Banking Executive Accountability Regime (BEAR)

KPMG Response to Consultation Paper

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

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Banking Executive Accountability Regime: KPMG's submission to consultation process

Thank you for the opportunity to provide feedback on the Banking Executive Accountability Regime (BEAR) Consultation Paper released on 13 July, 2017.

As a leading professional services firm, KPMG is committed to meeting the requirements of all our stakeholders – not only the organisations we audit and advise, but also investors, employees, governments, regulators and the wider community.

We also strive to contribute to the debate that is shaping the financial services industry. As such, we outline in this document KPMG's views on some of the policy considerations related to the BEAR. We would be pleased to provide further information that would assist the Treasurer as you are making decisions on the Regime's design and implementation approach.

Should you require any further information or have any question please contact Rachel Merton, Head of Government Relations on 02 9455 9109 or at rmerton@kpmg.com.au

Yours sincerely

Ian Pollari

Partner, Financial Services

Introduction

The Australian Government is seeking to better define the accountabilities of key financial services executives and introduce consequences such as civil penalties and remuneration constraints in an attempt to better align rewards with long-term performance, discourage inappropriate risk-taking amongst banking executives and respond to growing community concerns that financial institutions have a 'poor compliance culture.'

We believe the proposed BEAR provides an opportunity to further embed governance standards and enhance corporate culture to drive stronger long-term performance for shareholders and ensure more accountability to broader stakeholders.

In this document we have responded to the content and questions contained in the consultation paper. Views expressed in this document reflect KPMG's understanding of the key issues which need to be considered by Treasury and APRA based on the unique dynamics of the Australian financial service environment, our international experience and our understanding of the interests of market participants. We have deliberately chosen not to address questions on which we do not possess a distinctive point on view.

Key considerations

Chapter 3 - Institutions to be covered by the BEAR

There are a range of complexities associated with the proposed scope of institutions covered by the BEAR. These challenges are particularly heightened for smaller banks and foreign institutions (*BEAR impacts on foreign institutions* are shown on page 6). For example, as a number of foreign banks run their Australian operations as an offshore bank branch, issues arise from these banks' cross-border transactions given they often apply remote booking models and utilise regional or global trading hubs.

There are a substantial number of non-ADIs performing banking-like activities. The community holds similar expectations for these organisations and established banks (ADIs). It is recommended that when considering the burden implementing the BEAR will impose on ADIs, especially on smaller institutions, Treasury should consider mechanisms to ensure an uneven playing field is not inadvertently created.

Furthermore, and in accordance with APRA's track record of achieving principles-based regulatory outcomes, we consider that the application of the BEAR across different banking groups should be tailored based on how systemically important each respective bank is in the Australian market. We consider banks are empowered to do so using APRA's existing toolkit of prudential assessment methods.

Chapter 4 - Individuals to be covered by the BEAR

The BEAR consultation paper canvasses the inclusion of a broad range of executive and Board roles in the prescribed accountable persons and principles-based definition. In practice this may mean that there are a significant number of accountable persons in large ADIs. In smaller ADIs, including foreign owned banks, broad accountability may fall to a relatively small number of accountable persons (refer page 6 for *BEAR impacts on foreign institutions*).

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?*
    1.1. *Are there any other roles which should be included at a minimum?*
    1.2. *Should any of the roles be excluded?*

In practice, applying the prescriptive element of the BEAR will in some cases be complicated because not all prescribed roles are present in both ADIs and in subsidiaries. In some instances, key prescribed roles such as Chief Operations [Officer] may not formally exist within the parent ADI executive level (rather, operational responsibilities may rest with executives within operating entities or subsidiaries or be shared between multiple roles) and may be better covered under the principles-based element.

Other prescribed roles, such as Chief Risk [Officer], may exist at ADI parent but may not cascade through all subsidiaries. In addition, within some institutions there are relatively subordinate executives who exercise end-to-end control over operating businesses.

As a result, how accountable persons should be identified, and accountabilities cascaded within the organisation in these scenarios, will require careful consideration.

Are there any other roles which should be included?

The prescribed accountable persons list omits the role of 'Chief Human' [Officer] (Head of HR). Several important elements of the BEAR such as professional development, maintenance of accountability mapping, and operationalisation of remuneration and incentive schemes, will likely fall within the remit of the human resources function. These accountabilities are captured within the prescribed responsibilities defined in the UK Senior Managers Regime (UKSMR).

