CHALLENGER FINANCIAL SERVICES GROUP

SUBMISSION TO THE

REGULATION TASKFORCE

INTRODUCTION

This submission has two parts. The first part deals with general issues relating to the regulatory environment, the cost of regulation and the conduct of regulators. The second part deals with specific issues relating to APRA's final draft capital standards for life companies and proposed prudential standards on governance and fit and proper requirements.

Challenger's dealings with ASIC have generally been a neutral or positive experience. While ASIC takes an overly legalistic approach it is important to recognise the horrendous volume and complexity of the laws, regulations and policies for which it is responsible. This complexity results in almost every commercial decision by a regulated entity requiring review and legal sign off. This materially adds to the cost of doing business and affects the cost and availability of choice of products for consumers. The cost of this complexity cannot be justified particularly as the benefits are almost non-existent.

One of the significant issues with the current regulatory environment, despite the existence of the Council of Financial Regulators and an MOU (memorandum of understanding) between each regulator and each regulator and the Treasury, is the lack of co-operation and co-ordination in respect of overlapping and duplicated regulatory requirements placed on companies. For example, with respect to licensing there are separate requirements and no mutual recognition even by one regulator where the other's requirements are more onerous.

PART ONE
GENERAL ISSUES RELATING TO THE REGULATORY ENVIRONMENT, THE COST OF REGULATION AND THE CONDUCT OF REGULATORS

OBJECTS OF REGULATION

Financial regulation has two sets of objectives. The first set relate to safety including promoting: financial system stability; sound prudential management of deposits, life and general insurance; the integrity of markets; and consumer protection. The second set relate to performance of companies, the industry and the economy, these include promoting: viability, growth, innovation and competition.

If regulation is properly balanced the two sets of objectives should be mutually reinforcing rather than competing because performance enhances safety. However, if the dominant preoccupation of regulators is safety and it is pursued without regard to the impact on performance, the financial strength of the industry and economic growth will suffer.

Neither of those sets of objectives includes the elimination of risk, because that is neither possible nor desirable. Wallis said; *"Risk is an essential component of any financial system and, in an efficient system, is priced to*

reward those who bear it."[1] Regulation should allow a spectrum of market risk and return choices for consumers of financial products.

Parliament has incorporated both safety and performance objectives in Section 3(1) Objects of the Life Insurance Act 1995:

> *The principal object of this Act is to protect the interests of the owners and prospective owners of life insurance policies in a manner consistent with the continued development of a viable, competitive and innovative life insurance industry.*

APRA is therefore obliged by legislation to pursue safety and consider the impact of regulation on financial performance.

Current accountability arrangements for financial services regulators are similar to those of other statutory authorities which require reporting by the agency in its annual report against various criteria set by the executive of government and by Parliament (the Joint Committee of Public Accounts and Audit). Those annual reports are then subject to scrutiny by the Auditor-General and various parliamentary committees.

Rather than continuing to rely solely on the regulators reporting on their own performance, there would be value in introducing some independent expert oversight of their regulatory activities on an annual basis. Such oversight should have a particular focus on the balance the regulator achieves between safety and performance objectives and in particular the impact of the regulator's requirements on financial performance.

COST OF REGULATION

Like any intervention regulation results in significant costs, risks, unintended consequences and market distortions. Some of these are discussed below:

1. direct costs;
2. regulatory risk;
3. duplication and conflicts of regulation;
4. impacts on competition;
5. inefficient use of regulation; and
6. economic efficiency losses.

1. Direct costs

Regulation adds to costs. The regulated entity carries significant compliance costs and regulators have significant costs which typically are passed on to regulated entities through levies and licensing fees. These costs are borne by shareholders and passed on to consumers in reductions in the value proposition of regulated products. An important unintended consequence of the increased cost of regulation of the financial services industry post HIH is that consumers with limited assets or income have as a direct consequence been priced out of advice. These are precisely the people the new regulations were intended to protect.

[1] Financial System Inquiry final report, AGPS, March 1997, page 299

2. Regulatory risk

The difficult question for policy makers is how far regulation should go and what level of assurance should be provided to policy holders? Wallis pointed out that heavy regulation carries its own risks for the regulator, the operation of market forces and the operation of the regulatory process:

> *"If regulation is pursued to the point of ensuring that all promises are kept under all circumstances, the burden of honour is effectively shifted from the promisor to the regulator. All promises would become equally risky (or risk free) in the eyes of the investing public. Regulation at this intensity removes the natural spectrum of risk that is fundamental to financial markets."*[2]

Wallis warned that such an intensity of regulation also introduces a moral hazard by dulling the incentive for a regulated institution to monitor risks incurred in its operations.[3]

If regulation is intrusive and the regulator seeks a direct influence on decisions regarding appointments, investments or operations then the regulator not the board or management becomes accountable for the outcome.

3. Duplication and conflicts of regulation

Efficiency requires that where a company is subject to regulation by more than one regulator the responsibilities of each regulator are clearly delineated and do not overlap or their requirements conflict.

The Wallis Inquiry criticised previous regulatory arrangements, because:

> *"The excessive layering in the structure has resulted in duplication of supervisory, policy and administrative arrangements; slow decision making in important areas, including legislative review; and conflicts between those making policy and those implementing it."* [4]

Wallis recommended *"an allocation of functions among regulatory bodies which minimises overlaps, duplications and conflicts."*[5]

The government adopted Wallis's recommended regulatory framework and gave responsibility to the:

- RBA for monetary policy, systemic stability, and the payments system;
- APRA for prudential regulation of authorised deposit taking institutions, life and general insurance, and superannuation; and
- ASIC for corporations, market integrity and consumer protection.

As recommended by Wallis,[6] where more than one regulator has an interest in an issue or information, collaboration and information exchange is facilitated by the Council of Financial Regulators which consists of representatives of each regulator and the Treasury.

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[2] Financial System Inquiry, op cit, page 192
[3] ibid, page 195
[4] ibid, page 307
[5] ibid, page 198
[6] MOU between APRA and ASIC, paragraph 1.2

There is also a set of MOU's to facilitate collaboration and exchange of information between each of the regulators and between each of the regulators and Treasury. The MOU between APRA and ASIC says:

> *"The agencies agree that consistent with their separate roles they will co-operate where it is within their administrative powers to reduce duplication and compliance costs and achieve effective enforcement and compliance outcomes."*[7]

And:

> *"The agencies agree to provide each other with mutual assistance in relation to the exchange of information, appropriate referral of matters and cooperation in regulation, compliance, and enforcement within the framework of this agreement and which is consistent with all relevant laws."*[8]

It provides for liaison on routine operational matters occurring on an *"as needed"* basis between appropriate staff of the two agencies[9] and for full and timely exchange of information.[10] However these arrangements have proven ineffective. The consequence is overlapping and duplicated requirements which add to the compliance burden and may involve conflicts between the objectives of different regulators. Instances of these conflicts are dealt with in Part Two of this submission, particularly on governance.

With five regulators (APRA, ASIC, ASX, RBA and ACCC) responsible for various aspects of regulation of business and the financial system the efficiency of the total regulatory system is dependent on each regulator not duplicating the functions of any of the others.

4. Impacts on competition

The assumption that competitive neutrality will be achieved by a one size fits all approach to regulation fails to recognise that smaller companies are disproportionately affected by additional requirements because they are less able to absorb fixed costs. This has implications for competition because it favours companies with scale and reduces the contestability of markets by imposing prohibitively high barriers to new entrants.

Regulation that is highly prescriptive, imposing a template on all regulated entities forcing them to fit the regulator's requirements rather than requiring regulatory outcomes, will restrict the diversity of business models and product offerings.

Heavy regulation drives companies out of products and sectors where they are not market leaders and results in the development of oligopolies with a significant lessening of competition. The consequences for consumers are higher prices and limited product and service choice.

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[7] MOU, op cit, paragraph 1.2
[8] ibid paragraph 4.2
[9] ibid paragraph 5.2
[10] ibid paragraph 6.1

5. Inefficient use of regulation

Regulators need to start from first principles and consider what specific contributions are made by specific regulatory interventions. The assumption that layer upon layer of regulation will improve the quality of decision making or impede criminal activity ignores the reality that the more complex and prescriptive regulation becomes the more the focus of both regulators and regulated will be on form rather than substance. Policy holders are better served by a high quality intelligent management team than a fulsome and comprehensive bible of policies.

