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Dear Sir / Madam

## **Banking Executive Accountability Regime – draft legislation**

Thank you for the opportunity to provide a submission in response to the exposure draft (**Exposure Draft**) and explanatory materials relating to the Australian Government's proposed Banking Executive Accountability Regime (**BEAR**).

The Australian Institute of Company Directors (**AICD**) is committed to excellence in governance. We make a positive impact on society and the economy through governance education, director development and advocacy. Our membership of more than 40,000 includes directors and senior leaders from business, government and the not-for-profit sectors.

The AICD recognises the critical role of Authorised Deposit-taking Institutions (**ADIs**) in the Australian financial system. We support effective efforts of the government, the Australian Prudential Regulation Authority (**APRA**) and the banking sector to support good governance of ADIs, positive consumer outcomes and financial stability. The AICD recognises that governance of ADIs is essential to good consumer outcomes and financial stability.

As noted in our submission dated 4 August 2017, the AICD welcomes the BEAR's aim of strengthening accountability in the banking system. However, we remain concerned that the BEAR risks confusing the fundamental governance role of non-executive directors with executive management functions, and does not adequately consider corporate governance principles in its application. This remains our most substantive concern and we encourage further consultation with the AICD and other relevant stakeholders to address these defects.

This submission outlines our concerns relating to the Exposure Draft. We have again considered the BEAR through a governance lens, drawing on the practical perspectives of our members.

## **1 PRELIMINARY OBSERVATIONS**

### **1.1 Allow adequate time for consultation and review**

The AICD considers the one-week consultation period provided for public comment to be an entirely inadequate period for review and consideration of this complex reform.

Changes to Australia's banking system have significant impacts on the community as a whole, and new legislative proposals will intersect with many existing complex regulatory obligations already applied to ADIs. Given this, adequate public consultation should be an essential component of any major policy development in this space.

In the AICD's view, the one-week time frame provided does not provide enough time for interested parties to consider the implications of the reform proposal, engage with stakeholders and provide the government with an informed and useful submission. This increases the risk of serious unintended consequences that could adversely impact on the community and economy, as well as ADIs directly.

The AICD's comments and suggestions on the BEAR proposals are necessarily constrained by this unreasonable timeframe.

## **1.2 Commencement of the BEAR**

The AICD is concerned that the 1 July 2018 commencement date proposed in the Exposure Draft is not enough time for ADIs and their subsidiaries to comply with these complex and significant reforms.

Our specific concerns are as follows:

- The AICD assumes that following the passage of the BEAR through parliament, APRA will be required to provide additional guidance and interpretation to assist ADIs in complying with the BEAR. As it stands, it is difficult to see how this guidance will be achieved in time for the commencement of the BEAR. Assuming passage of the legislation in late 2017, and considering the disruption caused by the intervening Christmas period, we are concerned this timeline is not realistic for either ADIs or APRA;
- The AICD is concerned that the proposed commencement date does not allow for sufficient time for ADIs and APRA to introduce accountability mapping. The AICD supports the introduction of accountability mapping but we are concerned that this process is not rushed, and is effective and;

Given these concerns, we recommend that the BEAR's implementation date should be deferred, so that it commences on 1 January 2019. This will enable all ADIs to prepare their affairs to be in full compliance with the BEAR, and enable APRA to provide the industry with sufficient guidance.

## **2 THE BEAR AND ACCOUNTABLE PERSONS**

### **2.1 Appropriately recognise the role of non-executive directors**

We note that the explanatory materials make it clear that the BEAR is intended to apply to non-executive directors (**NEDs**), but only in relation to their performance of an 'oversight function', rather than day-to-day executive and management functions (EM paragraph 1.83).

The AICD welcomes this intent. NEDs are not involved in the day-to-day management and operation of the organisation. Rather, they bring independent and objective judgment to the governance function, working collectively as the board and committees of the board. They apply their experience and special area of expertise, which is often derived from a non-ADI environment, on a part-time basis. It is therefore appropriate that their accountability under the BEAR is limited to the responsibilities they actually perform.

However, the AICD remains concerned that the intent outlined in the explanatory materials has not been achieved in the Exposure Draft Bill itself, and is undermined by the wording of s 37CA – 37CB.

In particular, the AICD is concerned that the BEAR blurs the roles and responsibilities of NEDs with those of senior executives.

While the board is ultimately responsible for deciding the nature and extent of an ADI's risk profile, in an ADI context the board will ordinarily delegate the risk management function to management (i.e. the Chief Risk Officer), with the board being responsible for setting the risk appetite for the entity, overseeing the risk management framework (rather than its operationalisation) and satisfying itself that the framework is sound.

