JOINT CONSUMER SUBMISSION TO THE FINANCIAL SERVICES REFORM TASKFORCE

Financial Accountability Regime

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A joint consumer submission from CHOICE, Consumer Action Law Centre, Financial Counselling Australia, Financial Rights Legal Centre and Super Consumers Australia.

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CONTENTS

INTRODUCTION

The Australian community expects that banking bosses are held to account when they do wrong.

At the conclusion of the Banking Royal Commission, Commissioner Hayne was emphatic that primary responsibility for misconduct in financial services businesses lay with the senior executives who managed and controlled them. Every shocking example in the Royal Commission, “should be understood in the light of that one undeniable fact. Executives bear the responsibility”.[1]

The Australian public also expect the people who manage and control financial services firms to ensure that the misconduct and scandals cease. Customers want to know that the people in charge, and the staff they deal with, will now treat them fairly.

Accountability regimes have been globally recognised as a key tool to hold individual executives accountable for their actions, to drive better ex-ante decision making, and to provide better incentives for appropriate conduct.[2] A well designed accountability regime will be the engine that drives the right approach to all the other reforms coming out of the Banking Royal Commission.

If designed correctly, the new Financial Accountability Regime (FAR) could be a game-changer for corporate culture in Australia’s financial services sector. Unfortunately, two important aspects of Treasury’s proposed model for the FAR fall short of driving the sort of change that is needed.

First, a glaring omission is the need to hold senior executives to account for treating their customers fairly. Despite being a centrepiece of the Royal Commission's Final Report, and being an increasing focus of both the courts and regulators, **fairness is missing from the proposed accountability regime.** The Federal Government must create a new standard of fairness and expand accountability obligations in the FAR. Institutions and executives must be required to “take reasonable steps to treat their customers fairly”. This new fairness obligation will be a catalyst for reforming corporate culture, driving significantly better outcomes for consumers.

Second, the proposed deferred remuneration obligations fall short of community standards and expectations. The proposed benchmark is weaker than both the requirements set under the

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[1] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report,* Volume 1, p4

[2] Financial Stability Board, *Strengthening Governance Frameworks to Mitigate Misconduct Risk: A Toolkit for Firms and Supervisors*, p25

Banking Executive Accountability Regime (BEAR) and below global best practice. We want our financial institutions to employ senior executives who are motivated by the highest standards of integrity, not those who are shopping around for the least restrictive incentive payments. The deferred remuneration obligations must be significantly strengthened and be brought in line with global best practice.

The proposed model does, however, include some very promising developments. Both the strengthened civil penalties regime and non-objections power will give the regulators serious teeth to enforce standards on senior executives. Consumer advocates strongly support these important measures. Yet there are already concerning reports that major financial institutions are lobbying hard to water down these reforms.[3] This is the time when senior executives should be stepping up to accept new standards of conduct, rather than using their political influence to diminish their accountability.

We strongly support the FAR regime applying to all APRA and ASIC-regulated entities. In particular, the regime must capture superannuation funds. Super fund trustees hold $2.9 billion in Australia's savings and with such an important responsibility, executives must be held to high standards of accountability. The financial services industry does not have a monopoly on misconduct and mismanagement, the same problems of poor accountability and poor product design occur in the private health insurance industry. The FAR regime must apply to the private health insurance industry.

While the focus of the FAR is currently on the people who control and manage entities, other jurisdictions have developed much wider accountability obligations. For example, in the UK, there are five conduct rules which set the minimum standards for all financial services employees within a firm. Adopting wide-reaching conduct rules would help Australia's financial services businesses to change their culture and deliver better outcomes for consumers.

As a consumer movement, it is disappointing to see the timeframe for ASIC-regulated entities to be pushed back to some future, unspecified date. There are a number of large and complex entities including lenders and debt collectors that cause widespread consumer harm that will not be captured by this legislation. We urge the Government to release the timeframe for expansion to ASIC-regulated entities and to promptly consider applying the FAR to these entities.