6. Economic efficiency costs

One of Wallis's principal objectives was achieving efficient regulatory arrangements:

> *"Regulatory efficiency is a significant factor in the overall performance of the economy. Inefficiency ultimately imposes costs on the community through higher taxes and charges, poor service, uncompetitive pricing or slower economic growth."*[11]

Wallis said that prudential regulation results in a loss of efficiency in two ways; first, by restricting entry to a market it reduces competition; and second by limiting the behaviour of regulated institutions it limits the scope for commercial judgment by financial institutions.[12] Consumers lose as both providers of financial services and consumers bypass regulated products.

Tellingly, Wallis noted that one of the motivations for these attempts to limit the behaviour of regulated institutions was *"in order to limit the regulator's exposure to failure."*[13] If that comment pertained in 1997 it is more relevant in the post-HIH regulatory environment.

CULTURE OF REGULATORS

Like other organisations the focus and performance of regulators are to a significant degree determined by internal cultural factors. In the case of regulators the things that define that culture include shared views of the regulator's role and the nature of the organisations being regulated.

If regulator's take the view that their role is to protect depositors, policy holders and superannuation contributions at any cost then Australia will have an expensive and inefficient regulatory system. The consequence for consumers is an uncompetitive and poor value for money product offering. Statements like "there won't be any money lost on our watch" and "shareholders should be happy to accept lower returns for lower risks" may be well intended but do not justify overzealous regulation which unnecessarily reduces the value to consumers of regulated products and the return to shareholders who invest in the companies that provide them.

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[11] Financial System Inquiry, op cit, page 177
[12] ibid, page 195
[13] ibid, page 195

Prudential supervision carries an extra risk that the regulator will become actively involved in the management of regulated companies. If the regulator takes a view that it has a duty to inform itself of all aspects of a company's management and administration and seek to improve them, regardless of their relevance to any prudential issue, then regulation will be intrusive, inefficient and poorly focused.

If the regulator assumes that boards and management have a natural inclination to act recklessly or criminally then the result will be heavy handed regulation and compliance monitoring which is expensive and inefficient but still unlikely to deter those who deliberately act dishonestly. Since only a small minority of people in the financial services industry are either reckless or criminal a more effective response to these issues is enforcement of existing criminal sanctions.

A positive regulatory culture requires commitment to:

- Enhancing safety;
- Providing an environment for financial performance and growth;
- Allowing innovation;
- Promoting competition;
- Having a light touch;
- Minimising intrusiveness;
- Adopting a sensible commercial approach to requirements;
- Balancing safety and performance; and
- Cooperating with other regulators to contain the total burden of regulation on regulated entities and the community.

CHANGING THE REGULATORY ENVIRONMENT

The regulators of the financial services industry operate with a considerable degree of autonomy. While they may consult Treasury on regulatory issues they produce a range of legislative instruments that are not subject to any process of independent review other than by Parliament which only has the power to disallow them. The circumstances in which Parliament would take such action are extreme so that is not an effective process for checking the quality or quantity of regulation. The Senate's Regulations and Ordinances Committee performs some checks but these relate to form not to policy substance or the compliance burden.

The problem is compounded because the enabling legislation under which these instruments are promulgated puts very few restrictions on their content or scope. Parliament may have intended a principles based approach to regulation but the regulators set down black letter law. Parliament may have assumed that no regulator would overlay their own requirements on another regulator's core area of responsibility but in practice this duplication and often conflicting regulatory requirements have become common.

In the absence of legislation that provides a reasonable degree of control over the content of legislative instruments and the activities of regulators there is a need for some kind of active management and coordination of the total

regulatory process. The Council of Financial Regulators, which may have been an appropriate vehicle, at least to deal with the problem of regulatory overlaps, ceased publishing an annual report after 2002.

This raises the question of what sort of institutional changes might contribute to an improvement in the regulatory environment for the financial services industry?

Legislation

Since the regulators have autonomy in producing legislative instruments there would be value in amending their enabling legislation to more closely define the scope of those instruments. This has the potential to eliminate some areas of duplication and overlap. It would also be valuable in restricting the use of fit and proper powers only to situations where they are appropriate, which is dealt with more fully in Part Two of this submission.

Cost benefit analysis

The current Regulatory Impact Statement process needs to be reinforced with rigorous requirements for cost benefit analysis of new regulation. It would be appropriate for the standards for those cost benefit analyses to be set by an independent body such as the Productivity Commission. The cost benefit analysis should be publicly available and open to comment for an appropriate period before the regulation is placed on the Register of Legislative Instruments.

Consultation

One of the principal defects with current regulatory arrangements is the inadequacy of consultation arrangements with industry. The regulators currently control these processes. The Board of Taxation provides an appropriate model for a consultation process on regulation which would facilitate industry input and report independently of the regulators.

Sunset clauses

All legislative instruments should be placed on a rolling schedule of sunset clauses of sufficient duration to allow proper periodic review of their continuing value. The review process should not be in the exclusive hands of the regulators. The review process would provide a regular opportunity to update requirements for changes in business practices.

Systemic issues

The Inspector General of Taxation (IGT) provides a useful model for a small, independent, expert body to report on systemic regulatory issues. Like the IGT an Inspector General of Regulation could take up issues on complaint, on the Inspector General's own initiative or when they are referred by relevant Ministers. For transparency, the Inspector General would report to

Parliament. An Inspector General of Regulation would also be an appropriate independent authority to report annually to parliament on the regulators' performance against their regulatory objectives.

Regulatory ombudsman

Many regulated entities find themselves in dispute with regulators on issues where the regulators have wide discretion and there are no effective rights of appeal to an independent authority. Often the issues are not appropriate to be dealt with by a court or by Ministers. For such circumstances an ombudsman style process would be appropriate. The role could be one of the functions of an Inspector General of Regulation.

Independent authority to impose sanctions

One of the structural defects of the current regulatory system is that in the case of alleged malfeasance a regulator may be the complainant, investigator, prosecutor, jury and judge. That is not a model of good process. Sanctions such as disqualification, suspension or withdrawal of licence should be subject to due process which is not in the control of the regulator. This could be another function of an Inspector General of Regulation.

FOCUS OF PRUDENTIAL REGULATION

The predominant focus of prudential supervision should be on capital adequacy not on a template of management systems and governance requirements intended to assure quality decision making. A quality management team is far more important in achieving financial performance and policy holder security than a fulsome and complete bible of policies.

The underlying protection for depositors and policy holders is that shareholders' capital is at risk. Capital standards that result in unnecessarily low returns to shareholders will attract less capital. The solution to an incipient insolvency event is recapitalisation. Therefore the potential to make a commercial return is critical to protecting depositors and policy holders.

The need to develop more appropriate capital standards for the life insurance industry is dealt with in Part Two of this submission.

APRA's supervision now goes beyond capital adequacy, policies and systems and intrudes into the process of decision making. In some cases it has requested access not just to minutes but transcripts of board meetings. For board deliberations to be effective directors need to have full and frank discussions without concern that what they say will be available to third parties and used against them in litigation. Businesses have a right to protect their intellectual property, including the investment decisions they contemplate, as commercial-in-confidence. Other discussions, such as about the performance of individuals within a company, should not be revealed to third parties including the regulator for a variety of reasons including the risk of exposure to libel proceedings.

If a regulator influences business decisions in respect of investments, appointments, administration or operations, the regulator becomes responsible for the outcomes.

PART TWO
SPECIFIC ISSUES IN RELATION TO PROPOSED PRUDENTIAL STANDARDS

This part of the submission addresses issues arising from the prudential supervision of life insurance companies by the Australian Prudential Regulation Authority and in particular new and proposed standards on:

- Capital
- Governance; and
- Fit and Proper Requirements.

The capital standards have been revised by the Life Insurance Actuarial Standards Board and were reissued as Final Drafts on 30 November 2005. The new standards continue to require inefficient use of capital and there would be great value in the Regulation Taskforce considering the priority that should be given to reforms which would achieve competitive neutrality with ADI's as was originally proposed by the Wallis Inquiry.

