CHARTERED SECRETARIES
AUSTRALIA

Leaders in governance

12 August 2005

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Dear Mr Brunner

Governance for APRA-regulated institutions

Chartered Secretaries Australia (CSA) welcomes the opportunity to comment on the draft governance prudential standards and the discussion paper released by the Australian Prudential Regulatory Authority (APRA) in May 2005.

CSA is Australia's peak membership body for governance professionals, and considers itself fully qualified to respond to these matters. In Australia, CSA has over 8,500 members and affiliates representing the majority of public companies listed on the Australian Stock Exchange (ASX) and many unlisted companies. These include the major authorised deposit-taking institutions (ADIs), as well as general insurers, life insurers and authorised non-operating holding companies (NOHCs), superannuation trustees and fund managers.

Members of CSA have a thorough working knowledge of applied governance, including board composition and renewal, director and auditor independence, and committee composition and are frequently charged with the responsibility of advising boards on these matters.

In respect of the draft governance prudential standards, CSA comments as follows:

Section 1: General matters of concern

This section deals with a number of general matters of concern raised by the draft standards. In particular, CSA is concerned with the impact of the draft standards on smaller, unlisted companies.

The costs for smaller, unlisted companies

CSA notes that, while large APRA-regulated entities have compliance departments, smaller companies do not have such resources. They will, therefore, be forced to bring in external advisers to instigate the compliance process and to maintain it, or an internal resource will be seconded, placing a burden on operations. This will place unreasonable costs on smaller companies.

The mandatory structure is more likely to result in lower governance standards. For example, smaller companies may not have the funds available to meet the high cost of very experienced non-executive directors and, therefore, may have no choice but to appoint persons with little or no experience (and no proven ability).

Timeframe for implementation

CSA strongly recommends that APRA implement governance standards in the most efficacious manner, especially in consideration of the issue of costs to smaller companies. CSA is of the opinion that asking entities to be compliant with these standards by the first balance date falling after January 2006 is unreasonable as this could leave as little as six months for implementation. CSA recommends that a facility be put in place to allow companies to seek an extension of time where appropriate so as to allow smaller companies to set up the processes and management of implementation in a manner that will not unduly affect profits.

Carve-outs

CSA notes in the discussion paper that APRA believes that it is appropriate to require APRA-regulated institutions to put in place minimum governance standards, and that these proposed standards are 'at the firmer end of the governance spectrum that companies incorporated in Australia are expected to meet'. CSA notes that APRA regulates entities other than large listed companies that are not subject to existing governance standards and legislation in the same manner as are large listed companies. CSA encourages APRA to consider carve-outs for those large listed entities that are already adequately regulated, to avoid repetition and duplication of compliance, with the attendant spiralling costs that work against the effective creation of wealth.

The approach to monitoring and enforcement of the standards

CSA suggests that APRA clarify that the standards are preventative in their approach to good governance, rather than punitive.

CSA also notes that further guidance is required from APRA on whether there will be an appeals process, and what sanctions are likely to be invoked. Furthermore, how will the supervisory processes take place? As a matter of accountability and transparency, APRA needs to release further information as to how the monitoring and enforcement processes will be resourced and undertaken.

CSA also notes that APRA is unlikely to wish entities to be phoning them on a constant basis seeking further clarification of the standards and their imposition. APRA needs to clarify the proper avenues of communication for entities seeking to contact APRA in relation to the standards.

Section 2

This section deals with the key requirements as outlined in the draft governance prudential standards.

Independence of directors

We strongly support the role that director independence plays in ensuring good governance. We do note, however, that:

a) APRA-regulated subsidiaries in a corporate group where the parent company is also APRA-regulated

CSA supports the appointment of a majority of non-executive directors. However, it notes that, while board members and senior managers of the parent company are eligible to act as non-executive directors, finding a suitable pool of individuals to serve as independent directors may prove difficult when teamed with the draft requirement to have an independent chairman and, in particular, to have an independent financial expert on these regulated subsidiary boards.

While APRA has suggested that independent directors from the parent company board may serve as independent directors on these subsidiary boards, the issue of whether they will have sufficient time to properly carry out that role will inevitably arise, given that any independent director serving on those boards will almost undoubtedly also need to serve on that company's audit committee. Introducing a requirement for an individual financial expert to serve on the boards of these subsidiaries will only further narrow the pool of suitable candidates.

CSA also considers that it would be onerous to require a company of up to seven directors to appoint what are, in effect, three independent directors (including the independent chairman). Four independent directors are required on boards with more than seven directors. This over-emphasis on independence may dilute the quality of specific industry expertise on boards. Rather than the current proposed approach, we would suggest that the majority of directors on the board of an APRA-regulated subsidiary should be non-executive, with only one independent member plus the chairman required to sit on the board. The chairman and financial expert could then be selected from both the non-executive and independent elements of the board.

