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BANKING EXECUTIVE ACCOUNTABILITY REGIME

SUBMISSION

GLOBAL BANKS SECTOR GROUP

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By Email

Dear Manager

Submission: Banking Executive Accountability Regime

This is our submission on the Exposure Draft of the Treasury Laws Amendment (Banking Executive and Related Measures) Bill 2017 (**Draft Bill**).

1 General observations

We are grateful for the opportunity to make submissions on the Draft Bill and would be pleased to discuss any part of our submission with you.

We also acknowledge that some of the recommendations made in our submission dated 3 August 2017 in relation to the Proposal Paper entitled 'Banking Executive Accountability Regime' (**Consultation Paper**) have been reflected in the Draft Bill and Explanatory Memorandum.

2 Feedback on matters identified in the Draft Bill

2.1 The rights of individuals in the disqualification process

HSF Recommendation 1: greater clarity be provided regarding the presently uncertain scope of an individual's rights in the disqualification process.

APRA will be required by s 37J of the Draft Bill to give an individual and the relevant ADI an opportunity to make submissions before disqualifying a person for a breach of the Bank Executive Accountability Regime (**BEAR**). However, the Draft Bill is otherwise silent as to the individual's rights in the process. For example, it is unclear whether the individual has the right to see and test the evidence put against him or her, or a right to a hearing.

Such rights may be implied as a matter of general law, but it would be preferable if such rights were expressly set out in the Draft Bill.

2.2 Access to merit review when APRA makes a decision to disqualify individuals

HSF Recommendation 2: access to merits review be granted to individuals who are disqualified.

We think a fair go for someone who is to be banned from earning their livelihood is an independent review of APRA's decision on the merits. The Draft Bill does not provide access to merits review. His or her right of recourse will be limited to a narrow procedural review, known as 'judicial review'. Accordingly, rather than an appeal that considers the underlying merits of the decision, the arguments that may be raised are confined to those such as a breach of the rules of natural justice, taking an irrelevant consideration into account, an error of law, etc. And that is in the context of 'fuzzy' accountability obligations.

In our view, this is one of the most problematic aspects of the Draft Bill. It is inconsistent with the position with respect to ASIC disqualification and banning orders, where merits review in the Administrative Appeals Tribunal is available (see s 1317B of the *Corporations Act 2001* (Cth) (**Corporations Act**)). It also runs counter to the accepted wisdom (reflected in prior reports of parliamentary inquiries and the Australian Law Reform Commission) that public accountability in respect to regulatory decisions is critical, and administration is improved as regulators learn from tribunal decisions.

As Treasury would be aware, APRA previously had powers to disqualify individuals without seeking a court order. APRA's earlier disqualification power was the subject of 13 cases in the Administrative Appeals Tribunal (**AAT**) between 2005 and 2009. APRA's decision to disqualify an individual was overturned by the AAT in 8 cases and upheld in only 5 instances. In light of this history, we think an independent review on the merits is an important safeguard, and will lead to improved regulatory decisions.

2.3 APRA's ability to bring court proceedings for a civil penalty

HSF Recommendation 3: the Draft Bill be amended to reflect the intention that the BEAR legislation should cover conduct that is 'systemic and prudential in nature' and thereby provide a materiality threshold for APRA's ability to impose a pecuniary penalty.

Pursuant to s 37G of the Draft Bill, an ADI that contravenes its BEAR obligations is liable to a pecuniary penalty. In order to seek such a penalty, APRA must commence proceedings in the Federal Court.

For a pecuniary penalty to be available (s 37G(1)(b)), the contravention must relate to 'prudential matters'. However, 'prudential matters' are defined widely in the *Banking Act 1959* (Cth) to mean matters relating to (among other things):

- the conduct by an ADI of any parts of its affairs in such a way as to keep the ADI in a sound financial position, or not to cause or promote instability in the Australian financial system; and
- the conduct by an ADI of its affairs with integrity, prudence and professional skill.

Moreover, the phrase 'relates to' is a broad expression, normally interpreted by courts as just requiring some form of relationship which need not be direct or immediate. Accordingly, the requirement that the contravention relate to 'prudential matters' does not reflect the earlier Consultation Paper position that penalties would apply to poor conduct or behaviour 'that is of a systemic or prudential nature'. The Explanatory Memorandum also contains a number of references suggesting that the BEAR legislation is intended to cover conduct that is 'systemic and prudential in nature'. That language is not, however, reflected in the Draft Bill. We recommend that the wording of the Draft Bill be amended to address this issue.

