Regulation Impact Statement – *Banking Executive Accountability Regime*

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Background

Authorised deposit-taking institutions (ADIs)

Under section 9 of the *Banking Act 1959* (Banking Act), a body corporate that wishes to carry on 'banking business' in Australia may only do so if the Australian Prudential Regulation Authority (APRA) has granted an authority to the body corporate for the purpose of carrying on that business. Banking business is ordinarily understood to mean the mixture of deposit-taking and lending. Once authorised by APRA to undertake banking business, the body corporate is an authorised deposit-taking institution (ADI) and is subject to APRA's prudential requirements and ongoing supervision.

2017-18 Budget announcement

In the 2017-18 Budget, the Government brought forward a comprehensive package of reforms to strengthen accountability and competition in the banking system. As part of this package, the Government announced that it will legislate to introduce a new Banking Executive Accountability Regime (BEAR).

1. The problem

Financial stability is very important to economic performance and the wellbeing of Australian households and businesses. The Australian financial system is the backbone of the economy and plays an essential role in promoting economic growth. In order for it to operate in an efficient, stable and fair way, it is imperative that participants have trust in the system. It must operate at the highest standards and meet the needs and expectations of Australian consumers and businesses.

Banks, as ADIs, play a critical role in the financial system, including through their deposit-taking, payments and lending activities. ADIs enjoy a privileged position of trust, with prudential regulation designed to provide consumers with confidence in the safety of their deposits.

Participants need to be confident that financial firms will balance risk and reward appropriately and serve their interests. As the Financial System Inquiry noted:[1]

> Without a culture supporting appropriate risk-taking and the fair treatment of consumers, financial firms will continue to fall short of community expectations.

The experience of other countries – especially during the global financial crisis – demonstrated the substantial harm that can be caused to individual financial institutions – and the financial system as a whole – when the incentives provided to – and accountability of – the directors and senior management of financial institutions is not aligned with the sustainable operations of the institution.

- The collapse of Lehman Brothers in September 2008 is often cited as the catalyst for the global financial crisis[2], with the compensation arrangements of senior executives a significant contributing factor to the collapse of the institution.

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1 Financial System Inquiry Final Report, p.7, http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf .

2 See, for example, David Gruen, 2008, *Opening Statement to the Senate Standing Committee on Economics* *https*://static.treasury.gov.au/uploads/sites/1/2017/06/Opening_Statement.pdf

- The collapse of Baring Brothers in February 1995 reflected the "virtual total failure of risk management systems and controls, and managerial confusion, within the Barings Group"[3].
- A report on the US Savings and Loan scandal found that the "debacle ... was a consequence of the perverse incentives, permissive regulation and inadequate supervisions that had been built into the system."[4]

Overseas experience shows that excessive risk-taking behaviour, and misconduct more generally, can have non-trivial consequences to the financial stability of an economy. An example of this is the global financial crisis, where excessive risk-taking behaviour led to financial institutions requiring bail-outs, and in some instances their collapse. As the Financial Stability Board has noted[5]:

> Weaknesses in risk culture are often considered a root cause of the global financial crisis, headline risk and compliance events. A financial institution's risk culture plays an important role in influencing the actions and decisions taken by individuals within the institution and in shaping the institution's attitude toward its stakeholders, including its supervisors.

The Bank for International Settlements (BIS) Basel Committee on Banking Supervision revised its *Corporate Governance Principles for Banks* to reflect key lessons from the global financial crisis. It states that[6]:

> Effective corporate governance is critical to the proper functioning of the banking sector and the economy as a whole. Banks perform a crucial role in the economy by intermediating funds from savers and depositors to activities that support enterprise and help drive economic growth. Banks' safety and soundness are key to financial stability, and the manner in which they conduct their business, therefore, is central to economic health. Governance weaknesses at banks that play a significant role in the financial system can result in the transmission of problems across the banking sector and the economy as a whole.

As has been well documented, the Australian banking system performed well during the global financial crisis.[7] However, it is prudent to learn the lessons from the experience in other countries. Although Australia's experience in this regard has been different to that of other countries, the Government's intention is to take a proactive approach in ensuring that the prudential regulation framework continues to be effective in protecting the financial well-being of the Australian community.

Moreover, a series of incidents over recent years involving the misconduct of financial institutions associated with the major banks raised the question of whether systemic issues were emerging within the Australian financial system – and the banks in particular – that were not being adequately addressed through existing prudential standards. Instances of these behaviours and misconduct included, but are not limited to:

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[3] Reserve Bank of Australia, 1995, "Implications of the Barings Collapse for Bank Supervisors", RBA Bulletin, November, pp 1-5.

[4] National Commission on Financial Institution Reform, Recovery and Enforcement, 1993, *Origins and Causes of the S&L Debacle: A Blueprint for Reform – A Report to the President and Congress of the United States*, Washington DC, July 1993.

[5] Financial Stability Board, 2014, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk* Culture, April 2014.

[6] Basel Committee on Banking Supervision, 2015, *Guidelines: Corporate Governance Principles for Banks*, July 2015, Bank for International Settlements.

[7] See, for example, Tony McDonald and Steve Morling, 2011, "The Australian economy and the global downturn Part 1: Reasons for Resilience", *Economic Roundup*, Issue 2.

- alleged mishandling of insurance claims;
- alleged manipulation of interest rate benchmarks;
- the collapse of Storm Financial Limited;
- alleged breaches of anti-money laundering laws; and
- poor bank practices and possible unconscionable conduct in relation to small business lending.

