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31 March 2014

Financial System Inquiry
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Dear Sir/Madam,

Financial System Inquiry

The Australian Institute of Company Directors welcomes the opportunity make this submission with respect to the Government's Financial System Inquiry in accordance with the terms of reference announced by the Treasurer, the Hon Joe Hockey MP on 20 December 2013 (the Inquiry).

The Australian Institute of Company Directors (Company Directors) is the second largest member-based director association worldwide, with individual members from a wide range of corporations: publicly-listed companies, private companies, not-for-profit organisations, charities, and government and semi-government bodies. As the principal professional body representing a diverse membership of directors, we offer world class education services and provide a broad-based director perspective to current director issues in the policy debate.

The strong growth of the financial sector over the past 15 years has benefitted many Australians and the Australian share market in particular. Company Directors applauds the Government's commitment to ensuring the financial services industry remains stable and efficient and also to working closely with the sector to ensure that this is done in a way that does not impose excessive or unnecessary regulation.

We have limited our submission to commenting only on issues relating to the corporate governance arrangements of financial institutions (item 3(5) of the Inquiry's terms of reference) and do not comment on the issues relating to prudential regulation.

1. Regulatory approach to governance in the financial sector

As a general principle, 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). We acknowledge that the Australian Prudential Regulation Authority (APRA) has, over time, taken steps to ensure that the governance standards that it sets for financial institutions are in line with the Principles. In certain instances, however, the standard set by APRA is, in fact, a higher standard than applies to listed companies under the Principles. The primary reason given for this is the wide-range of institutions that APRA regulate that do not necessarily have well-developed governance structures and reporting practices in place. As such, APRA's governance approach aims to promote stability among the smaller institutions that it oversees, such as some of the credit unions, friendly societies and unlisted general insurance companies. To achieve this, it requires that all APRA-regulated entities meet the governance standards it has set.

Company Directors does not oppose the more vigorous surveillance of companies in the financial sector, particularly for prudential regulation, where APRA considers such an approach is justified in the circumstances. However, we do oppose the strict application of governance principles to *all* APRA-regulated companies without flexibility or exemptions. This is particularly the case where the reason for the strict application of these principles has been primarily to deal with one particular sub-set of these organisations. We note that listed financial entities are already required to comply with the "if not, why not?" disclosure regime under the Principles, which is highly effective. APRA's governance regulations are, in a large part, duplicative for these entities.

Mandated standards of corporate governance result in a "one-size-fits-all" approach to regulation which should, in our view, be avoided wherever possible. The greatest strength and contributor to the success of the Principles is that they apply on an "if not, why not?" basis which allows a company to adopt an alternative approach if the one recommended by the Principles does not suit the company's particular circumstances. Where the recommended approach is not taken, the company must disclose its reasons for choosing the alternative approach and why the recommended approach was not appropriate for its circumstances. The "if not, why not?" approach is appropriate for corporate governance regulation as it is not possible to say that there is one "right" approach to corporate governance. The flexibility that the "if not, why not" approach provides also encourages boards to put in place the best corporate governance arrangements for their companies' particular circumstances and can lead to the development of innovative, alternative practices that could produce better outcomes.

In our view, what is required is a more flexible system of governance regulation for APRA-regulated entities. To achieve this, Company Directors supports greater alignment of APRA's governance regulation with the ASX Corporate Governance Council's Principles, including the "if not, why not" approach taken under those Principles. A more flexible approach to governance regulation for APRA-regulated entities has been recommended by independent inquiries undertaken in the past[1]. Companies and their boards are best placed to decide what governance arrangements they should adopt – the regulatory regime for the financial sector should not distort their decisions and business judgments on these matters, but rather should allow the regulator to be assured that governance standards are being satisfactorily met. The "if not, why not?" regulatory approach allows this. It also has the advantage of creating the impetus for the board to focus on its governance practices and their appropriateness, rather than encouraging a merely box-ticking approach to governance.

Where APRA proposes to extend the governance standards that apply to APRA-regulated entities beyond those that are set out in the Principles or Corporations Act, a full cost-benefits analysis should first be undertaken to ensure that the additional requirements are justified and will not unnecessarily increase the regulatory burden for those entities.

We are also of the view that, to the extent possible, all APRA-regulated entities 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). Currently, while APRA Prudential Standard CPS 510 applies to a number of financial industries (namely, authorized deposit-taking institutions, general and life insurance industries), not all financial institutions are subject to the same level of governance standards. For example, Prudential Standard SPS 510, which applies to superannuation funds, does not require the same standard as CPS 510 with respect to board composition. We do not see

[1] For example, "The Failure of HIH Insurance: Report of the HIH Royal Commission" (April 2013), 6.2.6 Part Three HIH Final Report; "Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business (January 2006), p 95.

any compelling reason why all financial institutions could not be held to the same governance standards.