Should any roles be excluded?

Some of the prescribed accountable persons, for example Chief Information [Officer], may have relatively little authority or influence on the outcomes APRA is seeking to effect. This may be particularly relevant for foreign owned ADIs whose Australian IT function may primarily focus on administration of systems provisioned from centralised offshore IT centres.

Given a SOOA's focus on Branch oversight and strategy setting rather than execution, we also recommend that this position be considered to be out of scope of the BEAR. For further information, refer to page 6.

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?*

KPMG considers that principles-based requirement need to be such, that is, to capture roles with significant influence over conduct and behaviour that materially impact customer outcomes (i.e. whether or not community expectations are met) especially for non-banking entities (for example actuarial, product design and claims functions).

More broadly, a tiering system used by other regulators to categorise accountable persons, is recommended. This will provide a mechanism to consider the differences between the scale and complexity of business models and group structures.

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> 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?*

We recommend that the BEAR applies to accountable persons within APRA-regulated ADIs only. For further information on considerations for foreign ADIs, refer to page 6.

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

The proposed new BEAR expectations for ADIs and accountable persons draw heavily upon the Conduct Rules of the UKSMR. These expectations are broadly worded and the key terms are not defined – this includes 'reasonable steps' and the extent to which ADIs and accountable persons are expected to obtain comfort or assurance regarding the operation of the control environment, regulatory compliance and the discharge of delegated responsibilities. In order to ensure that ADIs can take an appropriate approach to interpretation and implementation, examples could be provided of behaviours which fail to meet the expectations.

From our experience in overseas jurisdictions, identifying whether the expectations have been breached is likely to be a lengthy, labour- and cost-intensive process for ADIs involving assessments from various functions (including Legal, Compliance, HR and Risk) and inputs into the ADI's internal adjudication process.

Given the new BEAR expectations focus on conduct and behaviour, there is an apparent blurring of responsibilities between APRA's role in supervising and enforcing these expectations and ASIC's role as the regulator for conduct matters. For example, at what point does poor conduct or behaviour become *'of a systemic and prudential nature'*? How will APRA and ASIC work closely and effectively together to regulate conduct and the BEAR expectations?

The Consultation Paper does not provide details of the expected interactions between the BEAR and APRA's existing Fit and Proper framework. Is it intended to revisit the definition of Responsible Persons given the proposed application of the BEAR? In particular, CPS 520 notes that the obligations it imposes on a Foreign ADI only apply in relation to the Australian branch operations. In contrast, the BEAR – in its current proposed form – is intended to apply to all subsidiaries with the branch's group or subgroup.

For ADIs which are part of a subgroup or larger group, a significant responsibility is placed upon both the ADI and the accountable person to take reasonable steps to ensure that the expectations and accountabilities of the BEAR are applied throughout. For some ADIs, the size of the group or subgroup or other factors such as geographical location and governance structures may limit the ability of the accountable person to exercise adequate oversight. This responsibility will also be more onerous to exercise in ADIs where accountable person roles are not included in all entities within the group or subgroup.

BEAR impacts on foreign institutions

Foreign ADIs understand the Government's focus on ensuring that financial institutions are held to high standards of accountability and transparency with regard to how firms govern and conduct their business. Foreign ADIs appreciate the opportunity to provide input into the BEAR consultation process and note some core areas of interest with regard to its application and implementation.

Institutions covered

Given the complexity and variability of Foreign ADIs' global operating models, and consistent with APRA's existing regulatory framework, it is recommended that the BEAR should be applicable to APRA-regulated entities only. The scope of the BEAR should not include broker-dealer subsidiaries and entities not controlled by a foreign branch (whose activities APRA does not currently regulate).

Given the wholesale nature of Foreign ADIs, the application of the BEAR may have adverse competition outcomes where the main competitors to its businesses are not structured as ADIs.

Individuals covered

For Foreign ADIs, we recommend limiting accountable persons to be the Head of a Branch only. Other local management roles within Foreign ADIs are typically of a more junior stature when compared with Australian ADIs (e.g. function, responsibility, remuneration, etc.), and as such should be outside of the BEAR's scope.

