Melbourne
Casselden
Level 39, 2 Lonsdale Street
Melbourne VIC 3000

Canberra
Level 3,
39 Brisbane Ave
Barton, ACT 2600

3 August 2017

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

By email

Re: Bank Executive Accountability Regime consultation

Dear sir or madam,

Industry Super Australia (ISA) welcomes the opportunity to provide a submission to Treasury in response to the proposed Bank Executive Accountability Regime (BEAR).

ISA manages collective projects on behalf of Industry SuperFunds, including research and advocacy, with the objective of maximising the retirement savings of over five million industry super members.

Around one half of Australian workers are members of Industry SuperFunds.

Many Industry SuperFund members bank with the major Australian banks and have a portion of their retirement savings invested in the shares and other securities of major Australian banks. An accountable and appropriately regulated banking system is important to ensure that Industry SuperFund members, as part of the broader Australian community, are treated fairly by the banking sector.

The BEAR seeks to restore community trust in the financial system, and improve efficiency.

While this is an important objective, policy makers should approach the BEAR proposals with caution. The BEAR will increase regulation, but is not clear that it will change how major banks treat customers or the broader community, and therefore it may not meaningfully improve community trust in the banking system.

Whether the BEAR will have even a modest effect on behaviour will depend critically on the legally enforceable expectations of Authorised Deposit-Taking Institutions (ADIs) and accountable persons. The approach outlined in the Consultation Paper is silent on what the Financial System Inquiry identified as a minimum condition for meeting community expectations, namely “fair treatment of customers”. Crafting effective expectations will require real dedication to improving bank accountability, because doing so will necessarily affect product pricing, and terms and conditions, which in turn affects the economics of banks.

The BEAR also risks undermining the ability of the Australian Prudential Regulation Authority (APRA) to perform its core mission, because some of the issues involved differ from, and could even be in tension with, prudential regulation. Should APRA be both a prudential regulator, and a community expectations regulator?

Background

Treasury's consultation paper on the BEAR identifies community concerns about poor culture and behaviour at banks, resulting in participants being treated inappropriately by banks and related financial institutions at times.

Given that the reforms are premised on "growing community concern" about the banking system, for the BEAR to be successful it must eliminate the behaviour in the banking system that underlies these concerns.

In describing the concerns, the consultation paper draws on findings in the House of Representatives Standing Committee on Economics Review of the Four Major Banks (the Coleman Report) that the major banks have a "poor compliance culture" and have failed to protect the interests of consumers. The Coleman Report places responsibility for these matters at the feet of senior executives, noting that "this is a culture that senior executives have created. It is a culture that they need to be accountable for."[1]

It is widely accepted that scandals in recent years have contributed to public distrust in the major banks and the banking system. It is a rare day to open an Australian newspaper and not be confronted with another instance of a bank charging customers fees without providing a service, or a dodgy financial adviser banned from providing financial services, together with a report of record profits and bonuses. That is, doing wrong by consumers, while doing right by bank insiders.

While it is easy to claim that the community is concerned about frequent scandals in the banking sector, concrete examples better make the point:

- A review of major media for the first six months of 2017 suggests that the big four banks and AMP have incurred up to $148 million[2] payable in compensation, reimbursements or refunds for alleged misconduct such as charging fees for advice that was not given, giving poor financial advice or failing to properly apply fee reductions. This estimate is particularly stark in light of allegations of "serious and systemic" non-compliance with anti-money laundering and counter terrorism laws at Commonwealth Bank[3]
- All of the major banks (ANZ, Commonwealth Bank, NAB and Westpac) and Macquarie have entered into enforceable undertakings with the Australian Securities and Investments Commission (ASIC) in the 12 months to August 2017 after their foreign exchange traders manipulated the foreign currency market over several years[4]

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[1] House of Representatives Standing Committee on Economics Review of the Four Major Banks, First Report ('Coleman Report'), 15.

[2] Clancy Yeates and Georgia Wilkins, NAB and Bankwest forced to repay customers: ASIC, *WA Today*, 2 February 2017; Adele Ferguson, 'I'm just a broken-down old shearer' – CBA faces grilling over CommInsure, *Canberra Times*, 4 March 2017; Commonwealth Bank media release, CommInsure notes ASIC report, 23 March 2017; 17-145MR Compensation update: major financial advisory institutions continue refund programs for fees-for-no-service, 19 May 2017; 17-178MR, ASIC bans former Westpac adviser for five years, 8 June 2017; CBA advice scandal payouts top $29m, *Herald Sun*, 16 June 2017.

[3] AUSTRAC media release, AUSTRAC seeks civil penalty orders against CBA, 3 August 2017.

[4] 16-455MR ASIC accepts enforceable undertakings from NAB and CBA to address inadequacies within their wholesale spot FX businesses, 21 December 2016; James Frost and James Eyers, CBA and NAB admit impropriety in foreign exchange trading, *Sydney Morning Herald*, 21 December 2016; 17-065MR ASIC accepts enforceable undertakings from Westpac and ANZ to address inadequacies within their wholesale FX businesses, 15 March 2017; Sue Lannin, Westpac and ANZ to improve supervision of staff after foreign exchange manipulations, *ABC News*, 15 March 2017; 17-144MR

Although the Coleman reports finding of ‘poor compliance culture’ created by senior bank executives[5] partly explains the ongoing scandals, the answer likely goes deeper. After all, the Coleman report finding begs the question of why senior executives have led their institutions in the manner they did, and how such a culture developed.