The major banks have been accused of a number of cultural failings in recent years. When this occurs, consumers are usually required to take action against ADIs, and in some instances are required to bear the legal costs. This can have a material impact on their financial livelihoods. This is occurring on a non-trivial scale – for example, in 2015-16 alone, ASIC has calculated that over $200 million in compensation or remediation costs has been paid out by the financial sector[8].

The Government requested the House of Representatives Standing Committee on Economics to undertake an at least annual inquiry into:

- the performance and strength of Australia's banking and financial system;
- how broader economic, financial, and regulatory developments are affecting that system; and
- how the major banks balance the needs of borrowers, savers, shareholders and the wider community.

In announcing this request, the Treasurer stated that: [9]

> This new process represents an important opportunity for the banks to explain how they deal fairly with their customers and, in turn, build confidence in their institutions.
>
> Banks operate under a social licence and have responsibilities to the Australian public. We expect them to have high standards.
>
> It is important Australians have confidence in their financial institutions. It is therefore critical that the major banks are regularly held accountable to all Australians through their Parliamentary representatives.

On 24 November 2016 the House of Representatives Standing Committee on Economics Review of the four major banks tabled its first report (the Coleman Report), recommending – among other things – a new regime for executive accountability.

The Coleman Report referred to a number of instances where participants in the financial sector have been treated inappropriately by banks and other related financial institutions:

- the provision of poor financial advice at NAB;
- the mishandling of life insurance claims at CommInsure;
- NAB's failure to pay 62,000 wealth management customers the amount that they were owed;
- the poor administration of hardship support at CBA;
- ANZ's OnePath improperly collecting millions of dollars in fees from hundreds of thousands of customers; and

[8] ASIC 2015-16 Annual Report.
[9] The Hon Scott Morrison, 2016, *Government follows through on bank accountability*.

- ANZ improperly collecting fees from 390,000 accounts that had not been properly disclosed.

The Coleman Report noted that:[10]

> 'The FSI concluded that the interests of financial firms and consumers are not always aligned. The major banks' appearance before the committee confirmed it.'
>
> 'The major banks have a 'poor compliance culture' and have repeatedly failed to protect the interests of consumers. This is a culture that senior executives have created. It is a culture that they need to be accountable for.'

The Coleman Report identified that there were systemic issues within the major banks reflecting – notwithstanding existing prudential requirements – a lack of accountability within the major banks at the senior executive level.

In particular, the Coleman Report lacked confidence that Australia's major banks had in place all the components of an effective accountability regime for directors and senior executives, with a:

- *Lack of clarity on the responsibilities*

  Sanctioning those that are responsible for misconduct is difficult if individual responsibilities are not clearly defined.

  In regards to ANZ's improper collection of fees, the bank did not believe that any staff members were responsible for the breach because:

  > The issue existed for a number of years...and there have been a number of organisational and staffing changes through that period.

- *Lack of clarity on the expectations*

  NAB also argued that more severe consequences for executives were not appropriate because they were not directly responsible for the misconduct.

- *Lack of timely and appropriate consequences to the person from breaches of expectations in fulfilling their responsibilities.*

  The Coleman Report found that no directors or senior executives had their employment terminated as a result of the recent inappropriate behaviour, and the impact on the remuneration of directors or senior executives was not clearly specified:

  "There are certainly individuals...who have had some consequences relating to remuneration...we have not had individuals terminated" *Mr Ian Narev, CEO of the Commonwealth Bank on the mishandling of claims in CommInsure*

Despite these developments, APRA has not disqualified a bank senior executive as not being a fit and proper person since it has been required to apply to the Federal Court to do so.

In addition, despite the potential harm of poor governance, risk management and behaviour by bank directors and senior executives, no separate civil penalty provision applies to a bank's failure to meet APRA's prudential standards in this area.

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[10] House of Representatives Standing Committee on Economics Review of the four major banks (first report), p.14.

2. Case for government action/objective of reform

It is well established that effective prudential regulation is essential to maintaining financial stability.

The Basel Committee on Banking Supervision's *Corporate Governance Principles for Banks* highlight the importance of the Board and senior management of banks having arrangements in place to[11]:

> align corporate culture, corporate activities and behaviour with the expectation that the bank will operate in a safe and sound manner, with integrity and in compliance with applicable laws and regulations

The BIS guidelines state that[12]:

> Among their other responsibilities, Board members and senior management are expected to define conduct risk based on the context of the bank's business. Cases of misconduct have been identified as stemming from:
>
> - the mis-selling of financial products to retail and business clients;
> - the violation of national and international rules (tax rules, anti-money laundering rules, anti-terrorism rules, economic sanctions, etc); and
> - the manipulation of financial markets – for instance, the manipulation of Libor rates and foreign exchange rates.
>
> The Board should set the "tone at the top" and oversee management's role in fostering and maintaining a sound corporate and risk culture. Management should develop a written code of ethics or a code of conduct. Either code is intended to foster a culture of honesty and accountability to protect the interest of its customers and shareholders.

The Financial Stability Board's *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture* notes the particular importance of having rules in place to ensure that appropriate compensation practices are in place in banks[13]:

> The FSB *Principles* and *Standards for Compensation Practices* aim to ensure effective governance of compensation, alignment of compensation with prudent risk-taking and effective supervisory oversight and stakeholder engagement in compensation. An employee's compensation should take account of the risks that the employee takes on behalf of the financial institution and the employee's performance in meeting the institution's risk, compliance, and other important policies. Compensation should take into consideration prospective risks as well as risk outcomes that are already realised.