Given a SOOA's focus on Branch oversight and strategy setting rather than execution, we also recommend that this position be considered to be out of scope of the BEAR. Inclusion of the SOOA would lead to a number of policy outcome disconnects, e.g. how would compensation restrictions apply, how would disqualification apply if the branch's operations was still within their remit, etc.?

Moreover, to avoid extra-territoriality and regulatory overreach, the BEAR should not apply to the SOOA and any other overseas personnel typically covered by an equivalent regulatory regime offshore.

Remuneration

Notwithstanding that Foreign ADIs already have established practices and controls from APRA on remuneration, the majority of the design of the remuneration program for Foreign ADIs is prescribed by Head Office, and such established practices and controls are agreed at a detailed level with our principal offshore regulators. Those regulators typically prescribe that the remuneration programs must apply globally. Consequently, longer lead times for modification or approval for changes need to be considered in determining the timeline for the BEAR's implementation.

Should the BEAR definition for Foreign ADI accountable persons extend beyond the Branch Head and possibly SOOA, it is recommended to apply a minimum remuneration threshold to determine application to appropriate positions.

Chapter 6 – Remuneration

Given the unique position of banks and other financial institutions in the Australian economy, a level of scrutiny of banking executive pay is to be expected. However, the introduction of mandatory deferral of 60% of variable remuneration (for certain executive accountable persons) for at least 4 years is excessive compared to similar international regimes, potentially undermining the competitiveness of ADIs in the market for talent and limiting their ability to motivate their executives to deliver on the company's strategy in the interests of stakeholders. As an overarching point, it is recommended that the resulting legislation be drafted in a flexible manner which accommodates the unique circumstances of individual ADIs, including the consideration of a minimum variable remuneration threshold below which the deferral requirements would not apply.

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?*

Shift to base pay?

There is a risk that the introduction of mandatory deferral requirements will encourage a shift from variable to base pay, particularly amongst:

- ADIs. As there are over 140 ADIs in Australia, these requirements will apply to entities which are significantly smaller than the big four banks. Our work with several smaller 'community' banks (and some of the larger banks) suggests that cash STI is often an 'expectation' of executives to the extent that it is viewed as part of fixed remuneration. Whilst variable remuneration is a considerably smaller proportion of total remuneration for the smaller banks compared to larger ADIs (for example a short term incentive equivalent to 20-30% of base pay is common for mutual banks) it remains significant. If companies are forced to defer all (or a significant portion) of the STI to meet the BEAR requirements, this may impact on the ability of these ADIs to attract and retain key talent (particularly as they compete for talent against financial companies who are not ADIs), culminating in an increase in fixed pay as 'compensation'; and
- Executives below the Key Management Personnel (KMP) level in larger listed companies. Companies may be hesitant to make significant fixed pay increases to KMP (those executives whose remuneration must be disclosed in a Remuneration Report), although these companies may cite the BEAR regulations as forcing up fixed pay. However, the risk of shareholder backlash (or proxy adviser scrutiny) is less of a concern below the KMP level (as it is not publicly disclosed) and may not deter companies from shifting the pay mix towards fixed remuneration. In this context, we have also observed a trend in recent years towards reducing the number of executives whose remuneration packages are publically disclosed

There has been a shift towards base pay in the UK since the caps implemented by the UK Prudential Regulatory Authority (PRA). While this adjustment was primarily due to the capping of variable remuneration at two times fixed remuneration[1] rather than the introduction of mandatory deferral requirements (i.e. 40% for material risk takers[2] and 60% for directors of entities of a significant size and bonuses in excess of £500,000[3]), the UK experience does show that the introduction of arbitrary regulation of executive pay can have this unintended consequence.

[1] *Prudential Regulatory Authority 2015* (UK) Rulebook: CRR Firms: Remuneration Instrument 2015 / 53, r 15.10.

[2] *Prudential Regulatory Authority 2017* (UK) Rulebook, r 15.17,

[3] *Prudential Regulatory Authority 2017* (UK) Rulebook, r 15.18.

Is this problematic?

If the sole purpose of the remuneration requirements was to discourage short-term excessive risk taking, then a shift towards base pay would not be problematic. In fact, the complete abolishment of incentives would be an effective way to achieve this end and would be arguably more transparent.

