29 September 2017

Mr Tony McDonald
Principal Adviser
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: BEAR@treasury.gov.au

Dear Mr McDonald

Banking Executive Accountability Regime – Draft Legislation

Thank you for the opportunity to comment on the draft legislation. We would have preferred more time to consider the draft bill and obtain more feedback from our member ADIs. In the short time available to consider the bill we have identified a significant number of issues that require further clarification.

Customer owned banking institutions comprise 70 per cent of domestic ADIs. On behalf of our member mutual banks, credit unions and building societies and their four million customers, COBA expresses our objection to the application of these burdensome new regulatory compliance obligations to our sector.

Under the proposed tiers in the draft bill, the vast majority of our sector are "small ADIs". However, there are some "medium ADIs" that are customer-owned and COBA expects this number to increase over the next few years. Some COBA members have subsidiaries while others are subsidiary ADIs of non-ADIs.

The Explanatory Memorandum to the draft bill points to the work of the House Economics Committee and the Government's response to the first report of that Committee in announcing a package of reforms to strengthen accountability and competition in the banking sector.

However, the EM is flatly misleading where it states that the Committee "undertakes an annual inquiry into the performance and conduct of Australia's banks." In fact the Committee undertakes an inquiry into Australia's "Four Major Banks". The Committee's examination of the performance of the Four Major Banks is the reason for the BEAR.

The BEAR has been designed to solve a problem that exists in the major banks, not in the customer owned banking sector. The conduct of other ADIs was not examined by the Committee and no case has been presented to apply the BEAR to other ADIs. Customer owned banking institutions are different from investor owned banks in that they are owned by their customers rather than a separate set of shareholders.

There is no case to apply the BEAR to customer owned ADIs because our business model ensures we have a built-in structural solution to the conflict between customer interests and profit maximisation that plagues the major banks. The community concern regarding recent poor behaviour by major banks does not apply to our sector. There is no problem in our sector for the BEAR to solve.

Our sector is already effectively regulated by APRA's prudential framework which includes standards covering many of the areas of the BEAR. These standards apply in addition to the duties of directors under the Corporations Act.

Imposing unnecessary new regulatory compliance burdens on smaller banking institutions contradicts the Government's objective of an "unquestionably competitive" banking system.

Retail banking markets in Australia, according to the ACCC[1], exhibit a number of indicators that suggest the current oligopoly structure is not vigorously competitive and has not been for some time. These indicators include:

- a concentrated market structure with the largest players maintaining significant market shares over a considerable time and sustaining very high margins and overall profits without attracting significant new entry or expansion by smaller players, and
- a high degree of symmetry in the product and service offerings of the large banks and "we do not observe strong rivalry between them to be the first to roll out new products and services to better meet the needs and wants of consumers."

The ACCC says that "in situations of oligopoly, all else being equal, a market structure that enables a competitive fringe of second tier firms to effectively challenge the price and service decisions of large incumbents is likely to produce significantly better outcomes for consumers than one that does not."

The regulatory compliance burden is a critical factor in determining whether the competitive fringe of second tier firms can challenge the major banks.

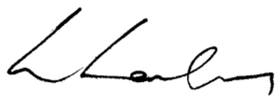
COBA seeks an exemption for customer owned banking institutions from the BEAR. We note that the draft bill includes capacity for the Minister to exempt an ADI or class of ADIs from the BEAR but if our sector is to be exempt this must be made clear now.

If the Government is unwilling to exempt our sector, we request that the Government responds to the concerns outlined below and in particular:

- the need for phased implementation of the regime, with commencement for small and medium ADIs two years after it applies to major banks, and
- the need to address the anti-competitive impacts of the deferred remuneration arrangements on our sector.

Detailed comments on these requests and on specific clauses of the BEAR draft bill are attached. If you have any questions about this submission, please do not hesitate to contact me on 02 8035 8448 or llawler@coba.asn.au.