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[11] Basel Committee on Banking Supervision, 2015, *Guidelines: Corporate Governance Principles for Banks, July 2015, Bank for International Settlements*.

[12] Ibid.

[13] Financial Stability Board, 2014, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk* Culture, April 2014.

Among the key lessons from the *Report of the Board of Banking Supervision Inquiry Into the Circumstances of the Collapse of Barings* was the importance of establishing clearly the responsibility for each business activity and ensuring this is communicated to all relevant parties.[14]

The essential components of an effective accountability regime are:

- clarity on the responsibilities of the person;
- clarity on the expectations of the person; and
- timely and appropriate consequences to the person from breaches of expectations in fulfilling their responsibilities.

Key elements of APRA's current requirements are based on principles developed by the Financial Stability Board and the Basel Committee on Banking Supervision.[15] Reflecting the importance of participants having confidence and trust in the Australian financial system, APRA has put in place prudential measures covering:

- *culture*: Prudential Standard *CPS 220 Risk Management* (CPS 220) requires the Board of a bank to form a view on the ADI's risk culture and the extent to which that culture supports the ability of the ADI to operate consistently within its risk appetite, and ensure that the ADI takes steps to make desirable changes to its risk culture;
- *remuneration*: Prudential Standard *CPS 510 Governance* (CPS 510) requires the ADI to establish a Board Remuneration Committee and maintain a Remuneration Policy that aligns remuneration and risk taking;
- *governance*: CPS 510 sets out minimum standards for good governance of an ADI to ensure that it is managed soundly and prudently by a competent Board;
- *risk management*: CPS 220 requires an ADI to maintain a risk management framework that is appropriate to its size, business mix, and complexity. Moreover, Prudential Standard *CPS 232 Business Continuity Management* requires an ADI to maintain a business continuity management policy that ensures it is able to meet its financial and service obligations to its depositors, policyholders and other stakeholders; and
- *fit and proper*: Prudential Standard *CPS 520 Fit and Proper* sets out criteria for determining the fitness and propriety of responsible persons. APRA may direct an ADI to remove directors or senior managers who lack the requisite fitness and propriety.

Notwithstanding these requirements, the Coleman Report identified that there was a lack of accountability within the major banks at the senior executive level.

Developments over recent years point to the need to strengthen the existing prudential standards – particularly in relation to directors and senior executives – to clarify responsibilities and expectations of these roles.

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14 Reserve Bank of Australia, 1995, "Implications of the Barings collapse for Bank Supervisors", *Reserve Bank Bulletin*, November 1995, p1-5. https://www.rba.gov.au/publications/bulletin/1995/nov/pdf/bu-1195-1.pdf, Board of Banking Supervision, 1995, *Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings.* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/235622/0673.pdf

15 APRA, 2014, *Regulation Impact Statement:* Harmonising cross-industry risk management requirements.

The importance of meaningful consequences to accountability

More broadly, there is concern that without meaningful consequences for the bank, directors and senior executives, these standards are not likely to achieve their objectives.

One of the barriers to achieving an effective accountability regime in financial institutions, and banks in particular, is that there can often be a significant difference between the timing of the benefits of decisions and the crystallisation of associated risks.

Regulators do not have the legislative authority to impose the stricter requirements needed to address the above-mentioned market and regulatory failure to hold ADIs and individuals within them to account in accordance with community expectations, and to protect the integrity of the financial system.

Furthermore, experience to date has shown that individual accountability imposed via Boards and shareholders has not been adequate to address these issues, especially when Board members themselves are often not held to account. As such, Government action is needed to ensure a fit-for-purpose accountability regime is put into place, which has appropriate consequences associated with misconduct.

Former APRA Chair John Laker noted – in the aftermath of the global financial crisis that:[16]

> The fallout from the global financial crisis is replete with examples of shareholders of major global financial institutions — particularly institutional shareholders — being seduced by short-term profit figures and share price gains, and failing to exercise the vigorous scrutiny and persistence expected of owners. As the recent Walker Review of corporate governance in UK banking institutions has lamented, major institutional investors were slow to act as issues of concern were raised, but quick to 'cut and run'. Similarly, the OECD has noted that shareholders of major global financial institutions have tended to be reactive rather than proactive and seldom challenged Boards in sufficient number to make a difference.

In the absence of Government action there would not necessarily be timely and appropriate consequences to the person from breaches of expectations in fulfilling their responsibilities – which is a concern, given the potential prudential consequences of the decisions of the senior executives and directors of banks. As John Laker noted:[17]

> Although the global financial crisis shone an immediate spotlight on liquidity and credit risks, it is now clear that agency or conflict-of-interest risk was a pervasive influence on risk-taking and leverage. This risk manifested itself in a number of ways:
>
> …
>
> remuneration arrangements in some major financial institutions that paid insufficient regard to longer-term risks and encouraged executives to 'roll the dice' on leverage, volume growth and risk controls.

In particular, there is a need for a heightened accountability framework to ensure that, where there is inappropriate behaviour, more of the cost of that behaviour is felt within ADIs rather than solely by the community. Internalising more of the cost of inappropriate behaviour in this way should provide greater incentives for improved behaviour within the sector.

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[16] John Laker, 2009, 'The Global Financial Crisis — Lessons for the Australian Financial System', Address to the Australian Economic Forum, 19 August 2009.

[17] Ibid.

The banking sector has not implemented sufficient accountability measures of its own accord to meet community expectations. Similarly, neither the market nor the regulatory regime has imposed consequences in accordance with these expectations. As a result, the cost of inappropriate behaviour has been felt largely by the community rather than within the banking sector.