The new standards for Governance and Fit and Proper Requirements are expected to be finalised next year and the Regulation Taskforce has an opportunity to consider them prior to their being registered as legislative instruments with a view to ensuring they do not unnecessarily add to the burden of regulation on the life insurance industry, duplicate and conflict with the roles of other national regulators, specifically the ASX and ASIC, and impose significant costs on consumers. APRA has foreshadowed some modifications to the current drafts but not issued the proposed revisions.

APRA has parallel processes developing prudential standards on governance and fit and proper requirements for other types of regulated entity (general insurers and authorised deposit taking institutions) so a focus on this area by the Regulation Taskforce would achieve major benefits across the financial services industry and avoid a further major accretion of regulatory burden within a timeframe close to the Government's consideration of the Regulation Taskforce's report.

Together, these new regulatory proposals for the life insurance industry will:

1. Make the industry excessively risk averse;
2. Result in the regulator taking an active and inappropriate role in the management of life companies;
3. Materially increase the cost of regulation; and
4. Impose excessively heavy and prescriptive capital standards which will initially result in an inefficient use of capital and ultimately to a withdrawal of capital from the industry.

Regulation should require that those who make promises appropriately manage the risks attached to them. Wallis said; *"Risk is an essential component of any financial system and, in an efficient system, is priced to reward those who bear it."*[14] It is not in the interests of policy holders for a regulator to impede a board's capacity to make reasonable business judgments because that will result in sub-optimal returns. In a competitive market consumers will seek higher returns and the long term consequence of excessively risk averse regulation will be to drive retirees into unregulated products. To the extent that unsophisticated investors are drawn to those types of investments by unsatisfactory returns on regulated products, the efforts by regulators to protect consumers will be counterproductive.

Section 3(1) of the Life Insurance Act 1995 states; *"The principle object of this Act is to protect the interests of the owners and prospective owners of life insurance policies in a manner consistent with the continued development of a viable, competitive and innovative life insurance industry."*[15] That is consistent with the broader objectives of other areas of business regulation which also consider the ability of business to innovate and provide cost efficient solutions to consumer needs. One of the objectives of the Corporate Law Economic Reform Program is to *"ensure business regulation is consistent with the promotion of a strong and vibrant economy,"*[16] and the final report of the Wallis Inquiry into the Australian Financial System said; *"In designing regulatory arrangements, it is important to ensure minimum distortion of the vital roles of markets themselves in providing competitive, efficient and innovative means of meeting customer's needs."*[17]

Wallis concluded that *"regulation involves a natural tension between effectiveness and efficiency"*[18] and that a cost effective regulatory system requires *"an explicit mandate for regulatory bodies to balance efficiency and effectiveness."*[19] However, there has more recently been too little focus by regulators in considering the implications of their requirements on costs, efficiency, competition, market contestability and the broader interests of policy holders.

In response to recent financial failures, both overseas (Worldcom and Enron) and in Australia (HIH), there have been significant increases in legislative requirements and regulation starting with the Sarbanes-Oxley Act in 2002 and continuing today across a wide front. Much of this new legislation and regulation is onerous and is now being found to be both ineffective and counterproductive in protecting consumers and investors. For example, the Australian Government is already winding back some excessive features of financial services regulation such as on product disclosure statements. The

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[14] Financial System Inquiry, op cit, page 299
[15] Life Insurance Act 1995, Section 3 (1)
[16] Hon Justice IDF Callinan, The Corporate Law Economic Reform Programme: An Overview, Corporations Law Update Conference, October 1998.
[17] Financial System Inquiry, op cit, page 15
[18] ibid, page 197
[19] ibid, page 198

route to finding the appropriate balance in every area of regulation should not be by moving back from an initial position of excess.

Prudential regulation should not start from the premise that without it boards or management would either be reckless or criminal. While transparent, best practice corporate governance arrangements provide some discipline they are not a sufficiently robust safeguard to protect against deliberate criminal behaviour. Designing governance arrangements with that as the bottom line will necessarily compromise the processes of legitimate decision making with little reduction in the risk of malfeasance. Only a tiny minority of people in industries that are subject to prudential regulation are either reckless or criminal and a more effective response is enforcement of existing criminal sanctions.

CAPITAL STANDARDS

The capital standards for life insurance have recently been revised by APRA and the Life Insurance Actuarial Standards Board. However, these new capital standards for the life insurance industry fall short of the unimplemented recommendations of the Wallis Inquiry, particularly as they follow a lengthy process of reviewing capital standards for ADI's to bring them into line with the requirements of Basle ll.

Recommendation 34: The intensity of prudential regulation needs to balance financial safety and efficiency.

> *The APRC's* (APRA's) *charter should emphasise the need to approach prudential regulation in a way that balances the objective of promoting financial safety with the need to minimise the adverse effects on efficiency, competition, innovation and competitive neutrality. This balance should preserve a spectrum of market risk and return choices for retail investors, meeting their differing needs and preferences.*

Recommendation 38: The APRC should regulate life companies.

> *The APRC should be responsible for the prudential regulation of life companies on a similar basis to that currently applied by the ISC.*
>
> *However, the prudential regulation of life companies should be designed to provide, as far as is practicable, neutral treatment of life products compared with similar deposit and other investment and risk products. This should minimise the opportunities for regulatory arbitrage between life company investment and deposit taking institutions.*

Recommendation 35: Prudential regulation of DTIs needs to be consistent with international requirements.

> *Prudential regulation of all licensed DTI's should be consistent with standards approved by the Basle Committee on Banking Supervision*

and should aim to ensure that the risk of loss of depositors' funds is remote. Quantitative prudential requirements such as capital adequacy, liquidity requirements and large exposure limits should apply. Regular on-site reviews of risk management systems should form an integral part of the approach to prudential regulation.

Prudential supervision should be sufficiently flexible to accommodate differences in the operation of DTI's, while pursuing the fundamental objectives of stability, efficiency and depositor protection.

The capital treatment of ADI's is now consistent with the Wallis Inquiry proposal, however, life insurance continues to be regulated under legislation that predates the Wallis Inquiry with capital standards set by the Life Insurance Actuarial Standards Board (LIASB).

The LIASB's current review of capital standards is highly problematic and will result in increased capital requirements substantially above economic needs. The consequence of excessive capital requirements is low returns which will drive consumers into products that provide no guarantees.

This is in conflict with Recommendation 34, which proposed a spectrum of risk and return choices for consumers and Recommendation 38 which proposed neutral treatment of capital requirements between life companies and ADI's.

The relative performance of life products should not be a matter of indifference to either the regulator or government. Government provides major tax incentives for individuals to accumulate financial assets to provide them with a financially secure retirement. Financial products which provide a secure retirement income stream need to be as attractive as possible if they are to compete against the higher but riskier returns of products which are not prudentially regulated. Establishing capital standards that do not result in an inefficient use of capital and less competitive returns on capital guaranteed life products should therefore be a priority for both prudential regulation and retirement incomes policy.

GOVERNANCE

While it is APRA's intention to regulate for the highest standards of governance, the framework which it proposes will not improve the quality of decision making or achieve a substantial reduction in risk. Elements of the proposed prudential standard will impair the capacity of regulated entities to apply best practice in corporate governance and will conflict with and compromise the integrity of non-prudential business regulation. The proposed standard will add to costs, promote excessively risk averse decision making and reduce economic efficiency. The current draft standard substantially unwinds the Government's reforms which followed the Wallis Inquiry which were designed to provide an efficient regulatory regime that minimise overlaps, duplication and conflicts between regulators.

Good governance will not be achieved by APRA prescribing a minimum one size fits all solution across a diverse range of corporate structures. Improved governance will be achieved by encouraging management and boards to apply best practice principles to the corporate structures they are managing, and requiring them to be transparent about their reasons for adopting particular arrangements.

Corporate structures provide a diversity of ways both to raise capital and organise business operations. Those structures are integral parts of the business models used by companies to deliver financial products to consumers and each corporate structure and business model has competitive advantages providing choice and utility to consumers. A prescriptive governance model will inhibit diversity and have the effect of favouring some corporate structures and business models over others. This is a compelling argument for maintaining the flexible transparency in the ASX corporate governance guidelines.