Given this, an individual NED is not generally in a position within an ADI to 'ensure' that risk management is in place with respect to particularly components of an ADI's operations at any given time. Should that be required of NEDs, it would require each NED to become intimately involved in the operational implementation of risk management in relation to almost any major internal project and plan.

This demarcation is borne out in the design of APRA's Risk Management Prudential Standard (CPS 220). Under clause 9 of CPS 220, the board is ultimately responsible for the ADI's risk management framework, and must 'ensure' that it defines the institution's risk appetite and establishes a risk management strategy.

However, CPS 220 provides that it is the responsibility of senior management of the institution (rather than the board) to monitor and manage all material risks consistent with the strategic objectives, risk appetite statement and policies approved by the Board. CPS 220 maintains the delineation between the supervisory and monitoring role of the board and the requirements imposed on senior management.

The BEAR Exposure Draft collapses this demarcation, by requiring NEDs ensure that there is appropriate 'risk management' in relation to a particular matter in an overall sense. The drafters of the BEAR, having anticipated this defect, attempt to cure it in clause 1.100 and 1.101 of the draft explanatory material.

However, the AICD is not convinced that this will be sufficient to prevent unintended consequences. We note that explanatory materials may elucidate the context and policy background to the enactment of a provision, but ultimately remain subordinate to the text in the exercise of construction.<sup>1</sup>

To cure this defect in the legislation, the AICD recommends the government reconsider the wording of s 37CB, and instead consider adopting a non-mandatory and non-exclusive list to assist directors (and APRA) in determining whether reasonable steps were taken. Such a list should be designed to ensure compatibility with existing lines of accountability.

## **2.2 Risk of hindsight review**

Under the BEAR, APRA may disqualify a person from being an accountable person if that person has not complied with his or her accountability obligations under s 37CA, and the disqualification is justified (s 37J). The explanatory materials indicate that 'the Government expects that such a decision would only be justified in serious cases' and 'minor incursions would be unlikely to result in a disqualification'.

However, this stated intention is (again) not borne out in the legislation itself. Instead, APRA is given an unfettered power to disqualify an accountable person without any materiality threshold in the legislation itself. Subsection 37J(4) provides that the Minister may determine matters to which APRA may have regard for the purposes of s 37J. However, these non-mandatory matters will not act to limit APRA's power to disqualify an accountable person.

The AICD is concerned that there is a serious risk of inappropriate hindsight review on the part of APRA in relation to these powers. For instance, should a matter arise which is a prudential matter which is cause for concern to APRA, it will be extremely difficult for any accountable person to demonstrate that they were effectively and properly discharging their responsibilities under ss 37CA – 37C in circumstances where a prudential matter has arisen.

The risk of hindsight review in the exercise of the powers in the BEAR is very substantial. If a matter arises that adversely affects the prudential standing or reputation of an ADI, APRA will be capable of exercising its examination powers in s 61A. As discussed below, these powers are extremely invasive, and will potentially enable APRA to identify weakness and deficiencies in any number of matters which have only become apparent when a matter of concern arises and there has been a failure of risk management.

In this situation, it will be extremely difficult for an accountable person (and particularly a NED) to demonstrate that they have, in fact, complied with the BEAR, given that they will need to demonstrate that the adverse prudential matter materialised notwithstanding their compliance with the BEAR.

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<sup>1</sup> Section 15AB of the *Acts Interpretation Act 1901* (Cth) reflects the subordinate status of such materials.

It is commonly known that in litigation a document which otherwise would not have taken on any degree of significance at the time becomes a critically important document in court proceedings when viewed in hindsight. Similarly, when a matter arises which could adversely impact on prudential standing, a particular risk management strategy or risk operational control will be subject to examination. A straightforward causal analysis of that matter will enable APRA to attribute a degree of failure to a particular accountable person, and the BEAR will justify disqualification.

The AICD recommends the government consider amending the draft legislation so that APRA's disqualification powers can only be used in serious cases.

It is not appropriate, from the perspective of good public policy and the rule of law, to provide a regulator with an unfettered power to examine and disqualify a person from their position for a minor or trivial matter. Whilst the AICD recognises there has been some attempt to address this in the explanatory materials, this is a totally inadequate protection and amendment to the draft Bill is required.