This is particularly problematic in relation to the banking sector because banks, as ADIs, play a critical role in the financial system, including through deposit-taking, payments and lending activity. ADIs remain at the centre of some of the most critical decisions in life, including buying a first home, starting a business, and saving and investing for retirement. It is imperative that, in providing these functions, ADIs maintain community confidence that they will balance risk and reward appropriately and serve the interests of consumers and businesses. If this confidence is undermined, ADIs will not be able to operate in an efficient, stable and fair way.

There is international precedent for this view, with deferred remuneration arrangements in place in other jurisdictions in response to the global financial crisis – most notably the Senior Manager Regime in the United Kingdom.

3. Policy options

Option 1 – status quo

Under Option 1, no changes would be made to the accountability requirements of ADIs and their directors and senior executives.

ADIs and their directors and senior executives would remain subject to ARPA's existing prudential framework, which includes Prudential Standard CPS520 *Fit and Proper* (CPS520). CPS 520 sets out minimum requirements for APRA-regulated institutions in determining the fitness and propriety of individuals to hold positions of responsibility. (See Appendix A for further details.) ADIs and their directors and senior executives would also remain subject to existing sanctions by APRA and ASIC for misconduct.

Option 2 – amend prudential standards – an enhanced governance/risk management/'Fit and Proper' regime

Option 2 would involve APRA making revisions to its existing prudential standards to provide greater clarity on the allocation of responsibilities of senior executives within ADI groups and the expectations of those undertaking these roles.

The essential components of an effective accountability regime are:

- clarity on the responsibilities of the person;
- clarity on the expectations of the person; and
- timely and appropriate consequences on the person from breaches of expectations in fulfilling their responsibilities.

This option would involve action to improve the first two components of an effective accountability regime. Revisions to prudential standards would include:

- the expectations of APRA-regulated institutions in conducting business affairs, including monitoring the performance of persons holding positions of responsibility; and

- the expectations of responsible persons in APRA-regulated institutions, including the manner in which these individuals perform their duties.

However, there would be no changes to the consequences to directors or senior executives for breaching expectations in fulfilling their responsibilities - as with Option 1, existing sanctions would continue to apply.

Option 3 – introduce a Banking Executive Accountability Regime

Under Option 3 a new Banking Executive Accountability Regime (BEAR) would be introduced to make ADIs and their directors and senior executives more accountable.

This option would involve action to improve all three components of an effective accountability regime.

The BEAR would:

- clarify heightened expectations of behaviour or accountability obligations for both ADIs and their senior executives and directors,
- clarify the allocation of responsibility of senior executives within ADI groups, and
- impose more significant consequences for not meeting these accountability obligations.

The focus of the BEAR would be on a narrower group of people than existing prudential standards – the directors and senior executives who set the policies, procedures and systems that influence the overall conduct and culture of ADI groups (accountable persons).

As part of this option, legislation and prudential standards would be introduced to implement an accountability regime with the following key elements:

Accountability obligations

- The obligations of an ADI would be to take reasonable steps to: conduct its business with honesty and integrity, and with due skill, care and diligence; deal with APRA in an open, constructive and cooperative way; and prevent matters from arising that would adversely affect the ADI’s prudential reputation or standing. An ADI would also be required to take reasonable steps to ensure obligations are met throughout the ADI group and by accountable persons within the ADI group.
- The obligations of an accountable person would be similar to the obligations of an ADI but would be framed in the context of the responsibilities of the accountable person’s position.
  - Accountable persons would be defined on both a principles basis, as someone who holds a senior executive position in an ADI group that has management or control of a significant part or aspect of the ADI group, and also in reference to a prescribed list of responsibilities in an ADI.
- ADIs would be required to register accountable persons with APRA prior to appointment. This would involve notifying APRA of the potential appointment and providing information regarding the candidate’s suitability.
  - Upon notification, APRA would consult its register of accountable persons and advise the ADI if the candidate has previously been removed or disqualified by APRA, or if APRA is aware of any other issues that could affect the candidate’s suitability for the role.

Allocation of responsibility - accountability statements and mapping

- ADIs would be required to provide APRA with accountability statements to detail the roles and responsibilities of each accountable person. ADIs would also be required to consolidate its individual accountability statements into an accountability map showing the allocation of roles and responsibilities across the ADI group.

Consequences

The key difference between Option 2 and Option 3 is in the consequences for banks, directors and senior executives for not meeting their responsibilities.

- **Civil penalties**: APRA would be able to seek civil penalties of up to 1,000,000 penalty units for large ADIs, up to 250,000 penalty units for medium ADIs, and up to 50,000 penalty units for small ADIs where an ADI contravenes its accountability obligations, with the Minister to set the threshold for large, medium and small ADIs.
- **Disqualification**: APRA's powers would be enhanced to allow it to disqualify accountable persons that contravene their accountability obligations.
  - In particular, APRA's powers would be enhanced to permit it to disqualify accountable persons directly without applying to the Federal Court.
  - Individuals disqualified under these powers would have a right of judicial review by the Federal Court, and merits review by the Administrative Appeals Tribunal (AAT).
- **Remuneration**: A minimum percentage of an accountable person's variable remuneration, depending on the size of the ADI, would be required to be deferred for a minimum period of 4 years, and ADIs would be required to have remuneration policies that provide financial consequences for accountable persons that contravene accountability obligations.

4. Cost benefit analysis of each option/Impact analysis

Option 1

The problem of poor conduct in ADIs will not be addressed. There will be no additional requirements imposed on industry.