FIT AND PROPER

It is appropriate to apply fit and proper tests to responsible officers and directors of APRA regulated entities and for those regulated entities to take primary responsibility for ensuring that those responsible officers and directors are fit and proper.

Regulated entities need to develop policies and processes and undertake the necessary fit and proper assessment prior to a responsible officer or director being appointed. Regular review of board and management performance should establish that they continue to be capable of carrying out their duties with the necessary level of skill, care and integrity. Regulated entities need also to have in place effective processes and have the resolve to take appropriate action when a review or event indicates that is not the case.

As the primary responsibility for ensuring that responsible officers and directors are fit and proper rests with the regulated entity, the purpose of LPS 520 should be to define those responsibilities.

The range of issues that it should deal with should be confined to ensuring that responsible officers and directors:

- Are qualified, skilled and capable;
- Act diligently and with due care; and
- Act honestly and with integrity.

APRA does have the authority to act against a responsible officer or director but should exercise that authority as a reserve power where a regulated entity cannot or will not act to remove a responsible officer or director who is not fit and proper.

APRA's current draft prudential standard on fit and proper is drawn too widely. As an example of APRA's intentions to use those powers widely its discussion paper on fit and proper explicitly contemplates using that power where it

believes an individual has a potential conflict rather than where misconduct has actually occurred.

APRA could use its fit and proper power to disqualify a responsible officer or director where it takes issue with an operational or investment decision. The possibility that APRA could use its fit and proper power where it disputes a business judgment will result in an excessive focus by boards and management on how investment and operational decisions will be perceived by the regulator rather than on their commercial merits. The consequence of that type of regulatory environment will be excessively risk averse decision making.

If APRA wishes to take issue with an investment or operational decision it should do so by way of enforceable undertaking. By that means there will be proper transparency that the regulator and not management or the board are responsible for the decision.

The power to disqualify a responsible officer or director as not fit and proper is an extreme sanction. It would therefore be appropriate to control its use within a legislative framework defining the circumstances in which it should be used, the processes for its application, and the powers and obligations of regulators and regulated entities required to apply it. The legislation should also set out well defined rights of review and appeal.

SPECIFIC MATTERS

This submission is structured to deal with each of the proposed prudential standards in accordance with the questions set out in the Taskforce Issues Paper, for the purpose of identifying specific regulatory burdens and duplication:

1. What is the relevant regulation and the agency that administers it?
2. What is the objective of the regulation and does it achieve it?
3. What is the burden placed on business by the regulation?
4. What is the annual cost of the regulation, or the lost opportunity as a result of it?
5. Who pays these costs?
6. In what way is the regulation unnecessary or unnecessarily complex?
7. Could the regulation or its administration be reformed or simplified to reduce the compliance burden?
8. Could any alternatives achieve the regulatory objective?
9. Which other government regulations does it duplicate?
10. Have there been attempts to address this duplication in the past?
11. What might be the solutions to this duplication?

One of the key focuses of this submission is that the regulators of the financial services industry have a responsibility not only to ensure confidence in the integrity of financial markets and a prudentially sound environment for savings and regulated products, but they also have a responsibility to facilitate an

environment in which a viable financial services industry can grow, compete and innovate.

In recent years the regulators have neglected the impact of regulation on the industry and indeed on consumers whose interests they are charged with protecting. Consumers also benefit from an efficient industry, competition and a choice of products.

The Regulation Taskforce has an opportunity to provide a better balance between these two sets of objectives.

CAPITAL STANDARDS

(a) PROBABILITY OF SUFFICIENCY

1. What is the relevant regulation and the agency that administers it?

Life Insurance Actuarial Standards Board Final Drafts AS2.04, AS3.04 and AS6.03.

2. What is the objective of the regulation and does it achieve it?

To provide minimum capital requirements for life companies. It does not achieve the objective because, while it does set minimum capital standards, it does so in a way that produces an uneconomic burden, in conflict with section 3(1) of the Life Insurance Act 1995.

3. What is the burden placed on business by the regulation?

The proposal is for 99.75% probability of sufficiency in any year. This imposes an excessive capital requirement.

4. What is the annual cost of the regulation, or the lost opportunity as a result of it?

This would require a material increase in capital requirements for life companies. The capital requirements would make capital guaranteed life products less competitive relative to unregulated products. That is contrary to the interests of current and prospective policy holders and contrary to the objectives of the Life Insurance Act to ensure the continued development of a viable, competitive life insurance industry.

The resulting increase in price for a given income stream will result in many consumers turning to unregulated products with a higher return. Consumers are less able to understand and manage the resulting increase in risk. Excessive capital standards therefore defeat the objective of regulation.

5. Who pays these costs?

The costs will be carried by both shareholders in life companies and future policy holders.

6. In what way is the regulation unnecessary or unnecessarily complex?

A 99.75% probability of sufficiency is inappropriate for a minimum standard. This level of sufficiency represents a “hard floor” as a life company would be in breach of the Life Insurance Act if this level were breached.

It is therefore prudent for a life company to hold capital targets in excess of the legislated minimum to ensure compliance with the minimum at all times (as required by the Life Insurance Act). When combined with such capital targets, it leads to uneconomic levels of capital, to the detriment of the life insurance industry.

This is demonstrated in the table below, which shows probabilities of sufficiency of a 99.75% minimum combined with various levels of additional targets. This assumes normal distributions.

Table 1: Probabilities of sufficiency of a 99.75% minimum combined with various levels of additional targets. This assumes normal distributions.

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companies, including requirements designed to ensure the solvency and capital adequacy of statutory funds;

(c) providing for the supervision of life companies by APRA and ASIC;

(d) providing for judicial management of life companies whose continuance may be threatened by unsatisfactory management or an unsatisfactory financial position;

(e) making provision to ensure that, in the winding-up of a life company, the interests of policy owners are adequately protected;

(f) providing for the supervision of transfers and amalgamations of life insurance business by the Court.

(3) Generally, this Act achieves these objects by provisions applying to all life companies. However, there are a number of special provisions that apply only to friendly societies (see in particular Part 2A).[20]

The objective of the proposed Governance prudential standard is to promote prudent management, solvency and capital adequacy as set out in 3(2)(b).

To the extent that imposing a particular governance model on all life companies may provide for supervision by APRA 3(2)(c) is also a relevant objective.

Both 3(2)(b) and 3(2)(c) should be qualified by the principal objects in 3(1) providing for *"continued development of a viable, competitive and innovative life insurance industry."*[21]

APRA has selected a governance model which it prefers and proposes to apply to all regulated entities. APRA's assumption is that its preferred model represents a high standard of practice and will therefore provide a material benefit in terms of enhanced prudential safety. The fundamental issue is whether the prescribed governance requirements provide a material improvement in prudential safety as a result of modifying the ASX requirements. There are strong arguments that not only do the prescribed APRA requirements not enhance prudential safety but that they detract from it.

Since it released the draft standard APRA has said:

> *"We do expect that institutions will be able to demonstrate application of these principles (responsibility, independence, renewal, expertise, diligence, prudence, transparency and oversight) both as part of their governance framework and in the day to day management of the institution."*[22]

Those objectives may appear reasonable but they will not be achieved if the specifics required result in dysfunctional governance arrangements which actually detract from the performance of regulated entities.

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[20] Life Insurance Act 1995, Section 3

[21] ibid Section 3

[22] Steve Somogyi, APRA Member, APRA Advocates a Prudential Culture, Speech to the APRA/ICA consultation, 17 June 2005, page 4

APRA's mandatory minimum standard has as its objective providing for supervision in accordance with Section 3(2)(c) of the Life Insurance Act. APRA has argued that it is necessary to duplicate other regulatory regimes so that it will be able to enforce its own requirements:

> *"If we do not prescribe minimum requirements then we are powerless to enforce our expectations with regards to governance. What we have tried to achieve in these standards is a sensible set of requirements for all regulated entities built on the widely accepted ASX Principles of Good Corporate Governance and on the requirements for auditors set out in the CLERP 9 reforms."*[23]

APRA argues it needs to impose its own corporate governance requirements because some insurers are not listed or incorporated locally and therefore are not subject to relevant regulators:

> *"Remember the ASX principles of good corporate governance do not apply to all APRA regulated entities – as the majority are not listed on the ASX. Similar arguments have also been raised with respect to APRA prescribing independence requirements for auditors. Again, a large number of the institutions that we regulate are not incorporated locally, hence not required to comply with the auditor independence requirements in the Corporations Act."*[24]

APRA are trying to justify a dysfunctional set of governance arrangements for Australian ASX listed and ASIC regulated companies on the basis of the ASX and ASIC's lack of jurisdiction over unlisted and foreign companies. Foreign companies will be subject to the governance requirements of the jurisdictions where they are listed.