[3] James Frost, *Banks lobby against $1m fines for executives*, Australian Financial Review, 7 February 2020 accessed at https://www.afr.com/companies/financial-services/banks-lobby-against-1m-fines-for-executives-20200206-p53yf6

RECOMMENDATIONS

1. The Treasury must clearly state that the objective of FAR legislation is "to ensure consumers are treated fairly and their financial wellbeing is promoted". This should mirror the drafting of the *Competition and Consumer Act 2010.*

2. The Treasury must consider the risk of consumer harm, as well as the complexity of entities, to determine the benchmark for the 'enhanced compliance' classification.

3. The Treasury should grant only APRA and ASIC the power to exempt entities for the new regime.

4. The Treasury must include functions that are critical to consumer outcomes, such as dispute resolution, customer hardship and the customer advocate, within the accountable persons framework.

5. The Treasury must implement Royal Commission recommendation 7.4 as part of the reform process.

6. The Treasury must add a fairness accountability obligation. Entities must be required to "take reasonable steps to treat their customers fairly" and accountable persons must be required to "pay due regard to the interests of customers and treat them fairly". This should mirror the individual conduct rules of the UK's Financial Conduct Authority.

7. The Deferred Remuneration Obligations be must be strengthened to:
    a. reflect global best practice,
    b. be no weaker than the obligations that existed under BEAR,
    c. be fit for purpose, and
    d. be scaled to reflect the risk profile of the entity and the accountable persons' function, as well as the total sum of the variable remuneration.

8. The non-objections power should be extended to ASIC to ensure that conduct risk is fully factored into senior executive appointments.

9. The court should be required to consider the impact that the penalty has on consumers and/or beneficiaries of prudentially regulated entities.

10. Conduct rules should be established for all staff delivering financial services in a FAR entity.

11. The Treasury must release the timetable for the expansion of the FAR regime to ASIC-regulated entities.

RESPONSE TO PROPOSAL PAPER

CHOICE welcomes the opportunity to provide feedback on the proposed approach to a new accountability regime for the financial services sector. The expansion of the regime to all APRA and ASIC regulated entities, the inclusion of civil penalties for accountable persons, as well as entities, and the shared responsibility of the scheme by the prudential and conduct regulators are all important steps forward. But the Financial Accountability Regime (FAR) needs to go further if it is to deliver a financial services industry that the Australian community can trust.

1. Objectives of the FAR

As we transition from the BEAR regime to the FAR, it is important to reflect on what we want the new regime to achieve. The UK's Financial Conduct Authority (FCA) sees its accountability regime as, "a catalyst for change - an opportunity to establish healthy cultures and effective governance in firms by encouraging greater individual accountability and setting a new standard of personal conduct".[4] The sort of culture that the FCA envisages of its scheme is what FAR entities should also be challenged to achieve. If we get the settings right, the FAR presents an important opportunity to drive cultural change within all our financial institutions, and stands to deliver benefits for financial services consumers and the broader economy.

It is important to acknowledge that the FAR regime exists to ensure that people are treated fairly and that executives are held to account when misconduct occurs. The Treasury must codify this principle in the objective of new FAR legislation. This will ensure that the focus of the FAR regime always remains on protecting people from harm, and not be a box-ticking, compliance exercise. We encourage the Treasury to look at the *Competition and Consumer Act 2010* for drafting guidance. This law states that,

> *"The object of this Act is to enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection."*[5]

This is also consistent with the *Telecommunications Act 1997*, which states that the main object of the Act is to provide a regulatory framework that promotes:

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[4] https://www.fca.org.uk/firms/senior-managers-certification-regime, accessed 6/2/20
[5] *Competition and Consumer Act 2010,* s2,.

> *"the long-term interests of end-users of carriage services or services provided by means of carriage services".*[6]

The Royal Commission urges policymakers to clearly state the underlying norms and principles of financial services legislation. Commissioner Hayne established that best practice for statutory drafting is that,

> *"the first requirement will be to settle upon the principle or principles to which the law is to give effect."*[7]

The Treasury is presented with a clear opportunity to establish the principles and underlying norms of the FAR. This will help simplify and clarify the law for entities, regulators, and the broader community.