The **advantages** of maintaining the status quo:

- **No change in regulatory burden**: ADIs and their accountable persons would not incur the regulatory costs of complying with heightened expectations.

The **disadvantages and risks** of maintaining the status quo:

- **Accountability gaps would remain**: The systemic issues within the major banks identified in the Coleman Report reflecting – notwithstanding existing prudential requirements – a lack of accountability within the major banks at the senior executive level would remain, reflecting:
  - a lack of clarity on the allocation of responsibilities of ADI group senior executives;
  - a lack of clarity on the expectations of ADI group senior executives; and
  - a lack of timely and appropriate consequences to the person from breaches of expectations in fulfilling their responsibilities.

- **Continued erosion of confidence and trust in the financial system:** ADIs would not have the incentive to improve their practices in the absence of increased regulatory requirements and so inappropriate behaviour would likely continue, contrary to community expectations.
  - Accountability gaps and misalignment of incentives can result in substantial harm to both individual ADIs – and the financial system as a whole – reflecting its corrosive influence on confidence and trust which underpins an efficient financial system.
  - There will be continued costs to customers in pursuing outcomes with ADIs relating to matters of a systemic and prudential nature.

As this option would maintain the status quo and therefore require no regulatory or legislative changes there are no regulatory costs associated with this option.

Option 2

The problem of poor conduct in ADIs could be partially addressed through APRA making revisions to its existing prudential standards to provide greater clarity on the allocation of responsibilities of senior executives within ADI groups and the expectations of those undertaking these roles.

The **advantages** of enhancing the existing prudential standards framework under Option 2 are:

- **Clearer guidance for ADIs and senior executives**: ADIs and their directors and senior executives would have greater understanding of their responsibilities and the expectations of behaviour in that role.
- **Builds on the existing flexible prudential standards framework**: This approach would build upon existing prudential standards, which are understood by APRA-regulated entities.

The **disadvantages** of Option 2 are:

- **Accountability gaps would remain in the absence of meaningful consequences for breaches**: There would be no additional consequences for behaviour that contravenes the expectations. ADIs who do not meet the heightened standards would potentially face minimal consequences and individuals would potentially remain in their positions as responsible persons.

  Detailed analysis of the regulatory costs of the UK Senior Manager Regime was canvassed in an independent cost-benefit report (the UK cost benefit analysis).[18] The UK cost benefit analysis noted the importance of meaningful consequences to an effective accountability regime.

  Firm-level non-compliance can be difficult to deter if the sanctions given are not sufficient to deter such behaviour.

- **Additional regulatory costs**: ADIs would face additional regulatory costs.

Regulatory costs

Should the Government implement Option 2, additional regulatory costs would be imposed on ADIs.

- These costs are expected to arise primarily as upfront costs to understand the new requirements, update systems, policies and procedures, and train staff.

The following costs are not considered regulatory costs for the purpose of this document: the cost to ADIs of defending civil penalty cases, the cost of any civil penalty, and the cost of challenging the removal or disqualification of an accountable person or a reduction in variable remuneration.

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[18] Cost Benefit Analysis of the new Regime for Individual Accountability and Remuneration. p.59

Using the regulatory burden measurement framework, it has been estimated that Option 2 would increase compliance costs by $10.2 million per year. A regulatory offset has not been identified. However, Treasury is seeking to pursue net reductions in compliance costs and will work with affected stakeholders and across Government to identify regulatory burden reductions where appropriate.

Table 1: Regulatory burden estimate (RBE) table (see Appendix B for further detail)

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	10.2	-	-	10.2

Option 3

The problem of poor conduct in ADIs will be addressed through clarification of the allocation of responsibility of senior executives and directors within ADI groups, heightened expectations of behaviour or accountability obligations for both ADIs and their senior executives and directors, and the imposition of more significant consequences for not meeting these accountability obligations.

The BEAR would achieve the essential components of an effective accountability regime through the following measures in legislation:

- making clear the responsibilities and expectations of accountable persons;
- putting in place the requirement for ADIs to provide APRA with accountability statements to detail the roles and responsibilities of each accountable person;
- putting in place the requirement for ADIs to consolidate its individual accountability statements into an accountability map showing the allocation of roles and responsibilities across the ADI group;
- putting in place heightened expectations of behaviour for ADIs and accountable persons in the context of their particular roles and responsibilities; and
- greater powers for APRA to disqualify or provide for financial consequences for accountable persons, or seek civil penalties against ADIs that breach their expectations.

The key difference between option 2 and option 3 is in the consequences for banks, directors and senior executives for not meeting their responsibilities.

Whilst ADIs will incur costs in complying with the obligations, it is expected that the heightened expectations and more significant consequences would result in beneficial behavioural changes that would reduce the incidence of misconduct, promoting trust and stability in the financial system. Detailed analysis of the regulatory costs of the UK Senior Manager Regime was canvassed in the UK cost benefit analysis.[19]

[19] Cost Benefit Analysis of the new Regime for Individual Accountability and Remuneration, p.59

The **advantages** of Option 3 are expected to be substantially greater than Option 2, as there would be enhanced consequences for contraventions of the heightened expectation of behaviour:

- **Deterring poor conduct and encouraging prudent management:** The consequences for contravening the accountability obligations are intended to have the effect of deterring poor conduct and incentivising improved behaviour by ADIs and their accountable persons.
- **Increased confidence and trust in the Australian financial system**: The meaningful consequences that would follow to both ADIs and their directors and senior executives would provide participants in the Australian financial system with assurance that ADIs have effective accountability arrangements in place – which is an essential underpinning to confidence and trust that is at the heart of an efficient financial system.
  - The UK cost benefit analysis noted the importance of meaningful consequences to an effective accountability regime.[20]