As a result of the Financial Sector (Shareholdings) Act 1998 unlisted Australian regulated entities will be subsidiaries of a group with widely held stock which will itself be listed and subject to ASX requirements.

3. What is the burden placed on business by the regulation?

The specific regulatory burdens and duplications resulting from the Governance Standard are dealt with in the subsections below:

(b). Control of companies;
(c). Director's duties;
(d). Review of board and senior management performance;
(e). Board renewal; and
(f). Directors domicile.

[23] Somogyi, op cit, page 5
[24] ibid, page 5

4. What is the annual cost of the regulation, or the lost opportunity as a result of it?

The governance standard will impose substantial additional direct costs for additional independent directors for subsidiaries in groups or the loss of executive directors' expertise from their boards.

The governance standard will make directors and responsible officers substantially and unnecessarily more risk averse.

5. Who pays these costs?

The costs will be borne by shareholders as direct costs and by consumers as lower returns on the products they purchase.

6. In what way is the regulation unnecessary or unnecessarily complex?

The governance standard is unnecessary for listed companies given that the ASX, has well developed policies that apply in this area.

The APRA governance model, in being completely prescriptive, fails to take account of the particular governance needs of regulated entities that are wholly owned subsidiaries in a corporate group. These are elaborated on in section (b) below.

The governance standard also introduces a number of unnecessary and undesirable requirements, specifically: introducing a proportional representation limit on directors who are associates of major shareholders; requiring access to documentation on performance assessments of directors and senior management and board succession plans; and introducing rules on directors' domicile. These introduce a range of problems that are dealt in sub-sections (b), (c), (d), (e) and (f) below.

APRA's one size fits all approach carries with it the likelihood that governance arrangements will have to be duplicated within a group. This duplication increases the pressure on management to concentrate on form rather than substance.

Good corporate governance will not be enhanced by application of a standard APRA mandated formula to a range of company structures for which it is inappropriate. It is the companies themselves that need to design their structures to support good corporate governance. This is an area where flexibility is necessary. The ASX corporate governance guidelines are the appropriate standard requiring regulated entities to be transparent and explain any departures from recommended best practice.

7. Could the regulation or its administration be reformed or simplified to reduce the compliance burden?

The simplest way of achieving good corporate governance is to allow the ASX Corporate Governance Best Practice Guidelines to apply as they were designed.

8. Could any alternatives achieve the regulatory objective?

To the extent that some APRA regulated entities are not within the jurisdiction of other Australian regulators, APRA could require that life companies which are not incorporated locally or a subsidiary of a locally incorporated entity adhere to any ASX or ASIC requirements that are directly relevant to prudential supervision as if they were locally incorporated and listed. Alternatively they could rely on the governance requirements of the regulators in the countries where they are registered and listed.

9. Which other government regulations does it duplicate?

APRA's proposed governance standard will duplicate the Australian Stock Exchange's Best Practice Guidelines for Corporate Governance. APRA's governance model replaces the flexible transparency of the ASX model that has been constructed to accommodate a wide variety of company structures with APRA's preferred model that fails to take proper account of the substantial differences between the structures of the entities it is regulating.

The prudential regulator argues its role justifies it overriding the flexible transparency of the ASX model because:

> *"APRA's duty is somewhat different to ASIC and the ASX. Our duty is to policy holders and depositors…Shareholders can vote against a Board which has inappropriately applied the 'if not, why not' principle."* [25]

However, while APRA's role is to protect the interests of policy holders and depositors that is not a sufficient justification for disrupting other regulatory regimes that themselves have a strong public interest purpose.

APRA said it is not attempting to exceed the requirements of other regulators:

> *"APRA has sought to impose some of the ASX governance principles and the CLERP 9 auditor independence requirements at the strong end of the spectrum. However, we have not sought to impose requirements that go beyond those of other regulators or that are in conflict with these other requirements."*[26]

However, APRA's draft corporate governance prudential standard exceeds the ASX guidelines by dispensing with flexible transparency (the so-called 'if not, why not' rule), introducing a proportional representation limit on directors who are associates of major shareholders, requiring access to documentation

[25] Somogyi, op cit, page 5
[26] ibid, page 5

on performance assessments of directors and senior management and board succession plans and introducing rules on directors' domicile.

APRA's requirements on the composition of boards conflict with principles underlying company law in respect of control and directors duties.

Good corporate governance is more likely to be achieved by allowing these regulatory frameworks to operate as they were designed and intended than by APRA imposing a one size fits all approach which will be detrimental to the performance of regulated entities.

10. Have there been attempts to address this duplication in the past?

This conflict has not arisen in the past.

11. What might be the solutions to this duplication?

APRA should accept that the ASX Best Practice Guidelines will produce good governance outcomes. APRA should then focus on producing a standard that deals with specific issues that are directly relevant to prudential safety, such as independence of actuaries.

(b). CONTROL OF COMPANIES

1. What is the relevant regulation and the agency that administers it?

The Australian Prudential Regulation Authority's Draft Prudential Standard LPS 510 Governance.

2. What is the objective of the regulation and does it achieve it?

To require a majority of independent directors on the board of regulated entities to prevent control by related parties.

3. What is the burden placed on business by the regulation?

One of the principal defects of the draft corporate governance prudential standard is that it fails to recognise the substantial differences between the corporate structures it is intended to regulate. Prudential regulation of complex structures remains a work in progress, with APRA yet to release a draft standard on regulation of corporate groups. The absence of an appropriate framework for regulating groups appears to be a major factor contributing to the proposed duplication of governance requirements.

The proposed prudential standard does not discriminate between what are appropriate governance requirements for the head company of a group, which is already required to comply with the ASX corporate governance best practice guidelines, and its wholly owned subsidiaries. Under the proposed standard a wholly owned subsidiary would be required to have a majority of

independent directors and to meet all other APRA governance requirements, duplicating those of the group. That would be cumbersome, expensive and increase the risk of conflicts between the policies of the group and a wholly owned subsidiary. These conflicts would be likely to lead to capital rationing where a majority independent board of a subsidiary acts against the best interests of the group. Such conflicts would be a failure of good corporate governance.

4. What is the annual cost of the regulation or the lost opportunity as a result of it?

The draft prudential standard would require subsidiaries of a group to replicate the full set of governance requirements including having a majority of independent directors on their boards. In the current market fees for independent directors for a life company would be likely to be in the range $70,000 to $120,000 plus costs.

If enough competent directors were available, which is not certain, that would result in the unmanageable situation of groups not being able to ensure that their wholly owned subsidiaries are not in conflict with the policies of the group.

If the draft standard is implemented companies would have the choice of either appointing additional independent directors to their wholly owned subsidiaries or restructuring their subsidiaries' boards.

To avoid the risk of a governance failure with the boards of the group and its wholly owned subsidiary being in conflict, the simplest solution would be to ensure that regulated subsidiaries have identical boards to the group.

However that has a major opportunity cost because it would deny regulated wholly owned subsidiaries the benefit of having a number of executive directors on their boards. These executive directors are the board members with the technical expertise and experience in actually operating the business.

5. Who pays these costs?

Any additional directors' fees would be a direct cost to the company.

The loss of expertise from the board of the regulated entity carries the potential for reduced financial performance and greater risk. This outcome is the opposite of the objective of the regulation.

6. In what way is the regulation unnecessary or unnecessarily complex?

Wallis recommended major reforms in the area of control of regulated entities. Previously the RBA had required a bank to be at the head of any group which included an authorised deposit taking institution, so that it would have the

capacity to regulate group risks, particularly multiple gearing and the potential for a bail out of an unregulated entity to threaten the solvency of an ADI.

