant and time consuming impacts on the broader business. For example:

(a) Senior executives will want their own teams to have clearly documented roles and responsibilities so they can ensure their prescribed responsibilities are adequately covered and they can attest to compliance.

(b) Risk, compliance and governance frameworks will have to be updated and internal reporting frameworks will have to be reviewed to ensure senior executives are receiving all the information they require.

(c) Employment contracts may need to be re-negotiated and roles and responsibilities will need to be updated with significant input from human resources, risk and governance.

(d) ADIs will also have to reconsider their breach reporting regimes to ensure they take into account the BEAR.

We consider that we can learn from the experience in the UK, where the SMCR came into effect just under two years after it was announced. We suggest that a minimum of 18 months from the date the legislation is passed should be allowed for implementing the BEAR.

Yours faithfully
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