BUDGET 2017- APRA'S NEW POWERS, AND HOT SPOTS FOR BANKS

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Legal Briefings – By **Tony Coburn**, **Hong-Viet Nguyen** and **Nicola Greenberg**

Under the Banking Executive Accountability Regime announced in the 2017-18 Budget on 9 May 2017, all senior banking executives will have to be registered with the Australian Prudential Regulation Authority (**APRA**). But what is APRA looking for, and how will it wield its new powers? This article examines the momentum leading to the Banking Executive Accountability Regime and key indicators of how, and when the regime may be enforced.

It is clear that regulators and politicians have their eyes firmly on remuneration arrangements and creating positive culture from the top down . The new powers given to APRA under the Banking Executive Accountability Regime (**BEAR**) begin with a power to change remuneration policies, followed by a power to ban executives and impose penalties of up to $200 million for misconduct.

APRA will follow a well-trodden path by linking remuneration practices with misconduct and poor consumer outcomes. The most recent authority regarding this approach is the final report on the Retail Banking Remuneration Review, released on 19 April 2017 (**Sedgwick Review**). The 14 recommendations set out in this review seek to drive cultural change and transform remuneration structures in the banking sector, and therefore close the perceived “trust gap” in the banking industry. It is likely that these will inform the behaviour, structure and focus of the new BEAR.[1]

In the discussion below we anticipate some of what lies ahead for Australia's banks, by examining the outcomes of the Sedgwick Review, and the broader context of banking culture, misconduct and remuneration.

OVERVIEW OF THE SEDGWICK REVIEW - WHAT IS APRA GUIDED BY?

The recommendations made by Stephen Sedgwick in the April 2017 review seek to shift bank culture and transform remuneration models relating to the sale of retail banking products, including basic banking products, non-cash payment products, general insurance products, consumer credit insurance, consumer lending and small business lending.

The review builds on reforms introduced under the Future of Financial Advice (**FOFA**)[2] reforms and the Life Insurance Framework[3] reforms, and the changes proposed by the Australian Securities & Investments Commission (**ASIC**) in respect of flex commissions.[4]

Individuals and organisations anticipating scrutiny by APRA should consider how their own business models stack up in light of the Sedgwick Review's key focus areas. In anticipation of review by APRA, entities can use the Sedgwick Review focus areas to conduct a mini self-health-check. To do so, an entity should consider how many of the following 'Sedgwick criteria' its business model currently satisfies:

- a complete ban on volume based remuneration;
- variable rewards based on overall performance, that ultimately amount to a relatively small proportion of fixed pay;
- customer measures that are genuinely customer-centric;
- a culture that identifies potentially high-risk behaviours, known as behavioural gateways;
- an internal audit process that involves a thorough examination of workplace culture, particularly programs or structures that show a bias towards sales in preference to ethical behaviour; and
- Board and Chief Executive oversight of audits, and the implementation of any recommendations arising from them.

In the coming weeks, APRA will no doubt draft its own 'health indicators', which are likely to be based on the focus areas outlined above. However, these cultural indicators should come as no surprise to anyone who has been following ASIC releases and recent media regarding bank culture. While the Sedgwick Review provided the most comprehensive round-up of key cultural indicators, and was the first publication to provide specific recommendations, there is plenty of further information available regarding indicators of banking culture. We have distilled the Sedgwick Review's focusses, and recent ASIC comments regarding banking culture into four cultural 'hot spots' for the financial services industry.

WHAT ARE THE FOUR 'HOT SPOTS' AND HOW CAN AN ORGANISATION ADDRESS THEM?

1. 'TONE FROM THE TOP'

The new powers conferred on APRA are the first to directly identify executives as individuals who may drive culture and strongly influence misconduct. In addition to monitoring the executives themselves, APRA may impose penalties on banks that fail to appropriately monitor the suitability of their executives to hold senior positions. This is consistent with the Sedgwick Review recommendations for regular reporting obligations on boards to set the standards for appropriate culture and behaviour. Additionally, ASIC has frequently referred to the board and senior management's role in setting the bar for behaviour, and having oversight of cultural issues within a corporation.[5]

The Sedgwick Review does not stop at board level when referring to 'tone from the top'. It makes specific reference to manager behaviour in applying discretionary rewards and performance feedback. In doing so, it highlights the actions of the manager, not simply the structure of the reward program as a contributing factor to cultural misconduct. A 2016 review of risk governance, culture and behaviour in banks found a correlation between seniority, and propensity to engage in risk-taking behaviour.[6] It is clear that APRA will not look at executive behaviour in a vacuum. Rather it will look at it as a way to influence and, if necessary, police the culture of an entire organisation. When examining the executives to be enrolled with APRA, organisations should consider how these individuals set the tone and represent the entity's response to poor culture and misconduct.

