

Submission to Senate Economics Legislation Committee Inquiry into the Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Bill 2017 [Provisions]

from

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1. Introduction

1.1. Who we are:

- We are academics interested in the regulation of the banking and finance industry. We have jointly published in the area and ran a Roundtable Conference on the topic in December 2015. Individually we have each written extensively on topics involved in this submission. In July this year we made a submission on the BEAR to Treasury.
- Dr Ann Wardrop is a senior lecturer at the Law School of La Trobe University whose main research interests are in banking and finance law and regulatory theory.
- Dr David Wishart is also a senior lecturer at the Law School of La Trobe University. His main research interests are in corporation law and theory, competition policy and regulatory theory.
- Dr Marilyn McMahon is an Associate Professor at the Law School of Deakin University. Marilyn's research areas are in psychology and the law, crime, criminal law and criminology.

1.2. Why we are submitting:

Our research focuses on organisational culture as a key focus of interest in the regulation of the banking and finance industry. We have investigated many differing mechanisms and strategies for increasing the responsibility and accountability of senior and influential directors and executives within authorised deposit-taking institutions (ADIs). We have also researched a wide spectrum of regulatory techniques aimed at ensuring the behaviour of institutions and personnel in the banking and finance industry is appropriate both in prudential and consumer protection terms. The BEAR is an Australian articulation of one such technique and we are keen to make our expertise available to the Senate Economics Legislation Committee. We are grateful to the Committee for inviting this submission.

1.3. Our approach:

While there is much in the detail, a very important aspect of the Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Bill 2017 (BEAR) is its principles and overall formulation. Accordingly, we direct our comments at four key matters, under two headings: issues to do with the way the BEAR works and, second, the impact of the Bill on the existing regulatory structure.

2. The Scheme of the Bill: The BEAR.

2.1. The Obligations.

2.1.1 The BEAR sets out ‘accountability obligations’ of both ADIs (cl 37C) and accountable persons (cl 37CA). These obligations are not quite duties but more than the original idea of ‘expectations’. The Explanatory Memorandum (at para 1.55) asserts that terms used to define the obligations, while not defined terms in the *Banking Act 1959* (Cth), have ‘ordinary meanings’ that are ‘generally well understood’ and are ‘used in other laws and considered by established case law’. However, in relation to the terms ‘honesty’, ‘integrity’, and ‘due skill and diligence’, the meanings of such terms in law differ between contexts, and vary over time and person.

2.1.1.1 The most contiguous area of law, corporations law, does not actually use the term ‘integrity’, and ‘honesty’ has effectively been replaced (for reasons of clarity) by duties to act for the benefit of the company and without conflicting interests.

2.1.1.2 ‘Skill’, while referred to in cases as a requirement of officers depending on what qualifications that person has held themselves out to have, is not otherwise required by legislation, mainly because it is simply too difficult to comprehensively define.

2.1.1.3 ‘Diligence’ is indeed referred to in s 180(1) of the *Corporations Act 2001* (Cth). In that context it refers to that which ought to be demonstrated by a reasonable person in that person’s job in a similar corporation.

2.1.1.4 We submit that these terms need clarification in the context of the *Banking Act*.

2.1.2 The obligation to deal with APRA in an ‘open, constructive and cooperative way’ is particularly fraught. It is a reference to the established regulatory approach of APRA in that APRA sets up conversations with ADIs in order to carry out its prudential functions. (This is discussed below at para 3). However, the obligation to deal with APRA in this way is enforceable against the ADI; a default may result in a civil penalty and, in relation to accountable persons, possible disqualification from acting as an accountable person, or by the docking of their variable remuneration. Unlike ADIs, accountable persons are not subject to a civil penalty for breach of their accountability obligations. Nonetheless, an ‘obligation’ enforceable to this extent requires firm and established criteria. These criteria are not easily identified from a simple obligation to be ‘open, constructive and cooperative’. This leaves open fundamental questions such as ‘what constitutes a failure to be ‘constructive’

or 'open'? Reference to dictionary definitions suggests that these words relate to attitudes. Adopting such definitions could lead to outcomes where staff suffer adverse consequences (even to the point of dismissal) for having a bad attitude. Further, we can find no 'laws' (as opposed to expressions of a regulatory approach, see para 3.5 below) in which the phrase is deployed as a criterion. Clearly, this is an unsatisfactory situation.