Recommendation 1

The Treasury must clearly state that the objective of FAR legislation is "to ensure consumers are treated fairly and their financial well being is promoted". This should mirror the drafting of the *Competition and Consumer Act 2010.*

[6] *Telecommunications Act 1997,* s3,

[7] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report,* Volume 1, p486

2. Scope of the regime

The *Proposal Paper* states that entities will be classified as either ‘core compliance entities’ or ‘enhanced compliance entities’. It is appropriate for the FAR to utilise a tiered compliance model as it expands to all APRA- and ASIC-regulated entities. The higher regulatory burden should lie with the entities who are at greater risk of failing to meet the objectives of the FAR, because of either their complex organisational structure, or their risk of harm to consumers.

The *Proposal Paper* outlines a model based solely on asset size to determine which APRA-regulated entities will adopt the enhanced compliance framework. Yet the Royal Commission showed that entities of all sizes were found to be engaging in inappropriate behaviour, particularly where, for example, they were targeting vulnerable consumers or selling inappropriate products. The Treasury should consider whether other measures may be better suited to determine the benchmark for higher regulatory obligations. For example, the complexity of an organisation may be better reflected in the number of employees, and risk of harm may have geographic or product dimensions.

The *Proposal Paper* also states that the Minister, ASIC and APRA will have the power to exempt entities or classes of entities from the regime, and notes that this exemption is expected to be used sparingly. We do not think it is appropriate to allow ministerial discretion to exempt an entity from the regime. If this power was established, there is a risk of unreasonable political influence in a scheme which could, for example, determine whether or not a CEO has to defer a multi-million dollar pay packet. The political influence of the financial services industry over political parties in Australia has been well documented. We should ensure that no entity can “buy” its way out of its obligations. The FAR ought to operate under the high standards of transparency and accountability that it expects of the entities it regulates, and this is best delivered by APRA and ASIC alone.

Recommendations 2 - 3

2. The Treasury must consider the risk of consumer harm, as well as the complexity of entities, to determine the benchmark for the ‘enhanced compliance’ classification.

3. The Treasury should grant only APRA and ASIC the power to exempt entities for the new regime.

3. Definition of accountable person

We welcome the expansion in the definition of accountable persons under the scheme. The use of both principles-based and prescriptive elements will give the scheme flexibility to identify the right set of accountable persons within a range of different entities.

As a guiding principle regulators should consider, for each type of regulated entity, what functions are critical to avoiding consumer harm. In the indicative list provided in the *Proposal Paper* at Attachment B, we would recommend including the senior executive responsible for the entity's customer hardship function, as a stand alone responsibility. The senior executive responsible for the entity's customer advocate function could also be added to the indicative list. The prescribed functions should be subject to consultation.

Recommendation 4

The Treasury must include functions that are critical to consumer outcomes, such as dispute resolution, customer hardship and the customer advocate, within the accountable persons framework.

4. Embedding fairness in the FAR regime

A new standard of fairness should be adopted in the accountability regime, which would, in part, reflect the intentions of recommendation 7.4 of the Royal Commission, which found that;

> *"As far as possible, legislation governing financial services entities should identify expressly what fundamental norms of behaviour are being pursued when particular and detailed rules are made about a particular subject matter".*

Recommendation 7.4 challenges lawmakers to articulate the norms of behaviour that the community expects from senior executives.

Commissioner Hayne, in his Final Report, explained that a very simple set of norms must inform the conduct of the financial services entities:

- obey the law;.
- do not mislead or deceive;
- be fair;
- provide services that are fit for purpose;
- deliver services with reasonable care and skill; and
- when acting for another, act in the best interests of that other.[8]

The accountability obligations outlined in the *Proposal Paper* do a reasonable job of implementing most of these norms as they apply to senior executives, with the notable exception of fairness. Fairness is at the heart of the culture that we want to see in our financial services sector. We should ensure that senior executives within financial services are held accountable for bringing a culture of fairness to the entities they control and manage.

We recommend adding new accountability obligations explicitly addressing fairness to entities and accountable persons operating within the FAR. Entities must be required to "take reasonable steps to treat their customers fairly" and accountable persons must be required to "pay due regard to the interests of customers and treat them fairly". This should mirror the individual conduct rules of the UK's Financial Conduct Authority.