    Firm-level non-compliance can be difficult to deter if the sanctions given are not sufficient to deter such behaviour. Evidence presented in the Parliamentary Commission on Banking Standards report shows that firms can include regulatory fines as a cost of business. Even total failure may not be a sufficient deterrent if the losses are diluted through public bailouts. More importantly, the sanctions are not often directed at those responsible for making the non-compliant decisions in the first place. Isolating individual responsibility ensures that those directly responsible for problems are sanctioned.
- **Clearer guidance for ADIs and senior executives**: ADIs and their directors and senior executives would have greater understanding of what their responsibilities were and the expectations of behaviour in that role.
- **Better alignment of senior executive remuneration with sustainable operations**: Mandating minimum deferral of part of variable remuneration should allow a sufficient period of time for contraventions of the accountability obligations to emerge before accountable persons receive their bonuses. This will help ensure that the incentives of accountable persons are aligned with the sustainable operations of the ADI, and the financial system, rather than on short-term gains with hidden long-term costs.

The **disadvantages** of Option 3 are:

- **Shift to fixed remuneration**: The requirement to defer a minimum proportion of variable remuneration may result in a shift from variable to fixed remuneration. However, it is not clear whether or not this shift would occur, or if it is problematic. For example, a shift to fixed remuneration may be positive if it reduces the extent of short-term excessive risk-taking.
- **Potential confusion on regulatory roles**: Since the establishment of APRA and ASIC following the Wallis Inquiry, there has been a clear distinction between their roles: with APRA focusing on prudential matters, and ASIC having responsibility for matters of corporate conduct (the 'twin peaks' model). There is a risk that APRA making rules around the conduct of senior executives of ADIs could blur the lines of responsibility between the regulators.
  - This has been mitigated by the BEAR having a focus on prudential matters, which are defined to include conducting the affairs of ADI with "integrity, prudence and

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[20] Ibid, p.59.

professional skill" – matters which the APRA Chair has noted are clearly within APRA's existing mandate:[21]

> The BEAR can be seen as a strengthening of the existing prudential framework. Although there are a range of new elements, it is not new territory.

- **Potential knowledge gaps occurring as a result of disqualification:** Due to the nature of the role senior executives have, there is a risk that knowledge gaps may arise if they are disqualified under the BEAR. This is a risk that already exists, for example through unanticipated vacancies. Given it is an existing risk, arguably made more likely to materialise, ADIs are likely to have put in place appropriate contingency arrangements.
- **Potential adverse impact on the market for executives:** There is a risk that the BEAR will make senior executive positions within ADIs unattractive, due to the additional obligations and associated penalties or consequences.
  - However, the obligations under this option are not intended to be punitive in nature; rather, they are simply good governance practices. If ADIs are requiring directors and senior executives to perform their roles consistent with best practice in good governance principles, then there should be not be an adverse impact on the attractiveness of these roles under this option. However, for those ADIs not currently following best practice principles, the enhanced accountability under BEAR could make their roles less attractive to some individuals.

Regulatory costs

Should the Government implement Option 3, additional regulatory costs would be imposed on ADIs. The magnitude of regulatory costs to a financial institution reflect, in essence, the extent to which their current accountability frameworks falls short of international best practice.

- These costs are expected to arise primarily as upfront costs to understand the new requirements, update systems, policies and procedures, and train staff, with a small ongoing cost owing to the requirements to provide documentation to APRA on a regular basis.
- Overall, the regulatory costs of the BEAR would be largest for ADIs who have the largest accountability gap. As the UK Financial Conduct Authority has noted – in the context of the Senior Manager Regime[22]:

  > The Regime is a formal expression of the common sense, good governance practice that any organisation should adhere to. It was created against the backdrop of a clear and shared understanding that a culture of personal responsibility must be embedded at the heart of financial services.

The regulatory costs of Option 3 are not expected to be significantly different to Option 2 – the principle difference being that more meaningful consequences would follow from a breach of accountability obligations. As the APRA Chair has noted:[23]

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[21] Wayne Byres, 2017, *Key Issues for the Year Ahead: Bank Capital and the Approaching Bear*, 'The Regulators' Finsia Event, 8 September 2017.

[22] Financial Conduct Authority, *Senior Managers Regime*

[23] Wayne Byres, 2017, *Key Issues for the Year Ahead: Bank Capital and the Approaching Bear*, 'The Regulators' Finsia Event, 8 September 2017.

> There have been questions raised about whether aspects of the new accountability regime will change the nature of APRA supervision. While our supervisory approach is always evolving, we intend to remain a supervision-led regulator, working to prevent problems rather than simply wait for them to happen and find fault after the event.
>
> If we are successful in that approach, the new powers granted to APRA should only need to be used rarely. That should not be interpreted as saying we would be reluctant to use them. But the goal must be that, with clear boundaries and obligations set out by the regulatory framework, Boards and executives conduct their affairs in such a manner that intervention by APRA is not needed.
>
> It is a much better outcome, for example, that Boards hold their executives to account for poor outcomes than have to rely on the regulator to do it for them.
>
> My observation is that this has been the experience in the UK, where a similar regime is already in place. Although there are strong powers for regulators if and when needed, the industry has responded by adjusting the way it operates so that the need for regulatory intervention has been quite limited.