- 2.1.3 On the other hand, we note that an attempt to resolve some issues has been made since the Treasury Exposure draft was released. In particular, cl 37C now requires an ADI to take reasonable steps to comply with its accountability obligations. This amendment seeks to remove the anthropomorphism implicit in the Exposure Draft's drafting that required firms to directly act with 'honesty and integrity'. We opposed such a direct obligation in our previous submission. Nevertheless the simple insertion of 'reasonable steps' to cl 37C still begs the questions of what is required for a company to be honest and to have integrity and how contravention of such an obligation might relate to 'prudential matters' and thereby make the ADI liable to a penalty imposed under cl 37G. We believe that these are *not* matters of accountability of a business entity and thus might be better referred to a wider set of obligations on ADIs in the conduct of their business. Similarly to require a firm to act with 'due skill, care and diligence', albeit by taking 'reasonable steps', is to imbue it with characteristics of humans. What is the 'skill' of a firm? When is it diligent? What is the standard of care expected of a firm and how do requirements of foreseeability apply for the actions of companies? Indeed, 'reasonable steps' only operates to shift the requirement from strict liability towards the incorporation of a reasonableness criterion. Comparison could be made to the care with which s 912A of the *Corporations Act* has been drafted, in that it requires a financial services licensee to 'do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly', to 'have in place adequate arrangements to manage conflicts of interest', and so forth. The Bill should be drafted in that way.

ADIs are entities whose actions are matters of its employees and officers. To be sure, those characteristics of action may be attributed to a firm, yet this is the function of the accountability regime itself. It is otiose to require it of the firms. An example of the confusion that might result is in the idea of negligence. In its corporate law sense as outlined above, the standard of care required is that of a reasonable person. Accordingly the accountability obligation to take reasonable steps to conduct business with the skill, care and diligence of a reasonable entity would possibly be self-defeating. The requirement is better placed on the accountable person, although in the Bill that is not enforceable by civil penalty (unlike the UK regime).

- 2.1.4 Moreover, how such obligations interface, both practically and theoretically, with similar duties under the *Corporations Act 2001* (Cth) is not clear. For

example, the duty of care and diligence under s 180(1) the *Corporations Act* and relevant case law is subject to the Business Judgement Rule in s 180(2) of that Act. Further, these duties do not include an explicit skills element but have already well-articulated limitations on responsibility in relation to delegation and reliance. While overlapping duties is unexceptionable, if a little confusing, the *Corporations Act* duties are subject to enforcement under the civil penalty regime set out in Part 9.4B. If the accountability regime has more rigorous requirements, the absence of direct personal liability is explicable. However, where the accountability requirements under the Bill are less rigorous than those in the *Corporations Act*, the situation might arise that APRA has no capacity to pursue failures in accountability in supervision of the Banking Industry whereas ASIC does have capacity to do so in general regulatory control. Moreover, a Court might be minded to say that the latter Act exculpates for the lack of accountability, even though (paradoxically) the purpose of the Bill is to heighten accountability. These comments apply also to the *Corporations Act* and equitable duties to act for a proper purpose, *bona fide* for the benefit of the company and to avoid conflicts of duty which are the equivalents of ‘honesty and integrity’ in the Bill.

The proposed accountability regime might also be undermined by the proliferation of terms describing those upon whom obligations and responsibilities are placed. The duties in the *Corporations Act* apply variously to: directors; directors and officers; and directors, officers and employees, (with ‘officer’ defined in s 9 of the *Corporations Act*). Section 5 of the *Banking Act* already defines ‘senior manager’ for various purposes and refers to ‘officer’ (utilising the definition in s 11CG(2)); the definition of ‘accountable person’ under the BEAR seems to be consistent with the definition of ‘officer’ although there could well be differences in the detail of tests. There is also the analogous concept of a ‘responsible person’ defined in APRA’s ‘fit and proper’ prudential standards. Given the overlapping nature of the duties, this is likely to confuse implementation. This is compounded by the late addition of ‘senior executive’ in clause 37BA of the Bill, although this is apparently a matter of the definition of the nature of responsibility rather than of a position – the difference is difficult to pin down.

2.2 Regulating Culture

According to both the Treasurer’s Media release of 9 May 2017 and the Treasury Consultation Paper of July 2017, a major objective of the Banking Executive Accountability Regime is to improve the culture and behaviour within banks. The episodes that give rise to implications of bad culture arise from insurance operations, deposit taking, interest rate fixing, money laundering and so forth. It might be that they are not matters within APRA’s purview.