### **2.3 Application to subsidiary directors and boards**

We note that the BEAR will apply to accountable persons of subsidiaries, which will include directors of subsidiary boards. The AICD is concerned that this unnecessarily broadens the BEAR beyond what is reasonably required by APRA to ensure prudential integrity within a particular subsidiary. ADI directors have informed us that this obligation will prove to be extremely burdensome to implement.

While the AICD recognises that the government's intention is not to capture a person simply because they hold a management role within a subsidiary, the AICD questions whether it is reasonably necessary to capture any person within a subsidiary organisation, given that APRA's focus is on prudential soundness, governance, and risk management, rather than issues relating to conduct and performance.

The AICD re-iterates its position that the BEAR should only apply to the individuals that perform core functions within the ADI group. This would appropriately limit the BEAR to those persons who are sufficiently senior to have relevance to APRA's prudential supervision over the ADI Group.

However, should the intention be to impose the BEAR on subsidiary boards, the AICD strongly recommends that the government limit the application of the BEAR to only apply to subsidiaries which are regulated by APRA. If the subsidiary is regulated by APRA, it would likely fit with the explanatory material of being significant and of public interest. Alternatively, the AICD recommends the government introduce a materiality threshold which will exclude subsidiaries which have no real risk of impacting on prudential matters relating to the group itself.

This is particularly critical if the commencement date is not adjusted, as it will be challenging for APRA and ADIs to liaise on the multitude of subsidiaries in complex ADI groups that would justify exemption in the time available.

### **2.4 Examination Powers and the role of APRA**

The AICD is concerned about the implications of the proposed examination powers in Schedule 2 of the Exposure Draft (**Examination Powers**). In particular, the AICD is concerned that the traditional right to silence is entirely abrogated by s 61B(3) of the Exposure Draft, namely the requirement for any person (whether an accountable person or not) to answer questions on pain of a criminal offence with a penalty of 30 penalty units (along with a criminal record).

The Examination Powers appear to have been based, to some degree, on the evidence-gathering powers provided to the Australian Securities and Investments Commission (**ASIC**)

in Division 2 of the *Australian Securities and Investments Commission Act 2001* (Cth) (**ASIC Act**). ASIC's powers are provided to ASIC as a law enforcement agency. The answers given in ASIC examinations can be used for later civil and criminal proceedings (subject to claims for privilege).

In contrast, the BEAR regime is aimed at establishing 'a clearer accountability regime on ADIs and people with significant influence over conduct and behaviour in an ADI'. It is not proposed, as far as the AICD understands it, to establish APRA as a law enforcement agency.

Accordingly, the AICD has concerns that the Examination Powers are not fit-for-purpose, and in fact go beyond what is required for APRA to exercise its responsibilities in implementing the BEAR. Given that the Examination Powers abrogate one of the fundamental rights of the common law, being the right to silence, the AICD strongly urges the government to re-consider the design of the Examination Powers so they are appropriately tailored to the government's aims of improving accountability within ADI governance.

## **2.5 Disqualification Process**

The AICD recommends in the strongest possible terms that the government ensure that merits review is included in the BEAR.

It is entirely inappropriate to subject a person to an administrative penalty which may end their career with no capacity for that person to seek a review of the merits of APRA's decision. The ramifications of a disqualification from APRA would be profound for an individual.

The decision to disqualify a person as an accountable person is one which will impact on the interests of individuals. It is therefore appropriate that they be afforded an opportunity to have another body (preferably the Administrative Appeals Tribunal) review APRA's decision to ensure that it is correct and preferable.

Merits review promotes the values of transparency and accountability within the process of administrative decision-making, which is entirely consistent with the policy aims of the BEAR. Indeed, it would greatly add to the integrity of the BEAR to include a merits-review process.

The AICD would be pleased to consult with the government further on this important issue of public policy.

## **2.6 Materiality threshold**

The explanatory material makes clear that the government intends for the disqualification power for accountable persons to apply only in a serious case. However, the AICD again reiterates the inadequacy of including the intent of the parliament within secondary materials.

The AICD strongly recommends that the government incorporate a provision with the draft legislation to ensure that the consequences, which flow from a breach of expectations under the BEAR, should not apply for single breaches which are not reflective of the overall culture or risk management of the ADI. In short, disqualification should only apply where there has been a systemic failing which has resulted in a serious prudential risk to the ADI or the ADI Group.

## **3 Remuneration**

The AICD considers that the structure of remuneration of CEO and senior executive positions is a matter for the board of an ADI, within the guidance of prudential standards, and we reiterate our comments made in our submission dated 4 August 2017. We also note that APRA's standards already require risk incentives to be considered in determining remuneration structures and provide powers to the regulator to supervise such policies.