2. Increasing compliance burden

Many company directors have expressed dissatisfaction with the amount of time spent by their boards (as opposed to their management) on compliance issues. Board meetings are increasingly dominated by the red tape of regulation. For companies in the financial sector, APRA's requirements, including those relating to governance, are the most demanding on their time. Of particular concern for Company Directors is that APRA's concept of board oversight is often misconceived, with the appropriate division of roles and duties between directors and management being blurred and misunderstood[2]. This expectation gap has been explained as follows:

> "Many people believe that corporate boards and their directors (both executive and non-executive) should be so closely involved in the affairs of the corporation that they can ensure nothing can go wrong. This view is fundamentally flawed, both in law and in practice, and has led to unrealistic expectations about what directors should be doing in areas that are the responsibility of corporate managers. If these expectations were to be met, all directors would have to become, in effect, full time employees of the organisation. This would undermine the non-executive directors' independence of outlook and objectivity which are vital for effective corporate governance."[3]

The board of a company, APRA-regulated or otherwise, has a monitoring, oversight and strategic role in relation to the company. The executive and its management team, on the other hand, are responsible for the day-to-day operations of the company and for the implementation of strategy set by the board. Unfortunately, this delineation is not well understood by the public, media and is not often reflected in the way the law is applied in Australia or in how APRA sets and applies governance standards. APRA seems to see boards as being involved in the day-to-day minutiae of the business and having a hands-on role in the company's affairs. This is particularly evident in APRA's recently released Prudential Standard *CPS 220 - Risk Management* and draft Prudential Practice Guide *CPG 220 - Risk Management* where APRA sets out its expectations of boards with respect to issues of risk. CPS 220 requires the board to "ensure" that the entity fulfils its risk management responsibilities - an unreasonably high standard that would require boards to become intimately involved in the day-to-day operation of the risk management systems of the company, rather than taking an oversight role, setting the risk appetite for the entity and satisfying itself that the framework is sound.

This pressure from the regulatory environment for directors to 'go deep' into management, operational and compliance issues to avoid potential personal liability needs to be addressed in the review of the financial system, particularly with respect to issues of governance and risk regulation. Any suggestion that this blurring of the roles of the board and of management is good for governance is confused. As set out above, the primary role of the board is to monitor and oversee the work of the executive and management. 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. If the board is too involved in the "doing" of the corporation's activities the board cannot provide the same objectivity and oversight of corporate management. In this way, the increasing compliance burden that these governance and risk standards place on boards actually adds to the company's

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[2] John Colvin, CEO and Managing Directors Australian Institute of Company Directors, *Company Director* magazine July 2010, volume 26, Issue 6 page 4.
[3] Tony Howarth's foreword in Cole S, *Mind the Expectation Gap The Role of A Company Director*, Australian Institute of Company Directors 2012.

systemic risk as boards become overwhelmed by the sheer volume of regulation that they are required to comply with, and therefore have less time to focus on the good governance of the company. This, in turn, creates significant risks of a different nature, as boards become distracted from planning for the future growth and development of their companies, which will ultimately be to the detriment of economic prosperity of all Australians. That is, the boards are overburdened with compliance at the expense of concentrating on future performance.

It is important to note that Australia has been well-served by the high standards of governance amongst its financial institutions. It also has some of the most highly educated directors in corporate governance in the world, with over 3,500 directors undertaking our Company Directors Course in 2013 and our participation rates in such courses far outperforming our international peers. This strong governance culture is evidenced by the fact that Australia did not experience the same level of corporate failures during the global financial crisis as occurred overseas. We should therefore resist following the world-wide trend (most notably the US and the UK) to react to the corporate failures during the global financial crisis through the introduction of new or expanded regulation to address governance concerns. While such a reaction may have been appropriate for these jurisdictions, a similar reaction is not warranted in Australia, which already has in place adequate and effective corporate governance regulation (if not over-regulation) for financial institutions. As such, we would recommend against the introduction of any dramatic changes to the current governance regime for financial institutions, other than has been suggested above.

3. General comments

In reviewing the regulation of financial institutions and the compliance burden that it places on directors, it is also appropriate to consider broader regulatory and liability issues that directors face in Australia. While these issues are not limited to the financial services sector, the heightened regulation and liability that directors of financial institutions face mean that they are particularly exposed to these issues. As Australia re-focuses its efforts on international competitiveness and productivity, Company Directors is of the view that a cultural shift in how we approach the regulation of corporations and directors is well overdue. One component of this shift is to place greater emphasis on the need for efficient and effective regulation. We have addressed our thoughts on this issue in Company Directors paper *Towards Better Regulation*[4]. The next component in this cultural shift is to focus on supporting directors who perform their roles honestly and diligently by re-considering the appropriateness of the many and varied ways in which directors' roles place them at risk of personal liability and the suitability of the defences available to them.