By implementing these obligations, we expect that entities will adopt a culture of ensuring not just whether their actions are diligently and honestly undertaken but whether they are fair for their customers too. These accountability obligations would be a "game changer" for corporate culture and would drive significantly better outcomes for consumers.

[8] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report,* Volume 1, p 8-9

Recommendations 5 - 6

5. The Treasury must implement Royal Commission recommendation 7.4 as part of the reform process.
6. The Treasury must add a fairness accountability obligation. Entities must be required to "take reasonable steps to treat their customers fairly" and accountable persons must be required to "pay due regard to the interests of customers and treat them fairly". This should mirror the individual conduct rules of the UK's Financial Conduct Authority.

5. Deferred remuneration obligations

Deferred remuneration obligations can discourage excessive risk-taking and reduce a culture of 'short-termism'. We strongly support their application to the financial services sector.

It is important that the Government gets the parameters of the deferred remuneration obligation right. Financial institutions must employ senior executives who are motivated by the highest standards of integrity, not those who are shopping around for the least restrictive incentive payments.

The *Proposal Paper* outlines an obligation to defer 40% of variable remuneration for at least four years, where the amount to be deferred is greater than $50,000. This is a considerable change to the BEAR. The BEAR operated under a tiered arrangement that set different benchmarks for CEOs and Senior Managers, depending on the size of the entity and the sum of the variable component (see Appendix A). Under BEAR, for example, the CEO of a large ADI would be required to defer the lesser of 60% of variable remuneration or 40% of total remuneration for four years.

By comparison, the UK's FCA and Prudential Regulatory Authority (PRA) requires that firms apply deferral periods of no less than seven years to all variable remuneration of Senior Managers, and to defer all variable remuneration for three to five years for Risk Managers and Material Risk Takers (see Appendix B). In addition, regulators can extend the period by up to three years rules where there are outstanding internal or regulatory investigations at the end of the normal seven-year clawback period.[9]

The FAR proposes to legislate a model below international best practice and below the benchmarks of BEAR, particularly for larger entities. The *Proposal Paper* does, however, anticipate APRA regulated entities being subject to additional requirements. APRA's Draft Prudential Standard CPS 511 on Remuneration contemplates all APRA-regulated entities deferring 60% of variable remuneration for seven years for CEOs and 40% for six years for senior managers and highly paid Material Risk Takers. The *Proposal Paper* indicates that any obligations imposed by CPS 511 would be in addition to the FAR, and that the FAR will not limit a regulator's ability to apply additional requirements. We consider that the Parliament should legislate deferred remuneration requirements at levels that the community would consider is right. The deferred remuneration levels being considered by APRA should therefore be reflected, as a minimum, in the FAR legislation.

[9] Policy Statement PRA PS12/15 FCA PS15/16 *Strengthening the alignment of risk and reward: new remuneration rules,* June 2015

We recognise the desire to move to a simple model as the scheme is extended to all ASIC regulated entities. However, the ‘flat’ model proposed by Treasury fails to reflect the diversity of entities that will be covered by the scheme. The CEOs, senior executives and other accountable persons of the largest ASIC-regulated entities should have higher obligations placed on them, in line with global best practice standards, as should people with very high levels of variable remuneration.

Recommendation 7

The Deferred Remuneration Obligations be must be strengthened to:

a. reflect global best practice;
b. be no weaker than the obligations that existed under BEAR;
c. be fit for purpose; and
d. be scaled to reflect the risk profile of the entity and the accountable persons’ function, as well as the total sum of the variable remuneration.

6. Penalties

CHOICE strongly supports the proposal that a new civil penalties regime will apply to entities and accountable persons. It is appropriate that accountable persons are subject to civil penalties for breaches of the regime. The UK's Senior Manager Regime has imposed civil penalties under its framework, which is viewed by the regulators as a wide-ranging success.

The level of penalties under the FAR must be set at a level which deters non-compliance and is seen as more than the cost of doing business. We strongly support aligning maximum penalties for entities and accountable persons under the FAR with the newly-imposed maximum penalty framework under the *Corporations Act 2001* (Cth), *Australian Securities and Investments Commission Act 2001* (Cth), *National Consumer Credit Protection Act 2009* (Cth) and I*nsurance Contracts Act 1984* (Cth).