In addition, the BEAR is silent on what could happen to deferred remuneration when an accountable person resigns, retires, or when an accountable person is made redundant or moves out of a role that constitutes an accountable person. While the explanatory materials

suggest that APRA's power to defer remuneration for a lesser period could be used in circumstances apart from the death or serious illness of an accountable person, no guidance is given as to what these circumstances might be. The AICD suggests that specific guidance be provided for these circumstances.

## **4 GENERAL OBSERVATIONS AND CONCERNS**

### **4.1 Compatibility and consistency with existing principles of corporate law**

The AICD welcomes the approach taken by the government in adopting a principles-based and functional approach to identification of an 'Accountable Person', rather than a wholly prescriptive approach as is the case with the UK's SMR. However, the AICD queries whether the 'general principle' approach is, in fact, entirely necessary in the legislation.

Section 37BA sets out the meaning of an accountable person. There is a 'general principle' approach, which captures individuals who have a position within an ADI (or an ADI subsidiary) which 'has actual or effective responsibility for management or control of the ADI or subsidiary' or 'management or control of a significant or substantial part or aspect of the ADI's subsidiary's operation (s 37BA(1)).

In addition to this 'general principle' approach, a person is an accountable person if they hold a number of 'responsibilities' as set out in s 37BA(3), including responsibility for 'overall risk controls and/or overall risk resources', and 'responsibility for management of the ADI's compliance function.'

To appropriately limit and control the scope of the BEAR, and given that APRA may, by legislative instrument, determine a responsibility for the purposes of s 37BA(3), the AICD recommends the government re-consider the need for a 'general principle' approach to the 'accountable person' definition in s 37BA(1).

In addition, the AICD is concerned that the requirement of 'due skill, care and diligence' in s 37C(1)(a) is without any form of defences, qualifications and relief. This is entirely inconsistent with the existing duty of care and diligence under s 180 of the Corporations Act, which provides directors with the business judgment rule.

The AICD strongly recommends that the government include an appropriate defence or qualification to s 37CA, so that it is (at least) broadly consistent with the Corporations Act, and it accords with principles of fairness and natural justice.

Finally, to avoid any contamination of existing Corporations Act duties, the AICD recommends that the BEAR legislation expressly acknowledge that it does not alter the duties imposed on officers under the Corporations Act or at general law, and applies only in relation to the new regulatory powers imposed under the BEAR.

### **4.2 Increased compliance burden on ADI Boards**

By effectively escalating the responsibilities of NEDs and boards with respect to governance, control and risk management, the BEAR will add to the already significant regulatory and compliance burden placed on the boards of ADIs.

There is a significant risk that the BEAR will cause unintended consequences for ADI boards and their subsidiaries. One possible unintended consequence we consider to be particularly undesirable is that ADI boards will spend even more time ensuring they are technically compliant with various regulatory requirements, rather than the overall good governance of the company.

This, in turn, creates risks of a different nature, as boards become distracted from planning for the future growth and development of their companies, but also addressing any serious underlying issues of culture or compliance weaknesses.

The AICD has concerns that the BEAR will have the unintended consequence of not working to empower ADI boards to improve culture and outcomes within the banking sector, but instead contribute to regulatory fatigue. With a rushed and inadequate consultation period, it is highly likely that poor drafting and overlap or conflict with other regulatory provisions will add to the compliance time and cost of the BEAR.

The AICD recommends the government consider undertaking an analysis of the impact of the BEAR on compliance costs and functions across large and small ADIs. This analysis should account for existing obligations and responsibilities imposed on boards and NEDs, to ensure that the burden placed on the board is viewed in a holistic way, so that regulatory authorities can develop a more practical and realistic understanding of the real challenges of corporate governance within an ADI environment.

### **4.3 Ambiguous terminology and scope**

We acknowledge that the intent of the BEAR is to impose even higher standards of expectations on ADIs than already exist. However, as noted in our previous submission, we question how the regulator or a court could determine whether a director has acted with 'integrity', or dealt with regulator in an 'open and co-operative' manner.

The terminology of 'honesty', 'integrity', 'open', are highly subjective and open to interpretation.

The AICD is concerned that the incorporation of these new subjective concepts add to the confusing layer of obligations and requirements already imposed on ADI directors. Nor does the BEAR provide any meaningful assistance to APRA or accountable persons in exercising their responsibilities.