Yours sincerely



LUKE LAWLER
Director – Policy

[1] ACCC submission to Productivity Commission inquiry into competition in the Australian financial system, September 2017

Phased approach for smaller ADIs

If the Government decides to increase the regulatory burden on all ADIs for the actions of the major banks then we request a phased implementation timetable for ADIs other than the major banks. If the regime commences for the major banks on 1 July 2018, it should commence on 1 July 2020 for all other ADIs.

We also request the Government increase the scope of its proposed remuneration deferral exemption to ensure that smaller ADIs are better positioned to compete for executive talent.

The Government should delay BEAR commencement for small and medium ADIs ('smaller ADIs'). This should take place 2 years after commencement for the major banks. Small and medium ADIs would continue to be subject to the existing – and for them, effective - prudential regime in the meantime.

Imposing the regime on major banks only from 1 July 2018 would ensure that around 80 per cent of deposits are covered from day one.

COBA acknowledges that there may be some flexibility within the draft bill to provide a more proportional approach to the BEAR. However, there is no certainty if there will be such a proportional approach and no clarity about what a proportional approach would look like.

Similarly, there are a number of initial BEAR issues that APRA needs to resolve in order to have an operational BEAR by mid-2018.

To provide a proportionate and effective BEAR, there must be sufficient time to address these matters.

A phased approach allows APRA more time to resolve BEAR 'teething' issues and develop guidance on a proportional approach to the BEAR. This would ensure that the impact of the BEAR on smaller ADIs is minimised as far as possible. If there is no phasing of commencement, smaller ADIs would unfairly bear the learning costs of a new regime that responds to a lack of major bank accountability. At the extreme, this could create a perverse situation where regulation targeted at major banks handicaps their smaller competitors.

There is no urgent case to apply the BEAR to customer-owned ADIs from July 2018.

The proposed July 2018 implementation date is clearly too aggressive for smaller ADIs. It would allow only a 6 month period to determine APRA's requirements and to implement compliance solutions. There are many areas where guidance is required, and we submit that APRA should develop this guidance in consultation with industry. This can't happen in an effective manner within the proposed timeframe. COBA notes that industry's response to the initial consultation shows a strong and consistent view that least 24 months is required to implement the BEAR.

Introducing a 'limited' BEAR with a temporary, narrower scope from mid-2018 would still impose an unnecessary burden on smaller ADIs. While this approach may be well intended, it is unlikely to be effective in reducing the regulatory compliance burden and does not meet the policy objective of greater accountability for the major banks. Similarly, while a limited scope may reduce some variable costs of compliance, smaller ADIs would still be likely to incur the fixed costs.

We note it is likely that prudential regime could change in the near future as result of the new BEAR powers. The EM flags this: "APRA may update CPS 520 [Fit and Proper] to reflect the new and strengthened BEAR expectations as appropriate."

A phased implementation would also provide sufficient time to review relevant prudential standards. Small and medium ADIs would then be able to implement a single, consistent regime that satisfies both the prudential standards and statutory requirements under the BEAR. This will minimise any potential inconsistencies and reduce the additional regulatory burden.

Increasing the scope of remuneration deferral exemption

COBA request that the Government revises its proposed deferral exemption (37ED) to include medium ADIs and increase the deferral threshold amount to $100,000.

The customer-owned banking sector does not have the share-based remuneration packages seen in the major banks. Indeed, major banks are likely to have already met deferral requirements due to these share-based packages. Customer-owned ADI variable remuneration is cash as we do not have ordinary shares. Deferred cash decreases in value over time relative to shares.

Deferral requirements will disproportionately impact customer-owned ADIs' critically important ability to attract executive talent. Our sector will either have to increase remuneration due to these requirements or curtail or even abandon variable remuneration programs. This will negatively affect our sector's ability to attract talented executives. None of these outcomes increase the prudential stability of an ADI.

Increasing the scope of the 37ED exemption will put smaller ADIs in a better position to attract the necessary talent to ensure they can compete with the major banks. See further information below.

Phased implementation provides an appropriate timeframe for implementation

There is a strong industry view that at least 24 months is required to implement the BEAR.