The following costs are not considered regulatory costs for the purpose of this document: the cost to ADIs of defending civil penalty cases, the cost of any civil penalty, and the cost of challenging the removal or disqualification of an accountable person or a reduction in variable remuneration.

Using the regulatory burden measurement framework, it has been estimated that Option 3 would increase compliance costs by $11.5 million per year. A regulatory offset has not been identified. However, Treasury is seeking to pursue net reductions in compliance costs and will work with affected stakeholders and across Government to identify regulatory burden reductions where appropriate.

The cost-benefit analysis of the UK Senior Manager Regime noted that:[24]

> Quantifying the benefits of the policies is not straightforward, given uncertainty around the extent to which the policies will in fact change behaviour and the lack of clear evidence of the results of other, similar policy changes.

The UK report – while acknowledging that estimates were indicative only – presented an estimate of the harm caused as a result of the lack of an adequate accountability regime, and applied a percentage reduction in similar, future harm as a result of the SMR. In the UK, the benefits in the form of reduced harm ranged from £40 million to £600 million per annum.

- Adopting the same methodology as the UK report, the benefits of the BEAR (Option 3) in the form of reduced harm are estimated to range between $20 million to $300 million per annum. As with the UK estimates, these are indicative only and subject to a high degree of uncertainty.

Table 2: Regulatory burden estimate (RBE) table (see Appendix B for further detail)

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs

[24] Cost Benefit Analysis of the new Regime for Individual Accountability and Remuneration, p.89

Average annual regulatory costs (from business as usual)				
Total, by sector	11.5	-	-	11.5

5. Consultation plan

The BEAR formed part of the Government's response to the Coleman report – in effect, taking into account the evidence provided by the four major banks to the House of Representatives Economics Committee.

The Government undertook targeted consultation prior to the 2017-18 Budget announcement. The Government consulted Australian regulators – in particular APRA – in developing potential options to address accountability gaps in ADIs in response to the Coleman report. This consultation continued after the Budget announcement. The Government also met with regulators in the UK to discuss the experience to date of the Senior Managers Regime – with follow-up discussions following the Budget announcement. Options to address accountability gaps were also canvassed in discussions with the Chairs of the major ADIs in February 2017.

While the 2017-18 Budget set out the broad parameters of the BEAR, it was envisaged that there would a number of points of detail that would require further development in consultation with relevant stakeholders. At the same time, the Government was concerned to ensure that the BEAR was enacted by the end of 2017, in order to address the identified accountability gap as soon as possible – constraining the total amount of time for consultation.

The Government's consultation put the emphasis on seeking stakeholders' input on the policy design of the BEAR – acknowledging that this would be likely to compress the amount of time available for input on exposure draft legislation.

On 13 July 2017 the Government released a consultation paper which outlined:

- The policy context and rationale for the BEAR;
- Key features of existing accountability frameworks;
- Institutions to be covered by the BEAR;
- Individuals to be covered by the BEAR;
- Expectations of ADIs and accountable persons under the BEAR;
- Remuneration; and
- Implementation and transitional issues.

The paper also included 17 questions for consultation, targeted at the points of detail where views of stakeholders were particularly sought.

Shortly after the release of the consultation paper, Treasury conducted round table discussions with industry bodies and technical experts, and had meetings with several major ADIs, including the four major banks.

Submissions to the consultation paper closed on 3 August 2017. A total of 48 submissions (37 public and 11 confidential) were received from a wide range of respondents, including banks, industry

groups, consumer bodies and law firms, with many submissions providing detailed responses to the questions for consultation.

Key issues raised by stakeholders in the consultation on the discussion paper included:

- the application of the BEAR to ADI groups but not their competitors (e.g. insurers) would place ADIs at a competitive disadvantage (though some stakeholders argued limiting the BEAR to ADIs was appropriate);
- significant time would be required to implement the requirements of the BEAR – and accordingly, commencement should be deferred;
- including only some non-executive directors (NEDs) would undermine the Board of the ADI's collective responsibility and blur the distinction between a Board's oversight function and the responsibilities of executive management;
- the BEAR was 'one-size-fits-all' and would disproportionately impact smaller ADIs, potentially undermining competition;
- the BEAR would limit the ability of ADIs to attract people to key positions;
- a lack of merits review for APRA's decision to disqualify directors; and
- the BEAR would extend APRA's mandate beyond prudential matters and create confusion in relation to ASIC and APRA's roles.

The draft legislation was also developed taking into account suggestions from stakeholders that flexibility would be needed in the regime. The obligations imposed on individuals by the BEAR were developed to reflect how ADIs operate in practice. Further, the draft legislation provides for exceptions in certain circumstances (for example to the 4 year deferred remuneration rule) and gives APRA the power to flexibly administer the BEAR (for example, by legislative instrument).

While the scope of the BEAR was considered to be appropriate (given that the problems of accountability identified had mainly occurred within ADIs) and was therefore left unchanged, stakeholders' remaining concerns were addressed in the draft legislation by:

- providing transitional periods for some requirements (particularly in relation to remuneration);
- extending the BEAR to all NEDs and EDs on the Board – making clear that obligations imposed on NEDs would be consistent with their oversight role; and
- ensuring requirements and penalties would be proportionate to an ADI's size;
- focusing the obligations under the BEAR on best practice governance principles – rather than imposing a punitive regime; and
- clarifying that the focus of BEAR is systematic and prudential behaviour.

The draft legislation was released for consultation on 22 September 2017 to seek views on the legislative design, to minimise the risk of unintended consequences, and to ensure the BEAR meets the policy objectives in an efficient manner. Submissions closed on 28 September 2017.