Breaches of the FAR go to the very heart of an entity's social licence to provide financial services to the community. We consider that if a breach imposed on an entity is such that it renders the financial institution insolvent, then the business should accept that fate. This risk should be real enough that businesses are not tempted to create a business model that relies on taking advantage of their customers. This regime cannot succeed in driving lasting and meaningful change in the financial services sector without significant penalties.

In limited circumstances the losses due to insolvency of an entity will fall heaviest on consumers, for example in the case of superannuation fund members. Some superannuation funds have limited resources to pay a penalty, outside of accessing members benefits. So a large penalty on the entity may punish innocent members rather than the trustee or executives. To ensure this law is appropriately targeted we recommend the court be required to consider the impact of the penalty on consumers and or beneficiaries, rather than the viability of the prudentially regulated entity.

Recommendation 8

The court should be required to consider the impact that the penalty has on consumers and/or beneficiaries of prudentially regulated entities.

7. Non-objections power

The non-objections power is an important means to bring additional discipline to entities' employment and re-appointment decisions regarding senior executives. It also addresses the problem of "rolling bad apples" where individuals move from entity to entity taking with them poor cultural practices or known involvement in misconduct.

We consider that both APRA and ASIC should have powers to object to veto the appointment of an accountable person. This will ensure that conduct risk, as well as prudential risk, is considered as part of the appointment of senior executives. It is essential that the FAR is understood as a driver of market integrity and consumers can trust that business executives

Recommendation 9

The non-objections power should be extended to ASIC to ensure that conduct risk is factored into senior executive appointments.

8. Extending the FAR to all non-ancillary staff

The focus of the FAR is currently limited to senior executives who control and manage an entity, as well as other people who are responsible for critical designated functions. These are the people who ultimately bear the responsibility for misconduct and it is appropriate that they are singled out for their responsibilities.

The UK has implemented a tiered model of accountability that moves beyond the senior executive, to all employees, with the exception of ancillary staff. This model ensures that individuals working at all levels can be held to appropriate standards of conduct. Appendix C outlines the five simple conduct rules that apply to all individuals, alongside the conduct rules that apply specifically to senior executives. This approach ensures a consistent approach to culture across entities and ensures that all staff know what conduct the community expects from them,

We see value in establishing accountability obligations to all staff who provide financial services in FAR entities.

Recommendation 10

Conduct rules should be established for all staff delivering financial services in a FAR entity.

9. Capturing APRA and ASIC-regulated entities

We strongly support the FAR regime applying to all APRA and ASIC-regulated entities. In particular, we strongly support the regime applying to superannuation funds and private health insurers.

Health care is an essential service. The Australian community expects that private health insurance executives are held to account when they do wrong. The financial services industry does not have a monopoly on misconduct and mismanagement. However the private health insurance sector has been equally plagued in controversy. For example, it was revealed that Australia's major private health insurers illegally rejected thousands of claims involving pre-existing conditions without seeking a doctor to review the evidence.[10] This left thousands of sick Australians without the protections of private health insurance cover. Further, this month APRA released warnings about the prudential standing of Australia's private health insurance sector, suggesting there may only be three viable insurers by 2022.[11] These examples raise concerns about both the conduct and prudential standing of the industry and highlight how essential it is they are captured by the FAR regime.

Similarly, superannuation is a compulsory product where people are forced to put aside income to save for their retirement. Australians have almost $3 trillion in retirement savings tied up in superannuation. It is essential that we hold trustees and the executives that work in superannuation funds to the highest standard.

This is especially important for the superannuation industry where funds have limited holdings outside of member savings. In these situations members may indirectly be punished for the misconduct of the trustee or its executives. For example, the Royal Commission revealed that trustees of both IOOF and HostPlus dipped into member funds to fix an error or pay a penalty. It gives the wrong incentive if superannuation fund members shoulder the risk for trustee and executive failure. The FAR regime will greatly improve the regulator toolkits and allow them to appropriately target the causes of misbehaviour.