But in the 2017-18 Budget address the Commonwealth Government seems to be planning to go much further than requiring a bank to take steps to manage these cultural issues. Under the BEAR arrangements, APRA will have the power to intervene in business decisions of banks even in human resources questions such as selection of senior executives and directors. APRA will not only have the power to disqualify senior executives for conduct breaches, it will have to approve each appointment of a senior executive or board member of a bank. And it will have the power to intervene in pay decisions made by Boards. This is a big step beyond APRA’s current role of prescribing standards such as governance standards to be applied by an ADI in the management of its own business.[7]

2. CORRELATION BETWEEN ETHICAL BEHAVIOUR AND POSITIVE OUTCOMES FOR CONSUMERS

Businesses targeted by the reforms will have to self-assess culture and propensity for misconduct. To do so effectively, those businesses will need to consider and assess the link between culture and positive consumer outcomes. The Sedgwick Review connects positive consumer outcomes with internal behaviour requirements at financial institutions. In particular, it highlights the need to minimise (or eliminate) any conscious or unconscious bias towards sales over consumer outcomes and ethics. Greg Medcraft, the ASIC Chairman, referred to this as a 'win-win' in a 2015 speech, and argued that good culture and positive consumer outcomes go hand in hand:

"*At the centre of what industry can do is creating a 'customer first' culture. We care about culture because there is often a strong connection between poor culture and poor conduct. We consider it to be a key risk area with respect to our role as a conduct regulator, as it often is a red flag to a broader regulatory problem.*"[8]

Financial institutions anticipating increased regulatory scrutiny should build these conclusions into cultural review processes. Instead of conducting separate reviews of consumer outcomes and ethical behaviour, the two should be examined together, to identify any trends or biases which indicate a poor culture and a bias towards sales over consumer outcomes and ethics.

3. BROADER IDENTIFICATION OF INCENTIVES AND REMUNERATION, BEYOND OBVIOUS INCENTIVE STRUCTURES

The Budget's most significant change for banking executives will be reflected in their bonus structures. The new regime requires deferral of at least 60 per cent of chief executive bonuses and 40 per cent of other senior executives' bonuses for a minimum of four years. This approach is consistent with the argument that although a financial institution may make broad statements about cultural values, the true measure of what the financial institution values is indicated by the type of employee behaviour that the financial institution rewards. In addition to deferral of bonuses, APRA is to be given powers to alter the structure of formal remuneration processes.

However, organisations should look further than formal bonuses and remuneration to study the effect of incentives on culture. The Sedgwick Review requires financial institutions to assess both their structured reward practices, and informal rewards. In particular, it requires financial institutions to consider discretionary rewards provided by senior management. The broad view encompassing remuneration, key performance indicators (**KPIs**) and informal incentives is designed to point out inconsistencies in an organisation's culture that are not visible at board or management level. Cathie Armour, Commissioner at ASIC, identified the KPIs imposed on junior staffers as a contributing factor in assessing culture across a corporation:

"Part of this is having leaders with a vision for the corporation that focuses on the long-term objective of creating a sustainable business. Often this means incorporating broader community interests into your strategic objectives but, frequently, at the factory [sic] floor level, the key KPIs are quantitative ones that don't take these other factors into account."[9]

The Sedgwick Review requires financial institutions to conduct an examination of cultural drivers at all levels, including the behaviour of managers when conducting performance reviews with junior staff. Leaders should be aware that although APRA's oversight is primarily on executives, the bans and fines for misconduct which may be pursued by APRA will probably address issues exacerbated by informal cultural drivers. Accordingly, if misconduct continues to be rewarded through informal incentives, it may not be enough to remove all formal volume-based remuneration. This means that organisations will need to take a holistic view when re examining remuneration arrangements (both monetary and non monetary).