The submissions to the Wallis inquiry gave almost unqualified support to the holding company structure as the preferred corporate form for financial conglomerates.[27] Wallis said financial conglomerates were an appropriate commercial response to "regulatory imperfections"[28] because they facilitated regulatory arbitrage, allowing a group to offer products through the entity with the lowest regulatory cost. Wallis recognised that reform in this area could provide dynamic benefits for companies, consumers and regulators:

> *"Provided the corporate structure and regulation are appropriate, this form of arbitrage is constructive rather than destructive, as it maximises benefits for consumers, increases competition and competitiveness of institutions and provides a regulatory incentive to ensure regulatory arrangements are responsive and effective."*[29]

Wallis recommended prudentially regulated entities be permitted to adopt a non-operating holding company structure provided there was legal separation to quarantine the assets and liabilities of the prudentially regulated businesses.[30] One of the safeguards attached to this recommendation was for independent board representation on subsidiary entities, but Wallis did not recommend that independent directors should have a majority on the board of a regulated subsidiary.[31]

7. Could the regulation or its administration be reformed or simplified to reduce the compliance burden?

APRA could either formulate an appropriate prudential standard on regulating groups that would avoid this duplication of governance requirements between groups and their wholly owned subsidiaries or preferably allow the ASX Corporate Governance Best Practice Guidelines to operate as they were intended.

8. Could any alternatives achieve the regulatory objective?

The efficient governance solution to the underlying issue is not reliance on duplication or multiplication of board structures, it is to impose the single prudential requirement that the boards of groups give priority to the solvency of regulated entities where any action by the group could jeopardise it, and that those actions be subject to a similar business judgment rule to that contained in the Companies Act.

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[27] Financial System Inquiry, op cit, page 346
[28] ibid, page 345
[29] ibid, page 345
[30] ibid, page 345
[31] ibid, page 348

(c). DIRECTOR'S DUTIES

1. What is the relevant regulation and the agency that administers it?

APRA's draft corporate governance prudential standard would set limits on the board representation of significant shareholders. These are set out at paragraphs 27 and 28.

Paragraph 27:

> *"Board representation must be consistent with a life company's shareholding. Where a shareholding constitutes not more than 15% of a life company's voting shares there should not be more than one Board member who is an associate of the shareholder where the Board has up to six directors, and not more than two Board members who are associates of the shareholder where the Board has seven or more directors. A director is taken to be an associate of a shareholder for the purposes of this clause, if the director is an "associate" of the shareholder, or the shareholder is an "associate" of the director, according to the definition of "associate" in clause 4 of Schedule 1 of the Financial Sector (Shareholdings) Act 1998. That definition is to be applied for the purposes of this clause as if subparagraph (1)(l) of that definition were omitted."*[32]

Paragraph 28:

> *"Where an individual shareholding is greater than 15%, as approved under the Financial Sector (Shareholdings) Act 1998, the Board representation of that shareholding can be proportional to the actual shareholding, but should not be greater than its proportionate shareholding."*[33]

2. What is the objective of the regulation and does it achieve it?

The objective is to limit the influence of directors associated with major shareholders.

APRA may consider this proposal is also a safeguard against related party transactions.

3. What is the burden placed on business by the regulation?

Wallis proposed general reforms to the limitation on shareholdings in all prudentially regulated entities. Banks had previously been subject to a normal limit of 10%; a limit of 15% authorised by the Treasurer; with any shareholding in excess of 15% requiring authorisation by the Governor General.

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[32] Draft Prudential Standard LPS 510 Governance, APRA, May 2005, pages 6 and 7
[33] ibid, page 7

Wallis set out the reasons for regulating against concentrations of ownership for prudentially regulated entities in the following terms:

> *"Spread of ownership protects institutions against undue influence by a major shareholder and creates a broad interest group in the shareholder base. A dispersed ownership base also protects against a form of contagion risk that may otherwise occur if a financial institution is associated with adverse changes in the fortunes of a major shareholder."*[34]

but noted:

> *"The case is much weaker for insurance companies, which are less susceptible to contagion risks."*[35]

The recommendation which was adopted imposed a limit on shareholdings of 15% for all prudentially regulated entities, with the Treasurer able to approve higher shareholdings in the national interest.

The corporate governance prudential standard cannot operate in isolation from and should not over-ride the principles on which company law is based. The Eggleston Committee[36] set out four principles[37] in relation to acquisition of a substantial interest in a company. These principles are given statutory force at a threshold shareholding of 20%, recognising that control passes with a substantial minority interest.

Wallis made the observation that market discipline contributes to prudent behaviour.[38] One of the most important market disciplines is the threat of takeover of an underperforming company. The legislated limit on shareholdings in entities that are subject to prudential regulation blunts that discipline.

The corporate governance standard needs to accommodate the realities of ownership and control within different structures. An Australian owned and incorporated life company may be a wholly owned subsidiary of a non-operating holding company in which the Treasurer has authorised a shareholding in excess of 20%. In such cases the governance standard needs to recognise where responsibility lies and where decisions are actually made.

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[34] Financial System Inquiry, op cit, page 338

[35] ibid, page 338

[36] Company Law Advisory Committee, Second Interim Report: Disclosure of substantial shareholdings and takeover bids (Canberra: AGPS, 1969)

[37] The shareholders and directors of the company should know the identity of the bidder; the shareholders and directors should have a reasonable time in which to consider the proposal; the shareholders and directors of a company should be supplied with sufficient information to enable them to assess the merits of any proposal; and as far as is practicable, each shareholder should have an equal opportunity to participate in the benefits offered.

[38] Financial System Inquiry, op cit, page 336

4. What is the annual cost of the regulation, or the lost opportunity as a result of it?

The most important national interest reason for the Treasurer to approve a shareholding above the normal 15% limit is to recapitalise a regulated entity that might otherwise fail. Obtaining such recapitalisations in the future will be made much more difficult if APRA's governance requirements restrict the capacity of a shareholder providing the recapitalisation to ensure that a board with appropriate expertise is put in place to implement a new business plan.

Wallis recognised; *"that no system of preventative regulation is perfect in all circumstances, prudential regulation must also deal with the resolution of failure when it does occur."*[39] If the proposed governance standard is not modified with respect to the proposed proportional representation limit on directors, APRA may in future be restricted in dealing with failure to broking mergers with existing institutions. That has implications for further concentration of risk and lessening of competition.

5. Who pays these costs?

To the extent that these governance requirements eventually reduce the intensity of competition within the industry consumers can expect to bear the costs.

6. In what way is the regulation unnecessary or unnecessarily complex?

Representation introduces an unfortunate dynamic into board decision making with some directors voting on behalf of some external interest rather than in the interests of the company. Good corporate governance is achieved by encouraging collegiate board decision making, not by limiting the selection of directors, using a negative test as to whether they are representing a major shareholder.

7. Could the regulation or its administration be reformed or simplified to reduce the compliance burden?

The ASX corporate governance guidelines provide the appropriate balance on the composition of boards, for a majority of independent directors and an independent chairman. This provides a safeguard in decision making, not only against related party interests but also against insular thinking.

If the real regulatory concern is related party transactions that might affect the solvency of a regulated entity, then there are appropriate civil and criminal remedies available for dealing with that. APRA would be better focused dealing with those issues directly than assuming that they can make any material difference to the level of risk with a prescriptive set of governance

[39] Financial System Inquiry, op cit, page 300

arrangements. Persons operating dishonestly with criminal intent are not likely to be impeded by additional governance requirements.

All regulators need to be aware of and vigilant against the risks that will arise from time to time as a result of associated interests in companies, however the proper remedies do not include proportional representation which would tend to institutionalise the problem.

8. Could any alternatives achieve the regulatory objective?

From time to time there will be a tension on boards between the interests of associates and the interests of the company. The Companies Act puts the onus on directors to resolve that tension in the company's favour. The APRA proposal is unnecessary.

9. Which other government regulations does it duplicate?

It is difficult to construe APRA's proportional representation rule, which is proposed in paragraph 28, in any other way than that it accepts that a substantial role of directors who are associates of a major shareholder is to represent the interests of that shareholder.

