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26 August 2014

Financial System Inquiry
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Email: fsi@fsi.gov.au

Dear Sir/Madam,

Financial System Inquiry

The Australian Institute of Company Directors welcomes the opportunity make this further submission with respect to the Government's Financial System Inquiry in response to its Interim Report.

As with our initial submission, we have limited this submission to predominately commenting on the issues raised in the Interim Report that relate to the corporate governance arrangements of financial institutions (discussed in Chapter 5 of the Interim Report). However, we have also included comments relating to regulatory burden (discussed in Chapter 7 of the Interim Report) and on Australia's insolvency regime (discussed in Chapter 3 of the Interim Report). We do not comment on issues relating to prudential regulation.

As the key objective of the Inquiry is to examine how the financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth, we also refer the Inquiry to our recent paper, *The Honest and Reasonable Director Defence: A Proposal for Reform*, a copy of which we **attach**[1]. The purpose of the Honest and Reasonable Director Defence proposed by this paper is to create an environment that is conducive to strong yet responsible corporate decision making and performance by supporting directors who act honestly. We see this as being a crucial step, in conjunction with other measures, to boosting Australia's productivity and competitiveness and will address many of the personal liability concerns facing Australia's directors. While this is relevant to all sectors, this is of particular importance to the Australian financial system.

1. Corporate governance

Role of boards and management

Generally speaking, we agree with the findings and observations set out in Chapter 5 of the Interim Report that relate to issues of corporate governance for financial institutions.

In particular, we agree with the Inquiry's preliminary assessment and observation that "sound corporate governance requires clarity of the responsibilities and authority of board and management" and also that "substantial regulator focus on boards has confused the delineation between the role of the board and that of management".

We have been pleased with the recent consultation and steps taken by the Australian Prudential Regulation Authority (APRA) to clarify its expectation of boards, in particular

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[1] This paper can also be located on our website (http://www.companydirectors.com.au/~/media/Resources/Director%20Resource%20Centre/Policy%20on%20director%20issues/2014/The%20Honest%20%20Reasonable%20Director%20Defence%20A%20Proposal%20for%20Reform_August%202014_F.ashx).

with respect to its prudential standard on risk management. However, it is our view that what is required is a more fulsome review of **all** current prudential requirements on boards to ensure there can be no argument that they require boards to be drawn into operational matters (even if this is not the intended effect of the requirements). As suggested in the Interim Report, the aim of the review should be “to determine whether requirements imposed on boards are consistent with the fundamental obligations of a company director”.

The review should cover not only APRA’s relevant prudential standards, but also its practice guides and how these standards and practice guides are interpreted by APRA in practice. Our members have noted, for example, that correspondence from APRA often requires action or attestations to be made by the board of the regulated entity, rather than by the regulated entity itself. This is the case even though the correspondence does not relate to matters that are within the purview of the board (ie they do not fall within the board’s role to monitor and oversee the work of the executive and management) and is a further demonstration of APRA’s failure to understand the appropriate division of roles and duties between directors and management. Placing regulatory pressure on directors to ‘go deep’ into management, operational and compliance issues to avoid potential personal liability does not improve governance practices. As noted in our initial submission, if the regulatory environment continually sets the expectation that directors will consider issues at the same level of detail as management, the value of the board’s monitoring function is diminished or usurped. The increasing compliance burden that these practices place on boards actually adds to the company's systemic risk as boards have less time to focus on the good governance of the company and its strategy and its ability to compete.

Differing governance standards

We do not see any compelling reason why all financial institutions could not be held to the same governance standards. As noted in our original submission, we are of the view that, to the extent possible, all APRA-regulated entities (including superannuation funds) should be held to the same standards of governance practices, allowing for the fact that the standards could still incorporate an “if not, why not?” approach (as suggested in our initial submission and discussed further in section 2 below).

Remuneration

We agree with the comments made in the Interim Report with respect to the remuneration structures of financial institutions in Australia. In particular, we agree that the principles-based approach to remuneration currently applied in Australia remains appropriate and that it would be inappropriate for Australia to adopt some of the more prescriptive approaches to remuneration policy taken in some overseas jurisdictions in response to the financial failures of the global financial crisis.

We are of the view that no additional regulation of remuneration structures should be considered at this stage. We do, however, continue to advocate for reform of the current regulation of remuneration arrangements under the *Corporations Act 2001* (Cth). In particular, we are of the view that the “two-strikes” rule should either be abolished or significantly amended[2]. It is our view that the rule has led to an overemphasis on remuneration issues by both boards and shareholders with attention being taken away from issues that are more significant from a value creation perspective, such as the company’s strategy, revenue generating potential or other sustainability issues. The rule

[2] See AICD submission to Federal Treasury in response to the Exposure Draft of the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011* dated 27 January 2011, which can be found on our website (http://www.companydirectors.com.au/~/media/Resources/Director%20Resource%20Centre/Policy%20on%20director%20issues/2011/AICD%20Submission%20to%20Federal%20Treasury%20on%20Remuneration%20Exposure%20Draft_27%20January%202011_F.ashx).

is also open to abuse by shareholders who target boards for reasons unrelated to pay, as we have already seen evidence of in recent years (for example, Gina Rinehart using her shareholding in Fairfax Media Limited at its 2012 annual general meeting to force a first strike against Fairfax's remuneration report).

We are also of the view that the remuneration reporting requirements as they currently stand are unduly complex, place a significant burden on companies and, in many cases, are of limited use to shareholders and other readers[3]. We argue that the reporting requirements under the Corporations Act be significantly overhauled and simplified to address these issues.