4. APPROPRIATE PROTECTIONS FOR WHISTLEBLOWERS

A new dispute resolution scheme will be established and will be known as the Australian Financial Complaints Authority (**AFCA**). It will replace the Financial Ombudsman Service, the Credit and Investment Ombudsman and the Superannuation Complaints Tribunal. This indicates that the Australian Government wishes to better equip consumers with the ability to report misconduct in financial services by providing a ‘one stop shop’.

Although not mentioned in the Budget or associated documents, we think that APRA will probably consider whether any additional measures are required to protect internal whistleblowers. We say this for the following reasons:

- Whistleblower disclosures are highly valued by the Australian regulators, and considered a ‘protected disclosure’ under the Corporations Act 2001 (Cth).

- There has been increased regulatory review of this area over the past two years. In 2016 ASIC invited 30,000 companies to participate in a research project regarding whistleblowing in the corporate sector. This project, 'Whistling While They Work 2' was carried out in partnership between the Australian Parliament and Griffith University, and has been described as Australia's largest whistleblowing research project.[10] Representatives of this study recently gave evidence to the first hearings of the Joint Parliamentary Committee inquiry into whistleblower protections in the corporate, public and not-for-profit sectors. Additionally, in December 2016 the Australian Government committed to new national whistleblowing laws by June 2018.

- It is likely that whistleblowers will first attempt to report misconduct through internal channels, rather than directly to the regulator. These individuals must also be provided sufficient protection to encourage them to come forward. To allow for this, the Sedgwick Review requires boards and chief executives to ensure that ‘effective, safe channels’ are available to staff who wish to report misconduct.

Introduction of a new accountability regime, complaints authority and increased powers for APRA indicate that significant change is ahead in the banking industry. The effectiveness of these changes will depend on the details of how they are implemented. However, the issues to be addressed are not new. With benefit of the information that has already been published, banks can prepare for the proposed changes.

As we wait for further information regarding the Budget changes, leaders in the financial services industry will be considering how their own businesses may be viewed by APRA in light of the Sedgwick Review's recommendations. In particular, we recommend an analysis of how the four 'hot-spots' (discussed above) can be addressed, and what steps can be taken now to become 'AFCA ready'.

ENDNOTES

1. To enact this regime, APRA have appointed Ms Jane O'Doherty. Ms O'Doherty leads a newly combined team comprising Governance, Operational and Insurance risk specialists, with a mandate to lead APRA's work in relation to culture and remuneration practices in the financial services industry.

2. Corporations Amendment (Future of Financial Advice) Act 2010 (Cth).

3. Corporations Amendment (Life Insurance Remuneration Arrangements) Act 2016 (Cth).

4. ASIC Consultation Paper 279: Flex commission arrangements in the car finance industry.

5. See, for example Corporate and personal liability for "culture" in corporations? (John HC Colvin and James Argent (2016) 34 C&SLJ 30) regarding proposed amendments to the Australian Securities and Investments Commission Act 2001 (Cth) and Corporations Act 2001 (Cth) to give ASIC more power in regard to corporate culture, and Evidence to Senate Standing Committees on Economics (Parliament of Australia, Canberra, 3 June 2015) 6 (Greg Medcraft)

6. Risk Governance, Structure Culture and Behaviour in Banks: A View from the Inside (Elizabeth Sheedy, Barbara Griffin 6 Feb 2016) conducted an assessment of risk culture in three large banks in Australia and four large banks in Canada. All seven appear in the top 50 banks world-wide by market capitalisation and assets.

7. For an interesting elaboration on this topic, see an editorial entitled “APRA’s now a bank co-manager” by Professor Rodney Maddock of the Australian Centre for Financial Studies in the Monash Business School published in the ausytralian Financial Review, Thursday 11 May 2017, at page 62.

8. Putting the customer first: Creating a win–win. A speech by Greg Medcraft, Chairman, Australian Securities and Investments Commission, CFA Australia Investment Conference

(Sydney, Australia), 13 October 2015

9. Viewpoint: A cultural matter, A recent roundtable discussion saw industry leaders debate the question: What defines corporate culture? Domini Stuart reports. Australian Institute of Company Directors, 01 September 2016

10. Whistling While They Work 2, the world's leading research into public interest whistleblowing.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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