

**Submission in Response to the  
Banking Executive Accountability Regime  
Consultation Paper  
July 2017**

This submission sets out my responses to the Banking Executive Accountability Regime (**BEAR**) Consultation Paper, issued in July 2017.

The comments and opinions in this submission are those of the author only.

I begin by making some preliminary observations, before setting out some key concepts that policymakers should have regard to in the area of executive remuneration. Finally, I respond to the specific questions contained in Chapter 6 of the Consultation Paper.

**Preliminary Observations**

- 1 Some of the comments about the Banks having a “poor compliance culture” and have “repeatedly failed to protect the interests of consumers” appear to be very wide and overly exaggerated on the evidence in the Coleman Report. These statements may be more accurate if qualified to “in this some areas of the wealth divisions”. This is important because the BEAR appears to cover all aspects of Banks and ADI’s operations. For example, there is little evidence of the retail banking divisions causing these difficulties or having a “poor compliance culture” or repeatedly failing to protect the interests of consumers.
- 2 The use of the word “culture” is a very difficult, uncertain and slippery concept to associate with making laws, particularly laws which attract criminal or civil penalties. I refer you to the discussions on this issue in “Corporate and Personal Liability for “Culture” in Corporations” by J H C Colvin and James Argent (2016) 34 CXSLJ30. I would also refer you to His Honour A. M. Gleeson’s submission No.2 to Senate Standing Committee on Legal and Constitutional Affairs, Inquiry into the Commercial Code Bill 1994, 26 September 1994, 2.

*“What exactly does it mean to say that there is an attitude existing within a body corporate? ... Legislation which creates criminal offences should be reasonably clear in its application. And what happens if there exists within a body corporate both an attitude and the opposite of the same attitude.*

...

*I have enormous difficulties about attaching criminal sanctions to attitudes, and I am bound to say that I do not think that expressions like “corporate culture” have a place in criminal law.”*

I also would add that the same is true for civil law and civil penalties.

- 3 Does the existing process, Consultation Paper and rush to regulate reflect the Federal Government’s own principles of best practice regulation? <sup>1</sup>
- 4 Assuming that regulation is needed and other non-regulatory possibilities are not more appropriate, best practice regulatory practices would entail asking, “what and where” is the mischief that needs to be regulated? Also, the mitigating factors of alleged poor behaviour should be looked at and considered. In this case, the process by the Banks dealing with refunds and compensation to affected consumers should be given greater weight. Regulation is not a panacea and sometimes can either exacerbate the problems or cause a longer term detriment which outweighs the reason for such regulation in the first place. This

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<sup>1</sup> The Australian Government Guide to Regulation

4 Assuming that regulation is needed and other non-regulatory possibilities are not more appropriate, best practice regulatory practices would entail asking, “what and where” is the mischief that needs to be regulated? Also, the mitigating factors of alleged

can happen, for example, when regulation is made with undue haste because emotions run high and escape logic and proper analysis. There is a strong argument that this is what is happening with BEAR. It is also a strong argument for a body like the Companies and Markets Advisory Committee (CAMAC) to be introduced.

- 5 APRA’s prudential framework referred to on page 3 of the Consultation Paper already deals with cultural, remuneration, governance risk management together with “fit and proper persons”. What analysis has been undertaken to assess these regulations against proposed regulations in a reasonable and critical manner?
- 6 The adoption of provisions of the UK Senior Manger Regime (**SMR**) and Hong Kong Managers in Charge (**MIC**) measures should be reviewed against the background of each particular country’s banking issues especially during the global financial crisis (GFC) - in particular bail outs by the UK government and taxpayers. Bail outs were not required in Australia. Indeed, Australian banks and the Australian banking regulatory regime were lauded around the world for how they weathered the GFC. Adopting the interventionist measures adopted in some overseas jurisdictions would require a detailed analysis of whether these regimes should be adopted or amended in a detailed way. Consistency with the UK and Hong Kong is not an argument by itself. In a similar way a comparison between duties of directors and officers in the relevant Corporations Acts and enforcement in the UK and Hong Kong should be reviewed before adding additional executive and director liabilities in this regard.
- 7 If the type of legislation is regarded as necessary for Banks, will this type of legislation and its principles (e.g. accountable persons) be considered for other bodies which have had similar issues or similar consumer concerns such as Superannuation Funds, Commonwealth Departments (e.g. Tax, Social Security, Defence and the recent census) and even Parliament itself? Where do you stop and what principles are being applied? What other approaches have been looked at other than regulation, which is a very blunt instrument and often liable to serious unintended consequences? There is of course also the need to bear in mind the difficulties in looking at “culture”, already referred to previously.