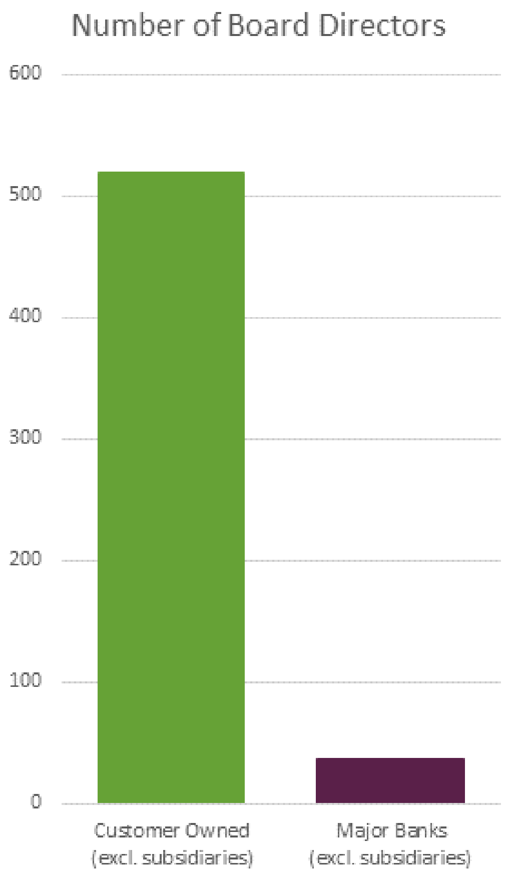
COBA's initial submission echoed this sentiment: the legislative framework underpinning the UK Senior Manager Regime [SMR], the Financial Services (Banking Reform) Act 2013, was passed on 18 December 2013. The Senior Managers Regime came into force on 7 March 2016.[2] A minimum two-year time frame could be appropriate for the BEAR. The UK experience with the SMR also had a significant amount of consultation and guidance prior to implementation.

BEAR compliance goes beyond just generating accountability statements and maps and identifying accountable persons. ADIs may need to revamp governance processes, risk management & human resources policies and reporting lines within the organisation.

The timr required is also dependent upon the extent to which individual ADIs have already undertaken the required processes, or similar exercises, and the relative staffing of the relevant business units (particularly HR departments). Smaller ADIs do not have the large HR and compliance department staff resources of the major banks to implement the BEAR by mid-2018.

Similarly, given that our sector comprises the majority of ADIs in the domestic banking system and the 'fixed' size of boards, our sector will have by far the largest number of directors subject to the BEAR (see graph below). There will be a significant transition exercise for our sector, which includes training and education costs.

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



<u>Selection of comments from first round submissions</u>

Allen Linklaters	"The UK provided a 3 year transition period in recognition of the very significant amount of work required by the regime. We submit that a similar period of time would be needed in Australia. We also note that while the implementation of the regimes in the UK and Hong Kong created a great deal of work for compliance teams and consultants and lawyers, it is far from clear that the work and expense for regulated institutions has had any real benefit to the community or consumers."
Clifford Chance	"The UK Financial Services (Banking Reform) Act 2013, which gives legislative effect to the SMR, was passed in December 2013. The SMR went live in March 2016, over two years later, in which period there were extensive consultation with the industry and rules published by the regulator"
Henry Davis New York	"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."
Financial Services Council (FSC)	"The FSC would support a two year implementation period from when the requirements are finalised."
Herbert Smith Freehills	"A long period of implementation will be particularly important if the legislation is enacted, to ensure that BEAR is effective and works well in the long run." "We recommend a transition timeframe of 24 months following enactment of the BEAR legislation"

Phased implementation provides time to develop a proportional BEAR for smaller ADIs

COBA believes that there must be proportional approach to the BEAR. We acknowledge that there may be some flexibility within the legislation to provide a more proportional approach to the BEAR. However, there is great uncertainty if there will be a proportional approach and what it would look like. A phased implementation provides sufficient time for APRA to develop a proportional BEAR regime for smaller ADIs.

The EM notes that there is to scope to engage with APRA to develop a proportional approach to the BEAR for smaller ADIs: "In particular, small ADIs could liaise with APRA to determine the appropriate representation for their size, business operations, customer base and presence in the Australian market".