Part of the answer is likely to be that banks focus not on the wellbeing of the community or customers, but (in practice) on the commercial interests of the bank, the interests of insiders, and a very narrow conception of shareholder interest – a conception which considers shareholders to be deracinated entities with no community, family, or values; whose only interest is profit.

The proposed BEAR reforms are unlikely to change how banks treat customers or the broader community

The major banks in Australia, and many other advanced economies, do not exist to serve the community (even though the core banking services they provide are arguably utilities). Today, the major banks exist to make money from the community, and prioritise this. Bank behaviour is unlikely to change until their institutional objectives change, and are broadened.

The proposals leave critical matters unanswered

The consultation document indicates that the expected conduct of ADIs and accountable persons will be outlined in legislation that would set a standard of conduct that the community expects of senior members of the banking sector.

These expectations will determine the effectiveness of the reform. If they have no teeth, the ability to remove executives and others who do not satisfy the expectations will similarly lack effectiveness.

The Consultation Paper suggests that the expectations of a bank could be to:

- conduct its business with integrity;
- conduct its business with due skill, care and diligence;
- deal with APRA in an open and cooperative way; and
- take reasonable steps to:
    - act in a prudent manner, including by meeting all of the requirements of APRA’s prudential standards, and maintaining a culture which supports adherence to the letter and spirit of these standards;
    - organise and control its affairs responsibly and effectively; and
    - ensure that these expectations and accountabilities of the BEAR are applied and met throughout the group or subgroup of which the ADI is parent.

Such a set of expectations are unlikely to meet the objectives of the BEAR. This is because they:

- Do not reference “fair treatment of customers”, or specify model behaviours to do so.
- Do not give regard to community interests, or specify how to determine what those are and how to give them regard.

ASIC accepts enforceable undertaking from Macquarie Bank to address inadequacies within their wholesale FX businesses, 19 May 2017.

[5] Coleman Report, 15.

- Do not identify how banks should behave when their short term commercial interests (or a narrow conception of their shareholders' interests) are in tension with fair treatment of customers or community interests. Indeed, one interpretation of the heart of the discontent with banks is that they have not appropriately resolved those tensions in the past.
- Would be difficult to meaningfully enforce. They seem too general and aspirational for a regulator to predictably determine when a firm has fallen short of the expectations such that enforcement action appropriate.

The expectations outlined in the Consultation Paper for accountable persons have similar weaknesses.

The regime should also include a mechanism for testing whether community expectations are met against predictable criteria.

Aspects of the proposed reforms depart from traditional prudential regulation and could harm APRA's ability to perform its core mission

A threshold issue for policy makers is whether the APRA is the right institution to undertake the responsibilities in these reforms, including assessing ADI executive accountability against community expectations.

APRA's primary objectives are to "establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions [it supervises] are met within a stable, efficient and competitive financial system".[6] The focus is fundamentally on ensuring institutions meet their obligations (i.e. they do not fail) and on stability in the financial system. APRA is not a law enforcement regulator like ASIC or the Australian Competition and Consumer Commission. It is not focused on securing the best banking outcomes for the community or even the best outcomes for banking consumers.

Given its primary focus on institutional and financial system stability through prudential regulation, APRA is arguably not the ideal institution to take on the responsibilities of the BEAR.

Prudential regulation is often in tension with business conduct regulation, which is precisely why APRA and ASIC are separate. Many prudential regulators believe that the threat of sanctions can result in prudentially regulated entities or their personnel concealing significant risks, raising the potential of a failure and its severity. Therefore, to perform its role effectively, APRA needs to maintain a close relationship with banks to be advised when there is a threat to prudential concerns.

Introducing policing responsibilities such as the removal and disqualification of executives, and bringing actions for civil penalties, may be more suited to another regulatory body, perhaps even a new one focused on developing and enforcing the social licensing requirements of banks.

Thus, while the BEAR reforms have a commendable objective, addressing the underlying issue will require genuine consideration of the extent and content of banks' social license. It is not clear that this can be achieved by deferring variable remuneration for a few years and empowering APRA to remove or disqualify executives.

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[6] APRA Vision, Mission and Values.

Genuinely successful reform of the banking sector likely will require the social license of banks to be fully explored and incorporated into bank licensing requirements.

Variable remuneration

The proposals seek to require at least 40 to 60% of variable remuneration to be deferred for four years.

It is important to note that this proposal is a prudential measure, in that it seeks to reduce the incentive for an executive to take significant risks that lift short term variable remuneration but ultimately damage the firm. This proposal will not affect the behaviour of banks toward customers or the community more broadly (financial system and institutional stability concerns were not the community concerns underlying the impetus for reform).

The proposal risks raising overall remuneration as bank executives bargain for higher fixed and variable remuneration to compensate them for the deferral period. This could, in turn, heighten community concerns about bank remuneration.

Policy makers should consider whether the magnitude of variable remuneration relative to fixed remuneration commonly provided in the banking sector, not just the deferral period, contributes to risk.

Assuming relatively large amounts of variable remuneration remain market practice going forward, deferring variable remuneration could be beneficial. However, a stronger approach might directly challenge the culture of the institutions such that executives do not need to have a financial incentive to avoid imprudent risks to the firm.

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Thank you again for considering our comments. We would be very pleased to discuss any matters raised in this letter. Please do not hesitate to contact us if additional information would be helpful.

Kind regards,

Zachary May
Director of Policy
Industry Super Australia