We also recommend that a materiality threshold be introduced (such as that contained in s 1317G of the Corporations Act), which requires the relevant contravention to 'materially prejudice' the interests of the corporation, or the corporation's ability to pay its creditors, or be 'serious'.

2.4 Definition of accountable persons

(a) *Impact on subsidiaries*

HSF Recommendation 4(a): the extent to which the BEAR conduct obligations apply to subsidiary directors and management should be clarified. Further guidance is required to ensure that the definition of accountable persons is not too far reaching and does not capture directors and managers of subsidiaries with activities and operations that do not substantially affect the prudential standing and reputation of the ADI.

As foreshadowed in the Consultation Paper, accountable persons are defined in s 37BA of the Draft Bill by reference to a general principle and a list of specific functions/responsibilities. The principle based element of the definition applies to both the ADI and its subsidiaries. It captures persons with actual or effective responsibility for management or control of the ADI or a subsidiary, or for management or control of a significant or substantial part or aspect of the ADI's or subsidiary's operations. This approach is one of 'substance over form' and is analogous in many respects to the definition of 'key management personnel' under the Corporations Act and to concepts used in the UK and Hong Kong equivalents to the BEAR, for which significant guidance has been provided.

The breadth of the principle based element of the definition makes sense in relation to identifying accountable persons in relation to the ADI. However, when applied on a subsidiary basis, it means that more people will be caught than the intention expressed in the Consultation Paper and Explanatory Memorandum. According to the Consultation Paper, the principle based element of the definition is intended to be broad enough to capture directors or senior executives of subsidiaries responsible for management of a significant proportion of the ADI's business or activities. However, the Draft Bill applies generally to subsidiaries of an ADI and does not restrict the application of the definition based on a subsidiary's significance to the ADI's business.

This runs counter to the policy objective stated in the Consultation Paper that the definition of accountable persons should identify the most senior directors and executives who will be held to a heightened standard of responsibility and accountability, but should not cast the net too wide. The risk, appropriately identified in the Consultation Paper, is that 'if everybody is responsible, nobody will be accountable' thereby depriving the BEAR of its purpose.

Indeed, the Explanatory Memorandum explains that it is not the Government's intention that a person will be an accountable person merely because they hold a management role in a subsidiary. However, even if overall responsibility for a subsidiary rests higher up the corporate chain, members holding a genuine management role within a subsidiary will be caught by the current drafting of the definition, even if they only have responsibility for a significant or substantial 'aspect' of the subsidiary's operations. Joint responsibility is expressly contemplated by the Draft Bill, and may apply here. This could significantly expand the potential number of accountable persons caught by the BEAR beyond those who have significant responsibilities in relation to the ADI or its business.

Accordingly, we recommend that the scope of s 37BA(1)(b) be confined so that it only applies to 'significant subsidiaries'. This is consistent with paragraph 1.29 of the Explanatory Memorandum which explains that '[w]here the activities of a subsidiary are significant, then an accountable person should have responsibility for that subsidiary'.

Unless this drafting is clarified before becoming law, we expect that the application of the BEAR conduct obligations to subsidiary directors and management will be an issue which requires significant discussion between ADIs and APRA to clarify how they intend to apply the provisions.

(b) *Matters adversely affecting the ADI's 'prudential standing or reputation'*

HSF Recommendation 4(b): the obligation should be amended so that it only captures the ADI's 'prudential reputation' rather than its reputation generally.

The Draft Bill requires the ADI and accountable person to take reasonable steps to prevent matters arising that could adversely affect the ADI's 'prudential standing or reputation' (s 37C(c)).

In our view, the inclusion of 'reputation' as a general phrase is too broad, and likely to capture unintended circumstances. For example, the current Draft Bill arguably prevents an ADI from making commercial decisions that may be unpopular with certain sectors of the community and therefore potentially adversely affect the bank's 'reputation' within that sector.

We recommend that the 'reputation' element be qualified in the same way as the standing requirement so that the scope of s37C(c) only extends to the 'prudential reputation' of the ADI. Additionally, it would be helpful for the Explanatory Memorandum to clarify that the obligation does not prevent an ADI from making commercial decisions that may be unpopular with certain customers.

2.5 APRA's power to direct a reallocation of responsibilities

HSF Recommendation 5: clarification be given regarding the circumstances in which APRA intends to use this power. Since the power is extremely broad and the impact is significant, it should be exercised sparingly.