As noted earlier, there are a significant number of initial issues that APRA would need to bed down having an operational BEAR. These issues include:

- additional or excluded accountable person responsibilities — 37BA(4) & 37BB(3) including with relation to subsidiaries
- materiality of a 'significant' subsidiary, given that the intention to capture large insurance or wealth management arms of an ADI
- determinations of variable remuneration — 37EA(2), 37EA(3) & 37EA(4)
- reasons to allow a shorter period of remuneration — 37EC(4) & 37EC(5)
- APRA's expectations of accountability maps and statements
- potential to relax periods for the allowance of non-registration
- alternative notification periods — 37F(2b)

Many ADIs will need guidance from APRA on these BEAR requirements. This will take time. Similarly, APRA will need time to examine its discretion under the legislation and determine an appropriate proportional approach for smaller ADIs.

Specific Comments

37BA Meaning of accountable person

Clarifying that accountable persons responsibilities relates to senior executives

COBA believe that the legislation intends to target the BEAR at senior executives. However, APRA needs to clarify how to treat staff that map to these responsibilities who are not necessarily senior executives.

Customer-owned ADIs do not have complex governance structures and large numbers of senior executives like the major banks.

In smaller ADIs, some responsibilities noted in 37BA(3) may not be assigned to senior executives but rather to junior officers several layers below them. For example, this may be an AML/CTF or compliance officer who is several levels below CEO. COBA does not believe it is appropriate to identify these people as accountable persons.

This AML/CTF issue has arisen in the UK, with the FCA noting: "some firms have allocated the responsibility for policies and procedures for countering the risk that the firm might be used to further financial crime to an individual at a lower level in the organisation than we would expect."[3]

The broad scope of potential accountable persons is exacerbated by differences between the EM and legislation in relation to accountable persons. The EM (1.10) indicates that an accountable person is "a Board member or senior executive with

---

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

responsibility for management or control of significant or substantial parts or aspects of the ADI group." However, 37BA in the legislation refers to "responsibility for management" which is a broader scope than senior executives.

Clarifying expectations with respect to subsidiaries and ADIs that are subsidiaries

APRA will need to clarify its expectations of accountable persons within subsidiaries and for ADIs that are subsidiaries. Some of our members have subsidiaries while others are subsidiaries ADIs of non-ADIs.

Any ambiguity will lead to an excess of accountable persons if an ADI identifies broader subsidiary executives and board members. This will greatly increase compliance costs. COBA notes that the EM highlights the intent to capture "large insurance or wealth management arms of an ADI". It is not clear what APRA's expectations are of a 'large' subsidiary.

There may be times where an ADI subsidiary has some accountable person responsibilities in its parent company. APRA needs to identify a proportional approach for these situations.

37C The accountability obligations of an ADI

37C(c) — The legislation must clarify that reputation relates to an ADI's *prudential* reputation and not its broader reputation. This should also be the case for 37CA(c).

37DB APRA may direct an ADI or subsidiary to reallocate responsibilities

37DB(1) — APRA needs to clarify what its expectations of "likely to give rise to a prudential risk". This will allow ADIs to ensure that they will conduct themselves in a manner that does not risk activating this section.

37E The deferred remuneration obligations of an ADI

37E(bii) — the term "likely to have failed to comply" is subjective and further guidance is required to understand APRA's expectations of ADI remuneration policies.

37EA(1a) —further guidance is required on the definition of variable remuneration. The 'achievement of objectives' can relate to objectives such as meeting compliance targets rather than meeting sales or profit targets. In the former examples, these objectives do not endanger the prudential standing of an ADI.

37ED Exemption for small amounts of variable remuneration

COBA supports the rationale of this exemption to provide a safe haven for smaller ADI remuneration packages. However, 37ED(a) must be amended to include medium ADIs or there will be unintended consequences around the threshold.

The customer-owned banking sector does not have the share-based remuneration packages of the major banks. Flexible and competitive remuneration packages are important for attracting talent, including from outside the banking sector. Talented executives are likely to lead to better prudential outcomes.