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### **Some Key Concepts that Policymakers Need to Have Regard to in the Area of Executive Remuneration**

The two issues raised in Chapter 6 arising from the 2017-18 Budget were referred to as;

- a minimum of 40 per cent of an ADI executive's variable remuneration, and 60 per cent for certain ADI executives such as the CEO will be deferred for a minimum period of four years
- APRA will have stronger powers to require ADI's to review and adjust remuneration policies when APRA believes these policies are producing inappropriate outcomes

I will deal with the two issues and the questions posed in the Consultation Paper below.

### **Corporate Governance Principles**

The first key concept that should be borne in mind is the need for sound corporate governance principles.

It is axiomatic that in private sector "for profit" companies (including listed companies) that companies are owned by shareholders who appoint directors to govern the business, and led by management under the supervisory control of the board of directors.

Remuneration policies are a critical element for the board and management to endeavour to obtain outcomes desired from the company strategy, Such strategy is usually agreed upon after lengthy analysis of competitors, business opportunities, risk appetites etc. Remuneration must also be set (and reset) knowing that in business, risks must be taken in order for a company to survive and prosper in an environment of complexity and uncertainty. The very nature of business life and economic cycles means that some actions and strategies will fail. This is also necessary to allow others to learn and do better, send price and market intelligence and ultimately improve corporate governance.

One of the important issues facing many companies is the possibility of risk averse thinking becoming too strong<sup>2</sup>. Government policy and regulation have a strong influence on this thinking including the way politicians and public servants talk about business, directors, profit, shareholders, increasing wealth and so forth. Regulation has been, and can be, a dampener on entrepreneurial activities in start-ups and also in the largest companies including Banks and other ADI's realising their potential for the benefit of all Australians in their superannuation, employment, tax, consumer and business outcomes. Wealth creation is critical for future employment, taxes and business opportunities and funding the Government and all its authorities including employment. Governments do not make money they tax those who do.

For a regulator to be directly involved in the setting and review of remuneration in Banks and other ADI's is contrary to principled corporate governance and can only end badly for both APRA and the corporations. One only needs to consider a very common issue when shareholders (including institutions and proxy advisors) disagree with Remuneration Reports and vote against "soft targets/skills" in favour of hard targets for "financial outcomes". The Board may be trying to introduce "softer" targets such as safety, customer satisfaction and people outcomes. What role should APRA take in this argument? What role should any third party including a Regulator/Government play in such companies? What responsibilities/accountabilities would they have and to whom? How much damage both directly and indirectly is likely to occur?

It is the role of directors to debate and formulate the remuneration of CEO's and direct reports in listed companies after analysing the complex web of strategy, shareholders, competitors, market conditions, attracting and retaining the best talent and so forth. APRA would be going well beyond its current powers of discussion and advice if it tried to manage remuneration in a fast moving economy, quick change of strategies and market pressure even assuming it would have the time, resources and intimate knowledge of each ADI's circumstances. Also, what happens if APRA does interfere in this area and it is instrumental in company failure of some sort (eg. lower share prices).

<sup>2</sup> See for example the Director Sentiment Index published by the Australian Institute of Company Directors over many years.

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Should it be liable in a class action for such a “management decision” and be part of the continuous disclosure regime?

### **Unintended Consequences**

Policymakers need to be mindful of the potential for unintended consequences of regulations – which are particularly pronounced in the area of executive remuneration. There are many examples of unintended consequences in interference by Governments and Regulators trying to change remuneration structures by way of tax treatment or direct legislation.

In the United States in 1993, President Clinton delivered his first budget which introduced a new section 162(m) into the Internal Revenue Code. It provided that companies could only deduct the first one million (US\$1m) of remuneration for the top five executives. The policy of the legislation was to discourage increases in executive pay. It had the opposite result. Employee share schemes and options flourished which were not covered by the particular drafting of the legislation. This led to a much higher executive pay.

In Australia we have seen the consequences of disclosure of executive remuneration increasing senior executive pay remuneration. Reports setting out competitors pay scales are regularly used in negotiations for executive contracts. The concept of “comparative wage justice” and “benchmarks” for companies is a natural and understandable concept at all levels. Although the argument for disclosure is grounded in good corporate governance principles of the owners knowing what certain top executives are being paid, it still has this side effect.

The two strike rule also had some unintended consequences. It allows for an eventual board spill if shareholders vote to do so after a company has two consecutive votes of more than twenty five per cent (25%) against its Remuneration Report. For example, Penrice Soda had two strikes against its Remuneration Report despite little or no increases in executive remuneration to the relevant executives. It appears to have been used as a lever by a disgruntled minority who wanted to obtain board seats. In other words, the two strikes legislation was being used for a possible outcome unrelated to any remuneration of executives.

The change in tax policy in Australia also more or less destroyed the continuation of employee share option schemes by taxing at the point of option vesting and not (as previously) at the point of exercise. Eventually this position was reversed. However, there was quite a lot of damage to bona fide and productive employee share option schemes in the interim.