Under the *Australian Prudential Regulation Authority Act 1998* (Cth), APRA’s functions relate to ‘prudential’ regulation, plus those functions conferred by other State or Commonwealth legislation. The *Banking Act 1959* (Cth) confers no powers

on APRA other than those limited to prudential matters. ‘Prudential’ itself is defined in the *Banking Act* in terms of maintaining regulated institutions in a sound financial position, maintaining systemic stability in Australia’s financial system, and conducting the affairs of those institutions with ‘integrity, prudence and professional skill’.

One would have thought that ‘integrity, prudence and professional skill’ would cover behaviour and culture within ADIs. The exact ambit of ‘prudential’ within the *APRA Act* or the *Banking Act* has not been comprehensively litigated. Nevertheless, there are indications in the Bill and the Explanatory Memorandum that a narrower interpretation of the meaning of ‘prudential’ may be intended.

One such indication is in para 1.47 of the Explanatory Memorandum where an emphasis is laid on the prudential aspect of conduct. Similarly, in para 1.34 there is reference to ‘prudential reputation or standing’. In cl 37G(1)(b) a distinction is made between a prudential matter leading to remuneration reductions and other reasons.

In Australia’s ‘twin peaks’ regulatory model, where APRA does prudential regulation and ASIC does the rest, it is clear that a distinction is made between normal non-compliance and prudential non-compliance. APRA is concerned with the maintenance of a stable, efficient and competitive financial system, as most such bodies are. In that context, a narrower idea of the meaning of prudential is quite feasible, supported by an approach, now often adopted in the EU, that conduct does threaten stability, provided only it is egregious enough and of sufficient financial impact. It is possible then that the accountability obligation of ‘integrity, prudence and professional skill’ will only be penalised if it of sufficient gravity to affect financial stability. The above indications point to an assumption that this narrower view is that under which the BEAR will operate. In that case, culture which doesn’t threaten systemic stability, will be assumed not to be within the purview of the Regime.

In our view, if the twin peaks model is to be maintained, ‘prudential’ should be more carefully defined. Moreover, enhanced conduct responsibility obligations, including requirements to map accountability, should be transferred to the *Corporations Act*, even if only for public companies. In that case it would be a welcome addition to ASIC’s powers, even those of the ACCC, to ensure business conduct and behaviour is appropriate.

2.3 Semi-indirect regulation

A policy choice was made in formulating the Bill. This was whether accountable persons should be directly liable for failures to meet obligations (as they are under the UK regime) or whether it should be the responsibility of the ADI to discipline the accountable person. The latter approach was chosen, no doubt in deference to a self-regulatory ideal. Accordingly, the civil penalty regime operates only on the ADI. However, the ADI is required on pain of civil penalty to ensure each of its accountable persons meets his or her accountability obligations.

APRA is empowered to declare the accountable person disqualified from acting as an accountable person under cl 37J or indeed to apply to the Federal Court for disqualification of a director or senior manager under s 21 of the *Banking Act* as not being a fit and proper person, thereby removing from them the capacity of future employment in the same capacity. The s 21 power has proved contentious with many disqualifications being overturned on appeal.

Our concern is with the ensuing complexity. The regime does not directly enact what it is trying to achieve: that someone in an ADI must take responsibility and be accountable for things that go wrong when they could have been avoided. In form, the idea is that it is for the ADI to determine the consequences but this is diluted by APRA's banning powers and its capacity to force the ADI to comply through supervisory processes. Accordingly, any attempt to address the culture of an ADI may fall between the stools of the consequences to individuals and corporate liability. For example, if an issue is to do with systemic distortion of behaviour (of sufficient impact to be prudential), an ADI has an incentive to cover up the problem or at least to protect its own senior management; APRA in these circumstances has the double onus of demonstrating that there was a failure of accountability and that the ADI did not take reasonable steps to ensure that the person was held accountable. We would recommend that behaviour of accountable persons should be a matter of direct liability, preferably taken out of the *Banking Act* and placed in the *Corporations Act*.

3. Regulatory Structure

3.1. APRA prides itself on employing a regulatory approach which is forward-looking, primarily risk-based, consultative, consistent and consistent with international best practice. It actively supervises by maintaining continuing conversations with institutions as to the matters with which it is concerned. ASIC, on the other hand is a much more traditional regulator, albeit one still adhering to the regulatory compliance pyramid based on the Ayres and Braithwaite model.

We are concerned that the BEAR rides roughshod over the delicate balance on which APRA's regulatory approach depends. This is not to say that we necessarily agree with such an approach, as it has the obvious dangers of capture and loss of legitimacy. However, we are suggesting that there should be more consideration given as to exactly how the BEAR will impact across the regulatory environment.