CSA notes that the draft standards comment on an APRA-regulated holding company, or indeed any APRA-regulated and non-APRA-regulated entities within a group, making decisions that are not in the best interests of other APRA-regulated entities within a group. CSA believes it is important to clarify that, in practice, the activities of many subsidiaries exist to benefit their holding company. The current drafting of the standards raise questions as to what a subsidiary can do when it is seeking to assist the holding company to its own detriment, which is amplified when the holding company is overseas. For example, can a holding company withdraw cash from a subsidiary if APRA believes it is to the detriment of the subsidiary? Capital adequacy ratios could be affected and CSA believes APRA needs to provide guidance on what constitutes 'detriment'. In addition, given that in most cases a majority of independent directors will be required on the subsidiary board and APRA's requirement that their duty to the company overrides any section in the constitution that permits them to act in the interests of the parent or the group, conflicts could regularly arise if the independent directors of the parent company are the ones on the board of the regulated subsidiary, leaving the board without a quorum to act.

CSA is also concerned that the APRA governance standards specify that an APRA-regulated entity will not be able to engage in the activities stated above even if an entity's constitution expressly authorises the board or individual directors to act in the interests of another group member. This may lead to confusion for a director of a wholly-owned subsidiary as to what authority they should follow, that is, the APRA governance standards, the constitution or the *Corporations Act*, to ensure they are acting in the best interests of the holding company or in the best interests of the subsidiary itself.

b) for smaller organisations, being able to sustain the costs of establishing boards of independent non-executive directors could place unreasonable levels of financial strain on them.

See our earlier comments for the potential for inexperienced or less experienced directors to be appointed to the boards of smaller companies in order to ameliorate this financial strain, with an attendant lowering of governance standards resulting from this mandatory structure.

Chairman of the board

CSA notes that smaller, unlisted companies will need to appoint independent, non-executive chairmen, who will expect to be paid more, given their heightened liability. This imposes additional costs on smaller, unlisted entities.

Board composition

CSA refers to our comments on independence in the earlier section of this submission.

Board member resignations

Unlike ASIC, standard forms are not available for all APRA-regulated entities to allow notification of appointments and resignations. If a formal notification regime is to be implemented, the infrastructure may need to be put in place to align with the relevant legislation for each industry sector.

Length of tenure

CSA agrees with APRA's stance that the length of tenure of independent directors should not be prescribed. No respected evidence has been discovered that supports the argument that the longer a director stays on a board, the less independent they are. Independence is a matter of fact, based on all the circumstances in each individual case.

Board audit and risk committees

CSA notes that smaller, unlisted companies will need to appoint independent, non-executive chairmen of such committees, who will expect to be paid more, given their heightened liability. Smaller companies will find the cost of such appointments difficult to manage. It would be more financially manageable for smaller companies to combine the audit and risk committees. APRA notes that 'special circumstances' will be attended to, but CSA notes that further guidance is required as to whether smaller companies will need APRA approval for any decisions they take on these matters. CSA strongly recommends that the standards emulate the 'if not why not' approach of the ASX Corporate Governance Council guidelines, and encourage entities to have two committees, but do not prescribe it.

CSA would also question the need for the draft provision that some members of the audit committee have 'expertise in the industry', given the requirement to have an individual with financial expertise on the board. Having a 'financial expert' on the audit committee already achieves APRA's objective of being at the firmer end of the governance spectrum.

CSA also notes that, if the proposals stand, further guidance is required as to what constitutes both 'expertise in the industry' and 'financial literacy'.

Board and senior management performance

CSA notes that there are many ways in which board, board committee and individual director assessments are carried out and that a definition of 'adequacy' would be of assistance for smaller companies when first instituting this process. It may be also that external advice will be required to implement a procedure which would lead to extra costs for smaller companies.

We are also concerned with the requirement for boards to assess the performance of senior managers. It is unclear whether the board itself is required to assess senior managers or, indeed, whether the CEO and chairman alone should deal with this procedure, with final results being presented to the board. In addition, if assessment of the performance of senior managers is to work, CSA notes that, for many boards, it is practical only to assess the performance of the highest level of senior manager (usually the direct reports of the CEO). In addition, we would question whether there should be a requirement for APRA-regulated subsidiaries to assess the performance of their senior managers, as they would be managers of the group rather than senior managers of the regulated subsidiary.

CSA also considers that it would be inappropriate for the regulator to require inspection of assessments of individual directors due to privacy concerns.

Independence of external auditors and actuaries

Auditors have specific independence requirements laid out in the *Corporations Act* and an Auditing Standard on independence. CSA does not support duplicating any rules relating to them.

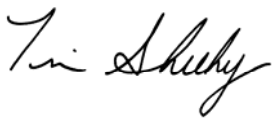
Internal audit

In very small companies, it would be rare to have someone dedicated to being an 'internal auditor', whether it be a full-time or part-time position. For this reason, small companies rely heavily on external auditors. Having to dedicate staff resources to an internal audit function would impose additional costs on small companies. Furthermore, there is a query as to whether there would be sufficient work to sustain such a dedicated resource. A level of assurance appropriate to smaller companies can be gained through processes and procedures, without the need to appoint an additional person.

Conclusion

In preparing this submission, CSA has drawn on the expertise of the members of its two internal national policy committees. We would welcome the opportunity to meet with you to discuss any of our views in greater detail. Please call me if you would like to set up a meeting. I can also arrange a meeting with our members.

Yours faithfully



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