Another point arising from Chapter 4 of the Consultation Paper is the possible introduction of a new regime of ‘named’ “accountable persons”. One would expect the remuneration for these positions will increase above the norm. This is because they require extra responsibility, accountability and liability. The type of person taking those roles are also likely to change with more of a compliance focus. Legal and accounting advice will additionally be required increasing costs. Decisions may also be slowed in this new bureaucracy. This is likely to put further brakes on growth.

### **Executive Remuneration**

In 2009 the Australian Productivity Commission was asked to look at Executive Remuneration by the Australian Government. It undertook a very thorough look at executive remuneration in Australia at that time. The final report was provided to the Australian Government on 19 December 2009 and released publically on 4 January 2010. One of the findings of the Productivity Commission was that although there were some outliers, Australian executives “appear to be paid in line with smaller European countries but below the UK and USA (the global outlier)”. It also stated;

*“But the way forward is not to by-pass the central role of boards. Capping pay or introducing a binding shareholder vote would be impractical and costly.”*

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However, it did recommend the introduction of the two strikes rule which now is part of the Corporations Act.

Shortly after the GFC hit, APRA convened a number of meetings with people with relevant experience in executive remuneration in APRA regulated entities. I was invited to attend along with several other external parties. At that time AICD had written a small brochure on executive remuneration called "A Guide to executive Remuneration". Whilst this guide is slightly dated (2009) it still has some useful principles which are being referred to.

APRA's "Prudential Standard CPS510 Governance" sets out its requirement for remuneration which are quite extensive but without trying to be prescriptive of any particular element of a remuneration package. It is similar to the ASX Corporate Governance Principles for listed companies and best practice in this area. It was also introduced after extensive and detailed examination and consultation.

### **40 to 60 percent proposal**

I now turn to the 40% and 60% minimums for variable remuneration being deferred for a minimum period of four years.

This proposal should not proceed to regulation. As discussed above, remuneration has many facets and must be capable of adaptation to many factors such as attracting and retaining talent, changing market conditions, achieving strategic outcomes, complying with regulation etc. .

Banks and other ADI's operate in a global market for this talent. Highly talented and appropriate senior executives and CEO's in Australia's Banks are difficult to find. Different types of remuneration will appeal to different individuals and be suited to different circumstances. Locking in any specific element of executive remuneration is unwarranted and counterproductive. The "squeezing of the balloon" effect is likely to occur if implemented. That is, remuneration will move to parts of remuneration not regulated to the possible detriment of shareholders and efficiency.

Banks need the flexibility to adjust remuneration quickly and the mix must also be capable of being changed between short and long term incentives. Short term weightings may be most appropriate in immediate circumstances. For example, a short term survival position. Having 40% to 60% variable remuneration locked up by regulation could cause great damage. What is the reason for this idea? Also there is some indication that setting longer periods and specific caps can become detrimental. This is because the relevant employees may heavily discount the prospects of receiving such remuneration making them unattractive in any negotiations forcing a "squeezing of the balloon". It should also be considered that a CEO's average term in the ASX 200 is now only about 5.5 years which is higher than compared to previous years.

### **Questions**

The questions posed in this Chapter are dealt with briefly below:

*Q: Would deferring variable remuneration be likely to result in a shift from variable to base remuneration?*

As discussed previously, it would be like "squeezing the balloon". The remuneration like the air in the balloon when squeezed would move to the other parts of the remuneration not so squeezed. This could be fixed remuneration, sign on bonuses, termination payments etc. It also appears to be an attempt to usurp the role of the Board in a critical area of corporate governance.

*Q: Would this be problematic and if so, can anything be done to prevent this outcome?*

There should be no attempt to try.

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As discussed, it interferes detrimentally to the roles of Boards and management of ADI's with little value and a large downside. See also legislative attempts interfering with executive remuneration discussed previously.

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

The complexities are significant and often very difficult. There is no one size that fits all. The constant changes in "best practice" tax regulation and the market place for executive talent make this a very fluid area for constant experimentation and debate. Particularly when the overlay of a global market for talent is added.

Q: *Does the proposed principles based definition of variable remuneration provide sufficient clarity as to the application of the BEAR to current and potential future remuneration structure?*

The answer to this question is found in its attempt, it is not practical or useful to define "variable remuneration" if the arguments for not proceeding with this regulation is accepted.

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

Definitely not.

See above discussions. Boards need to be able to change compensation quickly as possible subject to existing contracts of employment and offer flexibility in negotiation with new recruits.

Q: *Are the proposed enhancements to APRA's remuneration powers appropriate?*

Definitely not

See discussions above.

APRA would find itself in a position of less respect and influence across the board, including with the public. Interfering with actual remuneration of executives is not APRA's job or expertise. Questioning, engaging and influencing remuneration possibilities is. The current regime should be retained.

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