However, unlike base pay, variable pay can be subject to clawback and malus requirements and / or performance conditions that are related to risk, which allow for pay outcomes to be adjusted downwards after a period of time once 'risks' have crystallised. Properly constructed variable pay is arguably a better tool for holding executives to account for their actions (which is the intent of the regime) than base pay.

Increasing fixed pay is also a structural cost that disadvantages shareholders as against variable pay (which must be earned through minimum levels of performance).

There are also several objectives that companies are trying to achieve with their remuneration frameworks other than the prevention of excessive risk taking. Key objectives include encouraging performance cultures (as ultimately poorly motivated management teams will not deliver above average returns to shareholders) and alignment between remuneration outcomes and the interests of shareholders. A shift towards base pay would undermine the creation of a performance culture and alignment between performance and rewards.

What can be done to prevent these outcomes?

We suggest providing companies with the option of seeking shareholder approval for arrangements that differ from the legislated deferral requirements (for Australian listed ADIs). A shift towards base pay could be avoided if companies were given the ability to 'opt out' of these requirements, where these arrangements are not appropriate for their circumstances (as long as they are able to provide a clear justification to the market).

The option of seeking shareholder approval would not be inconsistent with international practice. In the UK[4] and the EU[5], variable remuneration is actually limited to 100% of fixed remuneration but companies can seek the approval of shareholders to provide variable remuneration of up to a maximum of 200%.

An alternative option would be framing these requirements as if not, why not guidelines (similar to the ASX Corporate Governance Principles and Recommendations) which could apply equally for listed and non-listed ADIs.

We suggest introducing a minimum threshold for these arrangements to apply. To avoid capturing small ADIs (whose competitiveness in the market for talent may be undermined by these requirements), it would be appropriate for the regulations to only apply to variable remuneration above a certain threshold (for example $250,000 or $500,000) that could be indexed or reviewed on a regular basis.

The imposition of minimum thresholds is not inconsistent with international practice. For example, the 60% deferral requirement in the UK only applies to 'directors of firms of a significant size' and

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[4] *Prudential Regulatory Authority 2015* (UK) Rulebook: CRR Firms: Remuneration Instrument 2015 / 53, r 15.9, 15.10.

[5] *Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002 / 87 / EC and repeating directives 2006 / 48 / EC and 2006 / 49 / EC* [2013] L 176/338 ('**CRD**') art 94(g).

material risk takers with bonuses in excess of £500,000.[6] Only 40% deferral is required for all other material risk takers.[7]

If these provisions are mandatory, deferral levels should be as closely aligned with the nature and size of the executive's role as possible to prevent a shift to base pay as 'compensation.' While we consider 60% deferral to be too high for all roles (including the CEO), we would not recommend extending 60% deferral below the CEO level (40% would be far more appropriate).

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

While the proposed definition is a start, there are a number of key issues / complexities which will need to be addressed within the definition. Rather than directly answer questions seven and eight, we have outlined our view on the key issues in defining variable remuneration (and the deferral period) and our positions on each of these key issues. Our view has been informed by our work with clients and our understanding of remuneration structures emerging in the market.

Performance / service conditions

A key complexity will be the conditions that make remuneration 'variable.' Clarity is required in the legislation to ensure there is no doubt about the application of the provisions.

In particular, will rewards subject only to service conditions be considered 'variable'? From our work in advising clients, we know that many companies are considering simplification of their remuneration structures. This might include remuneration frameworks with fixed remuneration and a simple grant of shares (or options) subject to service (rather than an STI or LTI). In the US, it is already commonplace to have a portion of the LTI granted in restricted stock (with no additional performance testing).

Our view is that any portion of an award which is only subject to future service conditions should not be considered 'variable remuneration.' While movements in the share price will ultimately determine the final value of the award, this is insufficient to make these elements of pay variable. Rewards for continued service would not reflect performance in excess of that required to fulfil the employee's job description / terms of employment.

If the definition does specify the types of conditions that make an award 'variable,' care should be taken not to draft the provision in a limiting manner for example 'individual and business performance.' Several incentives (e.g. LTI) may only be dependent on company performance for example relative total shareholder return (TSR). The provision could read 'including (but not limited to) individual, business and / or company-wide performance.'