3.2. The core issue in relation to the broader regulatory impact is that in three respects the BEAR misconceives the role which APRA has developed for itself.

- The first of these is that the new powers might change the perception of APRA's role within the industry itself. The likely shift is away from APRA being viewed as forward-looking, primarily risk based and consultative, to being perceived as adhering to a more punitive, compliance model of regulation; this would undermine APRA's effectiveness. Under the BEAR, APRA's supervision moves towards setting general standards of business performance assessed after the event, in addition to its traditional role of avoiding threats to financial

stability by setting particular requirements, for example, capital adequacy ratios or the requirement to appoint fit and proper person.

- 3.3. The second likely impact concerns the possible extension of APRA's enforcement role into 'culture' conceived broadly rather than its current operation as a matter of prudential supervision in the narrow sense. If culture is also a matter of behaviour to consumers, APRA's regulatory purpose changes and this may well be seen by ADIs as an intervention in what is properly a matter of their place in the market. Indeed, consumer protection is the role of ACCC and ASIC. A negative reaction to APRA taking on such a role may play out in reluctance to be cooperative in the systemic protection role. Merely to require a good attitude, as discussed above, may not substitute for acknowledgement of a specific legitimate regulatory role.
- 3.4. The third way in which the BEAR impacts on the role of APRA is that enhancing compulsion powers in investigation and requiring a standard of behaviour towards APRA undermines its reliance on willing cooperation. APRA works hard at its relationships with ADIs. *The APRA Supervision Blueprint* (2015) sets out APRA's current expectations concerning regulated entities and their representatives (p.8). The *Blueprint* states that they are expected to be 'open and transparent in their dealings with APRA' and to be 'honest, candid, professional and courteous'. It specifies that 'Opacity or failure of a regulated entity to cooperate with APRA will require APRA to adopt a more intrusive level of oversight'. Importantly the *Blueprint* threatens without identifying overt penalties. While this is reasonably normal for regulatory authorities and consistent with regulatory practices on the Ayres and Braithwaite model, the examinations power set out in cl 61C-G, the penalty regime set out in the BEAR for ADIs and the implicit punishments for 'accountable persons', and requirements to be 'open and cooperative', are much more troublesome. Coercive power inevitably changes relationships and we are concerned that these changes have not been assessed for their potential impact on the way in which APRA carries on its business.
- 3.5. If the BEAR is designed to deal with organisational culture in a more than formulaic sense of requiring compliance with a prudentially directed accountability map, it might well be more appropriate for supervision of culture be a matter of a separate unit within APRA, based on the DNB model (as set out in our article 'Regulating Financial Institution Culture: Reforming the Regulatory Toolkit' (2016) 27(3) *Banking and Finance Law Journal* 171-83).
- 3.6. We acknowledge that there is an argument that to change APRA's role might be no bad thing. This argument would point to the fact that the scandals at which the BEAR is directed happened on APRA's watch. On the other hand, the Australian financial system has been remarkably robust, for which APRA may claim credit. Without independent and extensive (and well-funded) research into the role of APRA, we are unwilling to commit to any opinion on this matter. We are willing to assert that if enacted the Bill will impact on the way APRA is perceived and conducts its business and that it appears that this will be an unintended consequence of the changes in the law.

4. Summary of Submission

The *Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Bill 2017* is like the curate's egg: good in parts. In particular, it represents a step towards ensuring that culture within ADIs does not prejudice systemic stability, efficiency and competitiveness. While not entirely establishing self-regulatory systems, the Bill appears to balance organisational autonomy against enhanced regulation, focussing on requiring firms to enforce responsibility. The requirement to map accountability and responsibility will make the governance of ADIs more transparent and in so doing may encourage the formation of better cultures.

We also welcome the proposal as redefining what is expected of officers, in particular for placing a focus on their accountability. However, we believe that such redefinition would be more usefully included in the *Corporations Act* directors' duties regime. Expectations of enhanced conduct duties may well catch the conduct implicated in recent scandals more directly than attacking it as a 'prudential matter'. Moreover, we are not convinced that the criteria for the new duties are well articulated.

We are concerned with a number of matters relating to the design, mostly to do with the functional separation between ASIC and APRA – the oft referred to 'Twin Peaks'. In our opinion, APRA's remit to deal with prudential matters delimits the effectiveness of the BEAR, yet to take a broader approach to 'prudential' may threaten the processes and methods adopted by APRA to ensure systemic stability, efficiency and competitiveness.

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