To take the concept of 'openness' as an example, the AICD queries what 'openness' could mean in the context of being an accountable person. Does 'openness' require a director to disclose their inner thoughts and deliberations on a particular matter? Does it require directors to disgorge their personal diary notes for a particular board meeting? Is legal privilege protected? Should a director have failed to inform APRA about a matter which later results in a problem will the director have breached their duties under this new regime?

Questions such as these are thrown up for each of these new concepts introduced in ss 37C - 37CA with little indication of how they are to be adhered to in practice. Contrast this with the normative concepts found within ss 180 – 184 of the Corporations Act which are based on long-standing fiduciary principles and are well understood.

Given this, the AICD strongly recommends the government revisit the design of ss 37C - 37CB, and ensure that it is based solely on concepts which are well established known within law, and can be measured objectively. This will assist directors and companies in complying with the BEAR, APRA in implementing the BEAR, and lawyers in advising on the BEAR. If concepts cannot be measured objectively, the AICD recommends that they are not included within the BEAR, but rather be included within updated APRA standards and guidance.

Certainty and clarity is essentially the best way of ensuring the BEAR works in practice to improve governance and accountability in ADIs.

The AICD is also concerned about an apparent broadening of the scope of focus of BEAR. While the explanatory materials re-state the previous policy intent that the BEAR will cover conduct that is 'systemic and prudential' (EM 1.22), once again, the draft legislation does not give effect to this intent.

Instead, s 37CA(1)(c) introduces into the regime the nebulous concepts of 'reputation' and 'prudential standing'. The AICD considers these otherwise undefined words and phrases will add a significant degree of uncertainty to the BEAR, particularly as it concerns accountable persons and their responsibilities.

A number of questions are left unanswered by the requirement to take reasonable steps in relation to matters relating to reputation. For instance, how does an accountable person demonstrate they have taken reasonable steps to protect reputation? Does this create overlap between the roles of ASIC and APRA, in terms of certain types of conduct? What is 'prudential standing'? The lack of materiality clauses added to the broad wording of the Exposure Draft is a matter of significant concern.

There is a significant risk that the incorporation of novel concepts into the law will only generate appealable disputes, ultimately frustrating the purpose of the BEAR.

The AICD would be pleased to consult with the government on alternative drafting that would implement the policy intent without this uncertainty of scope.

#### **4.4 Reform objectives**

In introducing the reform proposals, the draft explanatory memorandum notes that ADIs must operate 'at the highest standards and meet the needs and expectations of Australian consumers and businesses'. The AICD agrees. All participants must have trust in the integrity of Australia's banking system.

However, the AICD remains concerned that the BEAR does not sufficiently identify the conduct it seeks to address, namely, egregious systemic misconduct compromising consumer outcomes, financial stability or market integrity. Indeed, we are concerned that some elements of the BEAR now appear to go well beyond these matters.

As with all reform proposals and legislation, the policy objectives must be clearly defined to ensure the regulations are fit for purpose. This is particularly the case for the BEAR given the extensive range of laws and standards that already exist to address conduct and prudential matters.

To ensure the objects of the government are clear, we reiterate our recommendation that the government consider inserting an objects clause in the legislation or explanatory material.

#### **4.5 Civil penalties**

The AICD welcomes the civil penalty regime being applied by the Federal Court of Australia, and not by way of an infringement notice regime akin to that within the Corporations Act.

In addition, the AICD considers there is a significant risk that the same conduct by an ADI or a subsidiary could result in a breach of an ADI's responsibilities under the BEAR and contravention of a range of other civil penalty or other provisions to which the ADI or subsidiary is subject, including FOFA and Corporations Act provisions.

Finally, we reiterate that the question of indemnity should be resolved in a way that is consistent with the ordinary principles applied to liability in the context of the Corporations Act. The AICD welcomes the exclusion of legal costs from the prohibition on indemnifying ADIs and accountable persons under s 37KB.

#### **4.6 Three year review**


Given the significant nature of the BEAR and its potential impact across the banking sector, the AICD recommends the inclusion of a review mechanism in the BEAR which requires its application and effectiveness to be reviewed after three years. This will ensure that there is an opportunity to address any unintended consequences which may arise, particularly given the short consultation period given.



**5 CONCLUSION**

We hope our comments will be of assistance to you. If you would like to discuss any aspect of this submission, please contact Matt McGirr, Policy Adviser, on (02) 8248 2705 or at [mmcgirr@aicd.com.au](mailto:mmcgirr@aicd.com.au).

Kind regards



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