Timing of assessment / allocation methodology

A key issue will be at what point in the remuneration cycle variable remuneration is assessed and whether different allocation methodologies (i.e. fair or face value) should be taken into account. Our view is that the definition should be the market value of awards made in a particular financial year (to account for different allocation methodologies). Under a typical STI / LTI structure, we suggest that the calculation of variable remuneration be determined at the end of the financial year based on the

[6] *Prudential Regulatory Authority 2017* (UK) Rulebook, r 15.18.
[7] *Prudential Regulatory Authority 2017* (UK) Rulebook, r 15.17,

STI actually awarded in respect of that year (rather than the opportunity) and the market value of the equity granted under the LTI in that year (i.e. the number of rights granted multiplied by the market price at the date of the grant). This will mean that companies that use a fair value allocation methodology under their LTI would need to determine the 'face value' of the equity that is actually granted (which will exceed the executive's opportunity as a percentage of fixed remuneration). A variable incentive plan (where a grant of equity is determined based on performance over one year) would be calculated in a similar manner to the STI (i.e. the quantum that is actually allocated based on performance over the financial year).

Distributions

Another issue is the treatment of distributions on equity grants and whether they should be counted as part of variable remuneration. As more companies move to grants of shares (rather than rights), it is becoming increasingly common for executives to receive dividends over the deferral period. In light of our view that we should assess variable remuneration at the end of the financial year based on the quantum awarded in that period (on a face value basis), our position is that dividends should not be included as variable remuneration and would add an unnecessary layer of complexity to the calculation.

Alternative approach – should we define fixed remuneration instead?

The European Banking Authority (EBA) released a set of guidelines which set out the criteria for the allocation of compensation between variable and fixed remuneration under Article 94 of the EU directive[8] (which includes the mandated deferral requirements). The UK provisions are modelled off this directive.

Rather than defining 'variable remuneration', the EBA's guidelines specifically define fixed remuneration and subsequently define variable remuneration to mean 'all remuneration which is not fixed.'[9] This is an approach that could be considered in Australia, given that it is easier to define 'fixed remuneration' and may help to 'future proof' the provisions.

Fixed remuneration in the Australian context could be defined similarly to the 'base salary' definition in 'Termination Payments' provisions of the Corporations Act as all fixed salary, non-monetary benefits, superannuation contributions not dependent upon satisfying performance conditions, share based payments not dependent upon satisfying performance conditions (i.e. restricted share grants subject only to service) and fringe benefits.[10]

Defining the deferral period

The consultation paper is silent on the 'deferral period' and the requirements will need to address this point.

Clarity will need to be provided on when the deferral period starts. The deferral period could commence from the beginning of the performance period or alternatively, from the time when equity is actually granted under the incentive plan.

This is fairly straight forward for an LTI (as equity is typically granted close to the start of the performance period). For example, we would say an LTI with a three year performance period has been 'deferred' for three years.

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[8] *European Banking Authority 2016 (*EU) Guidelines on Sound Remuneration Policies, Title II – Requirements regarding the structure of remuneration, s 7, p 33.

[9] E*uropean Banking Authority 2016 (*EU) Guidelines on Sound Remuneration Policies, pt II, 'Definitions' p 8.

[10] *Corporations Regulations 2001 (Cth) Regulation 2D.2.01 (1).*

However, it is slightly more complex for deferred STI and variable incentive plans. For example, take a typical STI with deferral where performance is assessed over one year and 50% is deferred into equity for a further two years. The deferral period could be interpreted as two years (i.e. from the time of grant) or three years (if the performance period is included). A similar question will arise in relation to variable incentive plans where the equity granted is typically based on performance over the previous one year period and is allocated at the end (rather than the start) of the performance year.

Our view is that the deferral period should commence from the start of the performance period. That is, the performance year would count towards the four year period for both deferred STI and variable incentive plans. This is appropriate given that the awards are 'at risk' over the performance period (i.e. they are 'discretionary') and it would be the simplest approach. It is also consistent with the approach taken in the EU. [11]

End of the deferral period

The requirements will also need to address when the deferral period ends. A key question will be whether additional restrictions post vesting such as trading restrictions or holding locks, will extend the deferral period. That is, does the deferral period end when the executive becomes the 'legal owner' of the equity (regardless of any additional restrictions) or is it when all restrictions are lifted (and they have full rights as owner)?