We note the inclusion of s 37DB of the Draft Bill, which empowers APRA to give a direction to an ADI, or its subsidiary, requiring the reallocation of certain responsibilities from an accountable person to another person if APRA has reason to believe that the current allocation of those responsibilities is likely to give rise to a prudential risk.

This power is extremely broad, and neither the Draft Bill nor the Explanatory Memorandum indicate when the power will be exercised, nor require APRA to consult with the ADI in question before giving such a direction.

It may be the Government's intention that APRA only use this power sparingly, however addressing these issues in the Draft Bill or Explanatory Memorandum would give comfort to the industry that this broad power will be exercised appropriately.

2.6 Other areas requiring further guidance

(a) *Circumstances where disqualification is justified*

HSF Recommendation 6(a): the Draft Bill be amended to reflect the intention that disqualification would only be justified in 'serious cases'.

The Explanatory Memorandum indicates that the Government's expectation is that a decision by APRA to disqualify would only be justified in 'serious cases'. However, that notion is not expressly reflected in the Draft Bill.

(b) *Remuneration*

HSF Recommendation 6(b): further guidance be given on the start of the deferral period and the 'claw back' requirement.

Guidance on the commencement of the deferral period in s 37EC of the Draft Bill would be helpful, as it is currently open to interpretation.

In practice, the implementation of the 'claw back' requirement in s 37E of the Draft Bill is likely to create uncertainties for boards of ADIs. For example, at what point is a breach considered 'likely' to occur? Is there a threshold for 'likelihood'? How should the board determine proportionality of the claw back, particularly when the extent of the failure is still being considered or investigations are ongoing? Can a decision be reversed if subsequent information comes to light that exonerates the accountable persons? Further guidance on these questions would be helpful.

(c) *Non-executive director remuneration*

HSF Recommendation 6(c): further guidance be given to clarify that the variable remuneration of non-executive directors is not subject to the deferral requirements.

The Consultation Paper made clear that the deferral of variable remuneration was intended to apply to executive accountable persons of an ADI. However, the scope of the deferred remuneration obligations of an ADI in s 37E of the Draft Bill and the definition of variable remuneration in s 37EA are couched in terms of 'accountable persons', rather than 'executive accountable persons'. We think the Draft Bill should clarify the intended treatment of non-executive director fees.

2.7 Clarity of obligations

HSF Recommendation 7: further elaboration of what is meant by 'open, constructive and cooperative' is required.

The Consultation Paper contemplated an obligation incumbent upon ADIs to deal with APRA in an 'open and cooperative way'. In our earlier submission, we suggested that an alternate formulation of that requirement, which may avoid some of the legal uncertainties with the use of those terms, would be to require ADIs and accountable persons to deal with APRA in an 'honest and constructive' way.

The Draft Bill has extended the wording to require an ADI to deal with APRA in an 'open, constructive and co-operative way' in s 37C(b). Whilst this reflects our suggestion that the phrase 'constructive' be used, it does not necessarily resolve the issue raised in our submission as to the uncertain meaning of the other terms. The Explanatory Memorandum does not give any shade of meaning to those requirements, but rather states at 1.49 that 'the ordinary meanings of each of those terms are generally well understood, and are used in other laws and considered by established case law'. This fails to address the concern that both 'open' and 'cooperative' are highly uncertain terms that, in Australia, may cut across existing self-reporting obligations.

2.8 Flexible implementation

HSF Recommendation 8: that a flexible implementation timeline be provided for where an ADI has achieved substantive compliance with the BEAR obligations.

Given the significant implementation process that will be necessary in order for an ADI to implement the requirements of the BEAR, it would be sensible for some flexibility to be vested in APRA as to the implementation timeline provided that an ADI has achieved substantive compliance with the BEAR obligations.

To that end, we recommend that a 'Part 4 – Compliance with other Divisions of Part II AA' be added to Schedule 1, as follows:

4 Compliance with other Divisions of Part II AA

1	Compliance with Divisions (other than Division 4) of Part II AA of the Banking Act 1959 as inserted by this Act commences, or is taken to have commenced in accordance with section 2 of this Act.
2	APRA by legislative instrument, determine a longer period for an ADI to comply with its obligations under this Act provided the ADI has substantially complied with such obligations by the date prescribed in accordance with section 2 of this Act.
3	Without limitation to subitem 2, such longer period may relate to the scope, reach and detail of the ADI's compliance with its obligations under the Act.

2.9 Legal professional privilege

We welcome the clarification in the Explanatory Memorandum that nothing in the Draft Bill imposes an obligation on a party to waive legal professional privilege.

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