Having a regulator accept the concept of representation produces a conflict with a basic principle of company law. Under the Companies Act, directors who are associates of shareholders with a substantial interest are - like all directors - legally obliged to discharge their duties *"in good faith and in the best interests of the corporation."*[40] Breaches of this provision would render a director liable to civil litigation and criminal prosecution. Similarly, the ASX Corporate Governance Guidelines note that: *"All directors should bring an independent judgement to bear in decision making."*[41]

10. Have there been attempts to address this duplication in the past?

This conflict of regulations has not arisen in the past.

11. What might be the solutions to this duplication?

APRA should not seek to modify the operation of the ASX Corporate Governance Best Practice Guidelines. APRA should rely on the Companies Act to require directors to act in the best interests of the company, which would include protecting policy holders.

(d). REVIEW OF BOARD AND SENIOR MANAGEMENT PERFORMANCE

1. What is the relevant regulation and the agency that administers it?

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[40] Companies Act Section 181(1)(a)

[41] ASX Corporate Governance Council, Principles of Corporate Governance and Best Practice Guidelines, March 2005, page 20

The draft governance standard would require the board of a life company to have in place procedures to assess its own performance and the performance of individual directors and senior managers and to make those assessments available to APRA.

2. What is the objective of the regulation and does it achieve it?

To assure the performance of boards and senior managers and to provide for monitoring by APRA.

3. What is the burden placed on business by the regulation?

The ASX guidelines require assessments of directors' and senior management's performance but do not require that they be disclosed to any third party. Access to these reports should be strictly confined to those making them and those using them for the purpose for which they were intended. The prospect of wider disclosure of the evaluations of individuals, whether of directors or management, would inevitably compromise the value of the reports. The capacity to comment negatively on an individual would be constrained by the risks of potential litigation as reports passed to third parties would attract no privilege.

To be of any value in their primary purpose, which is to enhance performance, the reports necessarily need to point to areas where directors have deficiencies or could improve their performance. If they were published in any form there is too fine a line between reasonable criticism and adverse comment which would require a director to resign, even if only to protect him or herself from becoming a lightening rod for litigation in the context of some unrelated adverse event.

Another unintended consequence is the likelihood that in the event of a claim, director's liability insurers would regard adverse elements of an evaluation as material facts that should have been disclosed to them as insurer, providing a ground to avoid their liability.

4. What is the annual cost of the regulation or the lost opportunity as a result of it?

Undoubtedly some highly regarded existing directors would not be prepared to entrust their reputations to such an inexact process and it would become a significant impediment to attracting quality directors to serve on the boards of APRA regulated entities. The duties and personal risks, both financial and to reputation, attached to being a director are already causing many people to opt for private rather than public company directorships. For these reasons this additional layer of governance requirements may well have the reverse effect of what is intended and reduce the quality of directors available for regulated entities.

The effect of APRA's intention to scrutinise the day to day functioning of boards will inevitably result in directors becoming increasingly risk averse, or the only qualified people willing to serve on the boards of prudentially regulated companies being the most risk averse. The more intrusive scrutiny becomes the more likely it is that commercial decisions will be influenced not by their substance but by how they may be perceived by the regulator or construed by third parties in litigation.

Development of an excessively risk averse decision making environment will result in a deterioration in the financial performance of regulated entities.

5. Who pays these costs?

Excessively risk averse decision making will affect the profitability and growth of regulated entities and reduce the value proposition offered consumers of regulated products.

6. In what way is the regulation unnecessary or unnecessarily complex?

The negative implications of access to board and management performance evaluations to APRA outweigh any possible contribution that access would provide to the process of prudential supervision.

7. Could the regulation or its administration be reformed or simplified to reduce the compliance burden?

It should be adequate to rely on principle 8 of the ASX Corporate Governance Guidelines which recommends that companies *"Disclose the process for performance evaluation of the board, its committees and individual directors, and key executives."*[42] These reviews should be done regularly against both measurable and qualitative indicators with the nomination committee taking responsibility for evaluating the board's performance. The ASX guidelines provide the following reporting requirements:

- *"Whether a performance evaluation for the board and its members has taken place in the reporting period and how it was conducted"*[43] must be included in the corporate governance section of the annual report together with an explanation of any departure from the best practice recommendation; and
- *"A description of the process for performance evaluation of the board, its committees and individual directors, and key executives"*[44] should be made publicly available, ideally by posting it on the company's website.

Westpac is an institution that is subject to prudential regulation and has for some years given governance issues a major focus. The description it has

[42] ASX, op cit, page 47
[43] ibid, page 49
[44] ibid, page 49

published on its website of its process for reviewing board performance provides a useful example of the application of the ASX corporate governance guidelines:

> *"The Board reviews its own performance and that of the Board Committees annually. This is to ensure that the Board and Board Committees are working effectively.*
>
> *The performance of Non-executive Directors (including the Chairman) is subject to annual peer and executive management review. These reviews are wide-ranging and include, amongst other things, the Director's contributions to Board discussions.*
>
> *Also the Board has delegated to the Chairman of the Audit Committee the responsibility for reviewing the results of the annual performance review of the Board Chairman. Following this review, the Chairman of the Audit Committee reports to the Board without the Board Chairman being present.*
>
> *The performance review process is facilitated externally and includes written surveys of Directors, Group executives and the Group Secretary & General Counsel. The survey results are independently collated and the Chairman formally discusses the results with individual Directors and Committee chairs."*[45]

8. Could any alternatives achieve the regulatory objective?

If APRA's objective is to monitor the processes adopted by regulated entities for evaluating the performance of directors and managers, relevant information is publicly available and if necessary could be elaborated on by companies at APRA's request.

9. Which other government regulations does it duplicate?

Principle 8 of the ASX Corporate Governance Best Practice Guidelines.

10. Have there been attempts to address this duplication in the past?

This duplication has not arisen in the past,

11. What might be the solutions to this duplication?

Rely on Principle 8 of the ASX Corporate Governance Best Practice Guidelines.

[45] http://www.westpac.com.au/internet/publish.nsf/Content/ARCGBD+Board+performa...

(e) BOARD RENEWAL

1. What is the relevant regulation and the agency that administers it?

APRA's draft prudential standard requires at paragraph 77 that:

> *"The Board of a life company have in place a formal policy on Board renewal. This policy must provide details of how the Board intends to renew itself, in order to ensure it remains open to new ideas and independent thinking, while retaining adequate expertise. The life company must be able to demonstrate to APRA application of this policy. The life company must provide details of the policy to APRA if requested to do so."*[46]

2. What is the objective of the regulation and does it achieve it?

This requirement focuses exclusively on the question of renewal, ignoring the more critical question of ensuring that current members of the board possess the necessary and desirable range of competencies for the particular company.

3. What is the burden placed on business by the regulation?

The requirement for a company to make specific succession plans available to APRA carries with it similar risks as providing performance reports on directors to third parties. To be of practical use the reports would need to point to areas where directors have deficiencies or where their contribution is limited.

If they were published in any form there is too fine a line between reasonable criticism and adverse comment which would require a director to resign, even if only to protect him or herself from becoming a lightening rod for litigation in the context of some unrelated adverse event.

Another unintended consequence is the likelihood that in the event of a claim, director's liability insurers would regard adverse elements of an evaluation as material facts that should have been disclosed to them as insurer, providing a ground to avoid their liability.

The renewal plan requirement would be open to abuse by a domineering Chairman or group of directors who could use it to undermine the independence of a director who expressed dissenting views.

4. What is the annual cost of the regulation or the lost opportunity as a result of it?

Unusual governance requirements like APRA's renewal requirements are likely to be a factor discouraging qualified persons choosing to accept

[46] Draft Prudential Standard LPS 510, op cit, page 14

directorships on regulated entities. The opportunity cost of well qualified persons not being willing to serve on the boards of regulated entities is reduced financial performance and safety of regulated entities.

5. Who pays these costs?

The financial costs and risks will be borne by shareholders and policy holders.