For example, if a company had a three year LTI vesting period with a further one year holding lock, the deferral period could be interpreted as three years (being when the executive becomes the 'legal owner') or four years (when all restrictions are lifted). We are aware of one large bank who will be implementing this structure for FY17.

Another key question will be whether equity will have to vest in full to meet the requirements or whether partial vesting over the 4 year deferral period would suffice. For example, consider a variable incentive plan where performance is tested over one year and 25% of the equity vests after two, three, four and five years respectively (as is common in many foreign owned ADIs). Would the deferral period be five years or would only 50% have been deferred for four years or more?

In our view, the deferral period should end when all restrictions applying to the shares cease. While this is not the approach taken in the EU,[12] we believe that it is a fairer outcome as the executive is not able to deal in the shares / equity and they remain available for clawback.

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

As a general comment, this is a blanket, arbitrary rule which does not take into account the circumstances of individual companies. The ratio between fixed and variable remuneration is unique to each company and as mentioned above several ADIs (particularly smaller banks) will struggle to maintain their competitiveness in the market for talent (particularly as against other non-ADI financial institutions) if they are required to defer 60% for more than four years. Therefore, our view is that it is critical to err on the side of caution in setting both the quantum to be deferred and the length of the deferral period. We also suspect that setting deferral at such a high percentage is likely to lead to a bias towards fixed remuneration (the implications of which are outlined in the response to question six above). As outlined above, we would strongly support providing companies with the ability to 'opt out' of these requirements by seeking shareholder approval or on an 'if not, why not' basis.

[11] E*uropean Banking Authority 2016 (*EU) Guidelines on Sound Remuneration Policies, pt II, 'Definitions' p 8.
[12] E*uropean Banking Authority 2016 (*EU) Guidelines on Sound Remuneration Policies, pt II, 'Definitions' p 8.

We consider 60% deferral for certain executive accountable persons to be too high. Analysis of our data suggests that several ADIs would struggle to meet these requirements if the quantum was set at such a high level. If a deferral level is to be mandated, we consider a threshold of 40% for all executives to be more appropriate (up to maximum of 50%) which would not be inconsistent with international practice. The Financial Stability Board suggests deferral of between 40% and 60%,[13] the EU mandates 40% (and 60% only for 'high amounts')[14] and the UK requires 40% to be deferred for material risk takers (other than directors and bonuses in excess of £500,000).[15]

We also consider a four year deferral period to be too long. The typical LTI performance period in the Australian market is only three years. We consider that the intent of the legislation may be better addressed by mandating that all deferred variable remuneration would not be forfeited post-employment until the end of the applicable deferral period. This would provide for long term sustainable decision making and the ability to clawback remuneration once risks have 'crystallised'.

10. Are the proposed enhancements to APRA's remuneration powers appropriate?

The specific enhancements to APRA's powers are relatively unclear and will need to be clarified further.

However, we have interpreted the requirements as providing APRA with the power to require companies to amend their remuneration policies to include an ability for the Board to adjust remuneration outcomes downwards when executives do not meet the requirements of the BEAR (rather than only in circumstances when it is necessary to protect the financial soundness of the ADI or to respond to unexpected or unintended consequences)[16].

We consider APRA's existing powers under the CPS 510 to be sufficiently broad. Setting remuneration policies is the role of Boards (and Boards of Australian listed ADIs are also held to account for their decisions under the two-strikes legislation).

Chapter 7 – Implementation and transitional issues

Interpretation and implementation of the current accountabilities frameworks is evolving. For example, APRA's Information Paper on risk culture[17] signalled that the regulator was interested in organisational culture in the broad sense and the impact that this culture has on management of prudential risk. How APRA applies this viewpoint in supervisory activities is yet to be clearly established. Further clarity may be established as APRA engages with the industry. This clarity may inform the obligations under the BEAR.

A large project such as this, with regulatory and cultural ramifications will require considerable oversight and ownership from the CEO and Board.