[10] Christoper Knaus, 2019, 'Australia's biggest private health insurers illegally rejected thousands of claims', The Guardian, 8 July, accessed 11 February, https://www.theguardian.com/australia-news/2019/jul/08/australias-biggest-private-health-insurers-illegally-rejected-thousands-of-claims

[11] Michael Roddan, 2020, 'Just three health insurers 'viable': APRA', *The Australian,* February 4, accessed 11 February, https://www.theaustralian.com.au/business/financial-services/urgent-review-needed-into-private-health-insurance-system-apra/news-story/84536e122b35736db64d169824e4888c

10. Timeframes for implementation

The Proposal Paper notes that further consultation will take place on the timeframes for implementation. We think it is important that the implementing legislation includes the timeframe in which the FAR must be expanded to all ASIC-regulated entities.

Recommendation 11

The Treasury must release the timetable for the expansion of the FAR to ASIC-regulated entities.

APPENDIX

A. Deferred Remuneration arrangements under BEAR

Minimum amount of variable remuneration to be deferred

	If the accountable person is:	**... the amount is:**
1	The Chief Executive Officer of a large ADI	The lesser of: (a) 60% of the Chief Executive Officer's variable remuneration for the financial year (the ***relevant financial year***) in which the decision was made granting the variable remuneration; or (b) 40% of the Chief Executive Officer's total remuneration for the relevant financial year.
2	An accountable person of: (a) a large ADI; or (b) a subsidiary of a large ADI; other than the Chief Executive Officer of a large ADI	The lesser of: (a) 40% of the accountable person's variable remuneration for the relevant financial year; or (b) 20% of the accountable person's total remuneration for the relevant financial year.
3	An accountable person of: (a) a medium ADI; or (b) a subsidiary of a medium ADI	The lesser of: (a) 40% of the accountable person's variable remuneration for the relevant financial year; or (b) 20% of the accountable person's total remuneration for the relevant financial year.

4	An accountable person of: (a) a small ADI; or (b) a subsidiary of a small ADI	The lesser of: (a) 40% of the accountable person's variable remuneration for the relevant financial year; or (b) 10% of the accountable person's total remuneration for the relevant financial year.

B. FCA/PRA Deferred Remuneration Requirements

PRA requirements		
Category	**Role**	**Deferral period**
Senior managers (as defined under the SMR)		No less than seven years with no vesting prior to the third anniversary and vesting no faster than on a pro-rata basis thereafter
Risk Managers (excluding those covered by the SMR)	Members of the management body Risk managers and direct reports, except those identified solely due to committee membership Heads of material business units and their direct reports Heads of functions Managers of risk-taking MRTs	No less than five years with vesting no faster than pro-rata from year one
All other MRTs	Individual exposing firm to credit risk Individual exposing firm to trading book/market risk Individual approving introduction of new products Individual on local risk committee MRTs identified solely under quantitative criteria if subject to managerial oversight	No less than three to five years with vesting no faster than pro-rata from year one

FCA requirements

Category	Deferral period
Senior managers (as defined under the SMR) – a new definition will be introduced to cover this	No less than seven years with no vesting prior to the third anniversary and vesting no faster than on a pro-rata basis thereafter
All other MRTs	No less than three to five years with vesting no faster than pro-rata from year one

C. FCA/PRA Conduct Rules

Conduct Rules

Rule		Applied by
First tier – Individual Conduct Rules		
CR1	You must act with **integrity**	FCA and PRA
CR2	You must act with due **skill, care and diligence**	FCA and PRA
CR3	You must be open and cooperative with the FCA, the PRA and other **regulators**.	FCA and PRA
CR4	You must pay due regard to the **interests of customers** and treat them fairly.	FCA Only
CR5	You must observe proper standards of **market conduct**.	FCA Only
Second tier – Senior Management Conduct Rules (Senior Managers Regime)		
SM1	You must take reasonable steps to ensure that the business of the firm for which you are responsible is **controlled** effectively	FCA and PRA
SM2	You must take reasonable steps to ensure that the business of the firm for which you are responsible **complies** with the relevant requirements and standards of the regulatory system	FCA and PRA
SM3	You must take reasonable steps to ensure that any **delegation** of your responsibilities is to an appropriate person and that you oversee this effectively	FCA and PRA
SM4	You must **disclose** appropriately any information of which the FCA or PRA would reasonably expect notice	FCA and PRA