6. In what way is the regulation unnecessary or unnecessarily complex?

The ASX Corporate Governance Guidelines deal more effectively with these issues requiring that the board establish a nomination committee consisting of at least three directors, the majority being independent and chaired by either the chairman or an independent director. The responsibilities of the nomination committee include:

- Assessment of the necessary and desirable competencies of board members;
- Review of board succession plans;
- Evaluation of the board's performance; and
- Recommending the appointment and removal of directors.[47]

The essence of succession planning is *"to maintain an appropriate balance of skills, experience and expertise on the board."*[48] In this context specific board renewal plans are unnecessary.

The renewal plan proposal is completely unproductive for companies with recently appointed boards. For example, all Challenger directors were appointed in either 2003 or 2004.

7. Could the regulation or its administration be reformed or simplified to reduce the compliance burden?

There should be no disclosure to APRA of nomination committee deliberations, assessments or plans.

8. Could any alternatives achieve the regulatory objective?

A better balanced approach to ensuring the quality of boards is to rely on the ASX guidelines.

9. Which other government regulations does it duplicate?

The proposal duplicates the ASX corporate governance guidelines.

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[47] ASX, op cit, page 22
[48] ibid, page 22

10. Have there been attempts to address this duplication in the past?

This duplication has not arisen in the past.

11. What might be the solutions to this duplication?

In this area APRA should rely on the ASX Corporate Governance Best Practice Guidelines.

(f) DIRECTOR'S DOMICILE

1. What is the relevant regulation and the agency that administers it?

Paragraph 25 of APRA's governance standard will require that foreign-owned but Australian incorporated life companies have at least two directors who are not foreign residents, at least one of whom must be independent.[49]

Paragraph 24 requires that a majority of the directors of an Australian owned life company be Australian residents.[50]

2. What is the objective of the regulation and does it achieve it?

Paragraph 25 requires the board of a foreign-owned but Australian incorporated life company to have a specified local presence. It is not clear whether this is an end in itself or for the purpose of APRA having readily available contact at board level.

Paragraph 24 seems to have as its objective maintaining Australian resident control of Australian owned regulated entities.

3. What is the burden placed on business by the regulation?

These are completely unnecessary restrictions on board memberships both for foreign owned companies and Australian owned companies, particularly as the latter expand their activities offshore.

4. What is the annual cost of the regulation or the lost opportunity as a result of it?

These requirements are an unnecessary restriction on the field of available candidates for directorships on the boards of regulated entities.

[49] Draft Prudential Standard LPS 510, op cit, page 6
[50] ibid, page 6

5. Who pays these costs?

To the limited extent that it has any impact it is likely to have a negative effect on the composition of boards with some adverse effect on financial performance and the level of risk.

6. In what way is the regulation unnecessary or unnecessarily complex?

It is difficult to justify the presence of the requirement in paragraph 25 in a prudential standard. It is something more likely to appear (and quite probably later disappear) as a condition of comfort in a foreign investment approval for a takeover.

Paragraph 24 is an unusual piece of public policy which effectively creates a negative foreign control test to ensure the Australianness of an Australian company.

7. Could the regulation or its administration be reformed or simplified to reduce the compliance burden?

The requirements should be deleted as they have no relevance to prudential supervision.

8. Could any alternatives achieve the regulatory objective?

Local day to day contact between APRA and a regulated foreign owned entity that is incorporated in Australia should be through a responsible officer not necessarily at board level.

9. Which other government regulations does it duplicate?

Imposing these requirements duplicates the role of the Foreign Acquisitions and Takeovers Act.

10. Have there been attempts to address this duplication in the past?

This duplication has not arisen in the past.

11. What might be the solutions to this duplication?

These issues should be left with the Foreign Investment Review Board and the Treasurer, where they belong.

FIT AND PROPER REQUIREMENTS

(a) FIT AND PROPER TEST INADEQUATELY CONTROLLED

1. What is the relevant regulation and the agency that administers it?

4. What is the annual cost of the regulation or the lost opportunity as a result of it?

The costs are only likely to occur infrequently but be significant in terms of management time, legal advice and litigation.

5. Who pays these costs?

These are direct costs for the regulated entity.

6. In what way is the regulation unnecessary or unnecessarily complex?

Regulated entities are being told to rely on a prudential standard which is a legislative instrument, to prevail over statute law in the event of litigation. This introduces a significant level of uncertainty into the process.

7. Could the regulation or its administration be reformed or simplified to reduce the compliance burden?

No.

8. Could any alternatives achieve the regulatory objective?

This is a complex area which is beyond the scope of a prudential standard to resolve. Providing the necessary safeguards for whistleblowers and those who they make allegations against is a matter better dealt with by legislation.

9. Which other government regulations does it duplicate?

There is no duplication with other regulation.

10. Have there been attempts to address this duplication in the past?

Not applicable.

11. What might be the solutions to this duplication?

Not applicable.

CONCLUSION

Capital Standards

APRA and the Life Insurance Actuarial Standards Board have produced a final draft of revised capital standards for life insurance. This follows a lengthy process of reviewing capital standards for ADI's to bring them into line with the requirements of Basle II.

The review of life insurance capital standards has been undertaken without regard to the unimplemented recommendations of the Wallis Inquiry:

- to balance financial safety and efficiency, and preserve a spectrum of market risk and return choices for retail investors, meeting their differing needs and preferences; and
- to provide, as far as is practicable, neutral treatment of life products compared with similar deposit and other investment and risk products, to minimise the opportunities for regulatory arbitrage between life company investment and deposit taking institutions.

Life insurance continues to be regulated under legislation that predates the Wallis Inquiry. The current review of capital standards is highly problematic and will result in increased capital requirements substantially above economic need. The consequence of excessive capital requirements is low returns which will drive consumers into products that provide no guarantees, effectively defeating the purpose of the regulation.

The relative performance of life products should not be a matter of indifference to either the regulator or government. Financial products which provide a secure retirement income stream need to be as attractive as possible if they are to compete against the higher but riskier returns of products which are not prudentially regulated. Establishing capital standards that do not result in inefficient use of capital and low returns on guaranteed products should therefore be a priority for prudential regulation and retirement incomes policy.

The Regulation Taskforce should recommend a process for setting capital standards for life companies which is consistent with the treatment of ADI's under Basle II including allowing life companies to determine actual economic capital requirements on the basis of an internal model.

Governance

The draft prudential standard on corporate governance is an object lesson in the need to avoid duplication between regulators. The suggestion that a set of requirements that are appropriate for all companies listed on the Australian Stock Exchange are somehow inadequate for prudentially supervised entities is hard to justify, particularly when most of the proposed mandatory requirements do not relate directly to prudential issues.

The principle that should be adopted is that regulation should be closely controlled so that each regulator recognises the authority and jurisdiction of the others in their areas of responsibility and does not introduce overlapping requirements. For example APRA should not be generating its own general corporate governance requirements or its own foreign investment requirements.

Any governance requirements generated by APRA should relate directly to prudential issues such as the independence of actuaries and the responsibility of directors and management to protect the interests of policy holders.

General requirements for good governance should remain with the ASX.

In the case of foreign owned or controlled entities it should be possible for there to be recognition of the competence of foreign securities regulators.

Fit and Proper

APRA's draft prudential standard on fit and proper is drawn too widely. APRA could use its fit and proper power to disqualify a responsible officer or director where it takes issue with an operational or investment decision or the appointment of a director or responsible officer.

The possibility that APRA could use its fit and proper power where it disputes a management or board decision will result in an excessive focus on how decisions will be perceived by the regulator rather than on their actual merits. The consequence of that type of regulatory environment will be excessively risk averse decision making.

If APRA feels it necessary to take issue with a management or board decision it should do so by way of enforceable undertaking. By using enforceable undertakings rather than the implied threat of use of the fit and proper power there would be proper transparency that the regulator and not management are responsible for the relevant decision.

The power to disqualify a responsible officer or director as not fit and proper is an extreme sanction. It would therefore be appropriate to control its use within a legislative framework confining the circumstances in which it could be applied to ensuring that responsible officers and directors:

- are appropriately qualified, skilled and capable;
- act diligently and with due care; and
- act honestly and with integrity.

The legislation should also set out the powers, obligations and processes for regulators and regulated entities applying fit and proper requirements.

8 December 2005