Limiting this exemption to "small ADIs" is problematic. For example, if a small ADI becomes a medium ADI then previously exempt accountable persons would suddenly become subject to deferral. This is not a practical outcome. It leads to a perverse situation where an individual receives less effective income (due to deferral) as their employing entity crosses the threshold (proposed at $10 billion) to 'medium' status.

The effective reduction in income is exacerbated in customer-owned ADIs whose deferral amounts are cash[4] (decreases in value over time) not shares like in an investor-owned bank (can increase in value).

This will increase the need for 'new' medium ADIs to pay higher salaries or bonuses thereby increasing the incentive to scrap variable remuneration plans altogether. This does not strengthen an ADI's prudential safety.

Under the proposed legislation, a person working for a small ADI with an exempt remuneration package is not subject to deferral, but a person working in a medium ADI with the same remuneration package is subject to deferral. This is inequitable. The starkest example relates to those who are receiving bonuses that are insignificant, e.g. $10,000. They would be exempt under the 37ED in a small ADI but would have $4,000 of their bonus deferred for 4 years at a medium ADI. This can't be the intent of the deferral requirements—which are aimed at the massive compensation packages of major bank executives.

COBA also urges the Government to increase the deferral amounts threshold in 37ED(b) from $50,000 to $100,000 so that the deferral policy is appropriately targeted with an appropriate materiality threshold. Given the state of the banking market as described by the ACCC , surely the BEAR is not intended to disadvantage smaller ADI in the competition for executive talent.

Further guidance will be required from APRA about how it expects the deferment mechanism to work under a wide range of situations.

37FA Accountability statements & 37FB Accountability map

ADIs will need further guidance to develop these documents. It is important that smaller ADIs are able to develop these documents as efficiently and effectively as possible.

There have been issues with these documents in the UK. This is despite significant consultation and a much longer implementation period than proposed in Australia. This does not bode well if APRA expects to implement the BEAR by mid-2018.

An FCA supervisory review of these documents[5] found that:

- "…FCA-prescribed responsibilities or the overall responsibilities may not have been allocated to the most senior and/or most appropriate individual."
- "Neither have we always been confident that senior managers given responsibilities have sufficient seniority, resources or authority to discharge their responsibilities effectively."
- "Some firms submitted SoRs with additional information that was either not relevant to the individual's responsibilities or which focused on how the individual discharged their responsibilities, rather than what they were actually responsible for."
- "not enough information was given to be able to understand what the SMF manager was responsible for"
- "…there has not been enough detail given about reporting lines."

[4] Customer-owned banking institutions do not offer share instruments as part of their remuneration packages
[5] https://www.fca.org.uk/publication/feedback/fs16-6.pdf

These findings suggest that it is important for APRA to have adequate consultation with ADIs about its expectations on the accountability statements & maps. COBA member feedback notes that there are existing corporate governance frameworks that APRA can leverage to minimise the burden.

Questions arise about how to deal with shared accountabilities. For example, ADIs make certain decisions by committee (i.e. a Risk Committee). How does this map to who is individually responsible for risk?

37H Registration of accountable persons

The practical implications of accountable persons' registration will need more guidance.

Questions from COBA members include:

- What protections are there in place with respect to registration for someone who is leaving an ADI provisionally for another ADI? Could it be made public that they are leaving?
- At what point does an ADI register a prospective hire prior to appointment? How do conditional employment offers work with respect to fit & proper and the BEAR as well?
- Do we have to go to APRA before we hire someone and what happens in the interim?
- How do we treat subordinates (i.e. non-accountable persons) acting in an accountable person position? What happens if they are not effectively responsible?
- How does BEAR registration operate with the fit and proper registration?

37J APRA may disqualify an accountable person

COBA urges the Government to amend section 37J to provide access to a merits review under the Administrative Appeals Tribunal.

The proposed 'submission' appeal process in 37J(8) is clearly insufficient. This does not provide the natural justice of an independent, merits-based appeals mechanism.