We are firmly of the view that Australia needs to actively create an environment where directors that act with integrity are free to pursue and harness new opportunities, drive performance and create jobs without being overly focussed on personal liability concerns. This will occur when the law reflects sound policy settings, is clear, capable of being complied with and is appropriately targeted. In these circumstances, the Australian Institute of Company Directors has no objection to directors who breach the law being subject to appropriate penalties. In other words, a culture of positive and appropriate risk taking and entrepreneurialism is needed to take over from the existing culture of blame.

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http://www.companydirectors.com.au/~/media/Resources/Media/Media%20Releases%20and%20Speeches/2013/Towards%20better%20regulation%20July%202013.ashx

Company Directors has long suggested that the extremely limited protection afforded by the business judgment rule, for example, should be re-visited. We are concerned that requiring directors, who perform their roles honestly and diligently, to operate in a regulatory environment where there is a lack of an effective business judgment rule defence and a high risk of personal liability is detrimental to Australia's economy and prosperity. It deters good directors from accepting board positions, stifles innovation and entrepreneurialism, slows decision-making and dampens productivity.

At a federal level, we are of the view that the insertion of an overarching and broad-based defence into the Corporations Act is required to protect directors that act honestly and with integrity, but who now work in an increasingly complex and compliance-focussed regulatory environment. The insertion of an appropriate defence into the Corporations Act will give directors a sound footing upon which to make effective and competitive business decisions which will have positive ripple effects across the economy.

Also of concern to directors is the increasing risk of class actions being brought against companies by professional litigation funders. Increasingly, major litigation against companies is being funded by professional litigation funders who commence litigation with a view to obtaining a profit. Where a company is facing prolonged, expensive and complex litigation, its directors will often feel that it is prudent to settle this type of litigation because it distracts the board and employees from focusing on core business activities. The cost and time involved in defending these actions is excessive and there are still many unsettled areas of Australian class action law, particularly in relation to actions commenced by shareholders, which adds to the level of uncertainty for companies.

On 4 November 2013, Company Directors lodged a submission with the Productivity Commission in relation to its inquiry into *Access to Justice* setting out our views in this regard[5]. Our submission recognises that access to justice, including ensuring that the law is applied and enforced and that disputes are resolved fairly and effectively, is critical to ensuring the preservation of the rule of law in Australia. However, we are of the view that access to justice must be appropriately balanced against the economic and productivity consequences which flow from allowing third party funders to be involved in extensive, time consuming and costly litigation against corporations and directors for the purpose of obtaining a profit.

The approach taken to the regulation of litigation funding in Australia to date, has been one that provides little or no regulation for litigation funders. In large part this approach has sought to be supported by access to justice arguments. In our view, litigation funders should be subject to an appropriate regulatory regime that, at least:

- provides certainty for participants in litigation that involves litigation funding;
- protects potential members of a group intending to enter into a litigation funding arrangement and prescribes specific common safeguards and procedures;
- prevents law firms from establishing related litigation funding providers;
- requires litigation funders to meet certain prudential requirements so that funders have sufficient assets to meet any relevant costs orders made against them or the members of the plaintiff group; and
- ensures that foreign litigation funders who finance actions in Australia have sufficient assets to satisfy costs orders and that those cost orders and the funding agreements entered into with persons located within Australia, can be enforced.

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5 http://www.companydirectors.com.au/Director-Resource-Centre/Policy-on-director-issues/Policy-Submissions/2013/Submission-to-Productivity-Commission-on-Litigation-Funding-and-Class-Actions

We have also recommended that the Government undertakes a detailed analysis as to whether a regulatory regime that encourages the proliferation of funded class actions against corporations is in the best interests of the Australian economy.

As a final remark, if Australia has any aspirations of becoming an international centre for finance and related activities in the future, it must first address the serious constraints discussed above. It is our understanding that our international competitors (including Hong Kong, Singapore, London, New York and Toronto) already have in place director liability regimes that are not as punitive as the ones that apply to financial institutions in Australia. While we support the need for a strong corporate governance and director liability regime for our financial institutions, the excessive burden of liability for directors in Australia is of serious concern. Given it is the directors of financial institutions who make the final decision as to where to place investments and locate the head office, our current director liability regime causes a significant barrier to Australia increasing its standing as a financial centre unless addressed.

We hope that our comments will be of assistance to Treasury. 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