There was significant public criticism about the short consultation period on the draft legislation. In addition, some stakeholders reiterated their policy positions set out in submissions to the consultation paper. A total of 31 submissions were received on the draft legislation (26 public and 5 confidential) – nearly all from banks, their advisers, or industry bodies. Submissions made a number of technical suggestions that improve the operation of the draft legislation and are consistent with the Government's policy intent. The draft legislation was also changed to ensure that the disqualification of accountable persons is reviewable by both the Federal Court (as judicial review) and the AAT (as merits review).

6. Option selection/Conclusion

Given the importance of community confidence and trust in banks, and consistent with the Budget announcement, Option 3 is preferable and should be implemented as soon as it is practicable in order to address accountability gaps in the banking sector. It represents a credible new regime that will result in a substantial strengthening of bank accountability, with meaningful consequences where banks and their directors and senior executives fall short of prudential requirements, consistent with the community's reasonable expectations.

Although Option 2 provides greater clarity on the allocation of responsibilities of senior executives within ADI groups and the expectations of those undertaking these roles, it does not address all key components of an effective accountability regime - which Option 3 does via the consequences for banks, directors and senior executives for not meeting their responsibilities.

Another issue raised as part of the consultation was that the focus on ADIs would put them at a competitive disadvantage. ADIs argued that the BEAR should cover all APRA-regulated entities, on the basis that its application to ADI groups but not their competitors would place them at a competitive disadvantage. On the other hand, other submissions argued that the focus on banks was appropriate, given that was where the accountability gaps had been identified. This question can be revisited in due course once the BEAR legislation is in place.

Implementation

The BEAR will be implemented through amendments to the Banking Act and prudential standards. The BEAR will commence on 1 July 2018. This will enable accountability gaps in the banking sector to be addressed as soon as practicable.

Recognising the implementation steps that ADIs will need to undertake to comply with the BEAR, commencement of individual requirements will be in stages. This will include APRA outlining through prudential standards the implementation and transitional details of ADIs identifying and registering accountable persons, and providing accountability statements and maps.

Furthermore, a transitional period will be provided for the remuneration requirements, in order to give ADIs a period of time in which to change remuneration policies and renegotiate contracts with accountable persons.

Evaluation/review

The BEAR is a significant change to the regulatory framework. The legislation includes a requirement to conduct a post-implementation review three years following commencement of the BEAR. The terms of reference/scope of the review will be decided closer to the date, to allow consideration for issues that may arise during the operation of the BEAR.

7. Appendix A – Fit and Proper

Prudential Standard CPS 520 *Fit and Proper* sets out minimum requirements for APRA-regulated institutions in determining the fitness and propriety of individuals to hold positions of responsibility. Its objective is to ensure that an institution prudently manages the risks that persons acting in responsible person positions who are not fit and proper pose to the institution's business and financial standing.

The ultimate responsibility for ensuring the fitness and propriety of the responsible persons of an APRA-regulated institution rests with its Board of directors (or equivalent).

Persons who are responsible for the management and oversight of an APRA-regulated institution, and persons employed by a member of the group whose activities may materially affect the business or financial standing of the group, need to have appropriate skills, experience and knowledge, and act with honesty and integrity. These skills and qualities strengthen the protection afforded to depositors, policyholders and other stakeholders. To this end, institutions need to prudently manage the risk that persons in positions of responsibility might not be fit and proper.

The key requirements of this Prudential Standard are that an APRA-regulated institution and a Head of a group must:

- maintain a Fit and Proper Policy that meets the requirements of this Prudential Standard;
- ensure that the fitness and propriety of a responsible person generally be assessed prior to initial appointment and then re-assessed annually;
- take all prudent steps to ensure that a person is not appointed to, or does not continue to hold, a responsible person position for which they are not fit and proper;
- ensure that additional requirements be met for certain auditors and Appointed and Reviewing Actuaries; and
- ensure that certain information be provided to APRA regarding responsible persons and the APRA-regulated institution's and Head of a group's assessment of their fitness and propriety.

8. Appendix B – Costing assumptions

Option 2 - Amend prudential standards – an enhanced governance/risk management/'Fit and Proper' regime

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	10.2	-	-	10.2

General Assumptions

Details	Estimate
Number of large ADIs	4
Number of medium ADIs	20
Number of small ADIs	125
Number of accountable persons (total)	2,535

Regulatory Costs

Task	Frequency
Initial costs to update IT systems	Upfront
Initial costs to understand the changes to legislation, update documentation, policies and procedures, and develop and implement training.	Upfront
Internal reviews of remuneration policies and procedures and updating to meet new requirements	Upfront
Education of accountable persons on new requirements	Upfront

Option 3 - Introduce a Banking Executive Accountability Regime

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	11.5	-	-	11.5

General Assumptions

Details	**Estimate**
Number of large ADIs	4
Number of medium ADIs	20
Number of small ADIs	125
Number of accountable persons (total)	2,535

Regulatory Costs

Task	**Frequency**
Initial costs to update IT systems	Upfront
Initial costs to understand the changes to legislation, update documentation, policies and procedures, and develop and implement training.	Upfront
Internal reviews of remuneration policies and procedures and updating to meet new requirements	Upfront
Initial registration of existing accountable persons	Upfront
On-going requirements to register accountable persons, including notifications	On-going
Initial provision of accountability maps and statements	Upfront
On-going requirements to update accountability maps and statements	On-going
Education of accountable persons on new requirements	Upfront