Institutions will need to undertake the complex task of mapping prescribed accountable persons across multiple business models and jurisdictions and apply relevant principles to their individual operating model and organisational structures. Completing this process, and maintaining accountability mapping as roles change and organisational structures evolve will require new systems and processes. This will have considerable resource and time implications on existing staff to design

[13] *Financial Stability Board 2009,* Principles for Sound Compensation Practices – Implementation Standards, standard 6. *European Banking Authority 2016 (*EU) Guidelines on Sound Remuneration Policies, pt II, 'Definitions' p 8.
[14] CRD, art 94(1)(m)
[15] *Prudential Regulatory Authority 2017* (UK) Rulebook, r 15.1, 15.18.
[16] *Australian Prudential Regulatory Authority* 2017, CPS-510, s 58.
[17] http://www.apra.gov.au/CrossIndustry/Documents/161018-Information-Paper-Risk-Culture.pdf

and implement. The quality of existing structural and role data within organisations will be a key driver of the effort required.

It would appear that the intent of the BEAR is to ensure that accountability can be levelled at a single executive in the event that an institution is found to have failed to meet regulatory obligations, or in the event that societal expectations are not met. In practice executives operate in a complex and interdependent network. For example a failure in an operational area may be in part driven by failings in underlying IT systems. The IT system failures may exist because group investment priorities have not permitted the necessary technology investment. In a feedback statement on the UKSMR[18], the UK FCA observed that firms had struggled to provide clarity and detail around shared and divided responsibilities and that although there were circumstances in which this was appropriate, it needed to be articulated and justified.

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

The mechanism available under the BEAR appears binary: APRA may either de-register an individual or do nothing. While deregistration is a potent lever the binary nature of this mechanism makes it a 'blunt instrument'. APRA may have a greater ability to influence behaviours if it had at its disposal the ability to issue warnings or recognise transgressions that while not sufficient to warrant deregistration in themselves, if repeated, would result in stronger action (such as a 'three strikes' policy). The avenues open to individuals facing deregistration also need to be made clear.

The obligation to share details of internal disciplinary processes with APRA under the BEAR may have unintended consequences. There may be the temptation to deal with issues outside of formal internal processes in order to avoid the requirement to report. This may result in issues not receiving adequate or appropriate scrutiny, or in individuals within institutions not being treated fairly. Either of these scenarios may precipitate outcomes that are inconsistent with the intentions of the BEAR. If internal processes are also to be considered within the BEAR it will be important for the regulator to recognise that evidentiary standards applied by individual organisations may vary and may not be consistent with those applicable under the regulations. The fact that an individual was sanctioned internally for an action may not be sufficient to prove that they failed to discharge their BEAR accountabilities.

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

The time to implement will depend on the final weight of the BEAR and the level of (internal and external) resource available. Our experience in working with firms implementing the UKSMR was that the longest implementations ran from 12 to 18 months. Implementation time was influenced by the maturity of existing governance frameworks and complexity of the organisation structure. UK firms were able to leverage existing infrastructure supporting the Approved Persons regime in the UK (including the regulators approving the appointment of individuals to prescribed 'controlled functions') which has existed in the UK regulatory environment for many years. Whilst Australia's 'Fit and Proper' requirements form the basis of appointing responsible persons to key roles, the current regime is lighter-touch when compared with the UK Approved Persons regime and therefore provides a lesser scaffold upon which to address BEAR registration requirements.

Further transition arrangements need to be considered. A sufficient period of time will need to be provided to allow ADIs to adjust to remuneration arrangements (in light of reporting requirements,

[18] https://www.fca.org.uk/publication/feedback/fs16-6.pdf

remuneration cycles / multi-year grants, Board processes, etc.). For example Australian listed ADIs may need shareholder approval for equity incentive awards for a Managing Director / CEO or for changes to employee share plans. This approval is typically sought at the company's Annual General Meeting.

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?*

Based on UKSMR implementation may involve internal teams of 10-15 supplemented by external resources. The population size of Senior Managers was a material driver of cost at implementation. This could range from 5 to 60 individuals depending upon the size and nature of the institution. The ongoing cost of compliance should to be taken into account to manage and maintain the regime and populations.

In July 2017, the UK FCA estimated that the overall costs for firms to comply with the UKSMR were approximately £547-552m for one off implementation with ongoing annual costs of £140-190m[19][20].

[19] https://www.fca.org.uk/publication/consultation/cp17-25.pdf

[20] https://www.fca.org.uk/.../cp17-26-individual-accountability-extending-smcr-insurers