2. Regulatory burden

In our initial submission, we called for a reduction of the current compliance burden being faced by boards of companies in the financial sector. It was noted that APRA's requirements in particular, including those relating to governance, are considered to be the most demanding on the boards' time in this sector. We put the case that APRA appears to believe that boards are more involved in the day-to-day operation of a business than actually occurs and that this expectation should be addressed by the inquiry. This creates a significant compliance burden on boards and puts Australia at a competitive disadvantage internationally.

More generally, in our paper, *Towards Better Regulation*[4], we noted that deregulation – both stemming the growth in new regulation and cutting back existing red tape – is a crucial part of the new government's economic policy challenge. The plan of action that was put forward in that paper, which involved three pillars of reform covering the reviewing and cleaning up of existing regulation, getting new regulation right and regulator reform[5], should be applied to the financial sector. A deregulation agenda should be set requiring immediate action be taken with respect to all three of these pillars of reform.

We noted in our previous submission that it is important that the regulation of governance arrangements for financial institutions is not unnecessarily duplicative and that it is considered in the context of existing regulation, such as the provisions of the Corporations Act which are administered by the Australian Securities and Investments Commission (ASIC), and the ASX Corporate Governance Council's Corporate Governance Principles and Recommendations (the Principles). Accordingly, we recommended that there be a greater alignment between APRA's governance regulation and the ASX Corporate Governance Council's Principles, including the "if not, why not" approach taken under those Principles. Standards of corporate governance should not be mandated, as is currently the case under APRA's prudential standards relating to corporate governance and it should be left to the companies and their boards to determine (and disclose) what governance arrangements are most appropriate for their particular circumstances.

There is also a wider issue of whether the Corporations Act in its current form (and the obligations it imposes) can properly be understood by those trying to work within it. Arguably, what is required is an extensive re-writing of the Corporations Act for it to be

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[3] See AICD submission to CAMAC in response to its Information Paper, *Executive Remuneration* dated 13 August 2010 which can be found on our website (http://www.companydirectors.com.au/~/media/Resources/Director%20Resource%20Centre/Policy%20on%20director%20issues/2010/Submissions/SUBM201011%20AICD%20Submission%20to%20CAMAC%20on%20Executive%20Remuneration_13%20August%202010_F.ashx).

[4] This paper can be located on our website (http://www.companydirectors.com.au/~/media/Resources/Media/Media%20Releases%20and%20Speeches/2013/Towards%20better%20regulation%20July%202013.ashx).

[5] Note 4, page 15.

of longer-term benefit to Australia. On this important topic, we **attach** a recent article by Adam Creighton that was published in The Australian on 22 August 2014.

Where additional governance regulation is considered for financial institutions, it should only be introduced after a full Regulatory Impact Assessment (RIA) has been undertaken, including engaging with business and undertaking adequate consultation and, as identified in the Interim Report, assessing the costs and benefits of the proposed regulation on the community as a whole, and assessing the impacts and compliance costs for business. The importance of the RIA process in the development of efficient and effective regulation is outlined further in the *Towards Better Regulation* paper[6].

Once regulation is in place, its effectiveness should be subject to an ex post review. The appropriate timing for the review will depend on the significance of the regulation and the circumstances of its formulation, but should typically be within three to five years of the regulation being introduced[3] . It should follow a similar process to the RIA process, proportionate to the nature and significance of the regulation and broad enough to assess the performance of the regulation.

The way that regulation of the financial sector is then carried out by regulators can also add significantly to the regulatory burden. The Productivity Commission has previously noted that, even where new or reformed regulation is appropriate and well designed, poor enforcement practices can risk making the regulation ineffective, or unduly burdensome, or both[7]. Cultural change will be needed to promote a more balanced approach, and improve the way regulators interact and consult with business in relation to the regulations that they administer.

3. Insolvency regime

The question of whether a company is solvent under the Corporations Act is extremely complex and time-dependent.

As noted in our recent paper, *The Honest and Reasonable Director Defence: A Proposal for Reform*[8], it is the view of Company Directors that the current insolvency regime in Australia, which is arguably one of the strictest in the world:

- not only encourages, but effectively mandates directors to move to external administration as soon as a company encounters financial difficulties in order to avoid personal liability and consequent reputational damage;
- discourages directors from taking sensible risks when considering other kinds of informal corporate reconstructions or “work-outs” to deal with a company's financial problems;
- provides an incentive for creditors, especially secured creditors, to act in their own self-interest and arrange for the disposal of key assets and the termination of continuing contractual arrangements as soon as possible;
- can lead to financially viable companies suffering the consequences of external administration, including ceasing to be a “going concern”, suffering the loss of value and goodwill and incurring the expense of engaging administrators or receivers when it may have been possible under a less prescriptive legislative regime for the company to restructure itself and secure its financial standing; and
- can lead to losses by shareholders, creditors, employees and, in many cases, may have downstream impacts on the broader community through the loss of the value of their investments, retirement savings and jobs.[9]

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[6] See note 4, pages 18-29.
[7] Productivity Commission, “Identifying and Evaluating Regulation Reforms” December 2011, page XV.
[8] Note 1.

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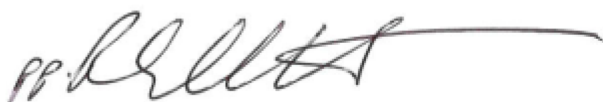
Irrespective of any further insolvency reform approaches that may have merit, we consider that a critical element to addressing the problems created by the insolvent trading regime is for directors to have access to a broad-based defence, such as the Honest and Reasonable Director Defence set out in our paper, that extends to the insolvent trading provisions under the Corporations Act.

We hope that our comments will be of assistance to the Inquiry. Please do not hesitate to contact Senior Policy Advisor, Gemma Morgan on (02) 8248 2724 if you would like to discuss.

Yours sincerely,



John H C Colvin
Chief Executive Officer &
Managing Director

[9] Note 1 at page 11.