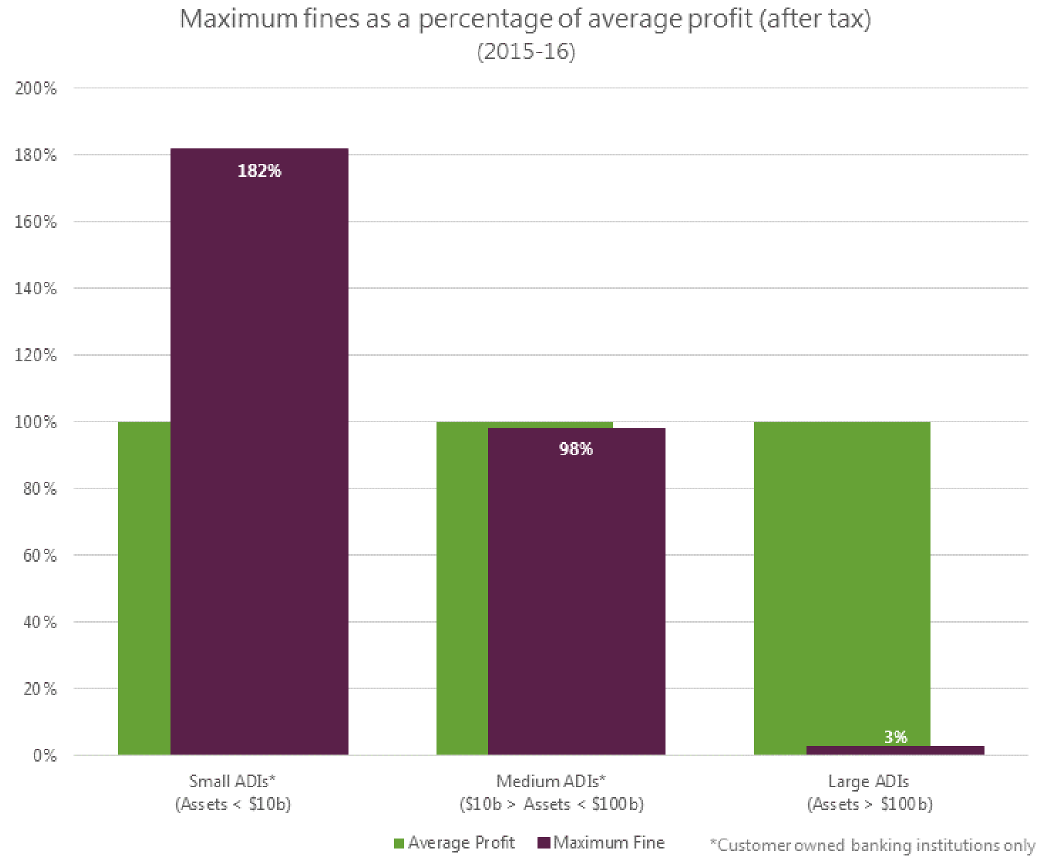
Given that the APRA power is analogous to the ASIC banning power, this would align the appeals mechanism with the mechanism for ASIC's banning power.

It also would ensure adequate independent oversight of APRA disqualifications.

If the Government does not change 37J then we request that it clarify where the respective ASIC and APRA jurisdictional boundaries are to ensure there is no overlap in disqualification powers. If ASIC & APRA are able to pursue action for the same behaviour, then this could lead to a situation where an individual may arbitrarily not have access to an appeals process.

37G Penalties

As an illustration of the grossly disproportionate nature of the regime for our sector, we have compared maximum fines under the penalty regime to average profit for customer owned banking institutions in the 'small ADI' tier and the 'medium ADI' tier with major banks who are in the 'large ADI' tier.



This comparison shows that the maximum fine for 'small ADIs' is considerably larger than the average profit for these ADIs. For a 'medium ADI' in the customer owned sector, the maximum fine is virtually equal to profit. For major banks, the maximum is a tiny fraction of average profit, i.e. 3 per cent.

We recognise that there is scope for proportionality under 37G(4) in that a court "must have regard to the impact that the penalty would have on the viability of the ADI." However, the 'threat' of a fine under the BEAR looms somewhat larger for small and medium ADIs than it does for major banks.

29 September 2017