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Phase 2 of the Reserve Bank Act Review
The Treasury
Wellington

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Submission on Phase 2 of the Reserve Bank Act Review – Consultation 3

The Institute of Directors (IoD) appreciates the opportunity to comment on the consultation document (March 2020) regarding the Reserve Bank Act Review aimed at safeguarding the future of New Zealand's financial system.

Phase 2 is a broad review of the Reserve Bank's governance and accountability framework and its financial regulatory powers. The consultation document is focused on the prudential framework for deposit takers and depositor protection. The IoD has submitted on the earlier rounds of consultation within Phase 2.

Our submission focuses on governance-related issues raised in the consultation document and, in particular, proposals affecting the accountability and liability of directors. Notwithstanding our feedback here, the IoD may make further comments as the review progresses.

Summary

The IoD has serious concerns about the proposed new director duties and does not support them in their current form. We are particularly concerned about the lack of clarity and certainty around the interaction between the new proposed duties and director duties under the Companies Act. It is vital that directors are clear about their core duties and how to discharge them. Clarity and certainty is needed at the outset, rather than leaving this to the courts. We have also highlighted a number of other issues with the proposed duties that would need to change. It is critical that there are also appropriate mechanisms to protect honest and diligent directors and these should align with those in the Financial Markets Conduct Act 2013 (i.e. due diligence defences).

We strongly oppose the proposed prohibition on indemnities and insurance in relation to the new positive duties. There should not be restrictions on indemnities and insurance in circumstances where there hasn't been deliberate wrongdoing or similar behaviour.

About the Institute of Directors

The IoD is New Zealand's pre-eminent organisation for directors and is at the heart of the governance community. We believe in the power of governance to create a strong, fair and sustainable future powered by best practice governance.

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Our role is to drive excellence and high standards in governance. We support and equip our members who lead a range of organisations from listed companies, large private organisations, state and public sector entities, small and medium enterprises, not-for-profit organisations and charities. Many of our members serve on boards of entities regulated by the Reserve Bank.

Our Chartered Membership pathway aims to raise the bar for director professionalism in New Zealand, including through continuing professional development requirements.

The IoD's Code of Practice for Directors provides guidance to directors to assist them in carrying out their duties and responsibilities with high professional standards. All IoD members sign up to the Code.

Background

The consultation document seeks views on the next steps in Phase 2 of the Review of the Reserve Bank of New Zealand Act 1989.

Phase 1, completed in 2018, focused on modernising the Reserve Bank's monetary policy framework. Phase 2 is a broad review of the Reserve Bank's governance and accountability framework and its financial regulatory powers.

In December 2019, after two rounds of public consultation, Cabinet made a series of in-principle decisions, including to progress Phase 2 through two pieces of legislation - the "Institutional Act", and the "Deposit Takers Act" (replacing the Reserve Bank of New Zealand Act).

The consultation document focuses on the Deposit Takers Act, which will provide for a new prudential regulatory regime for deposit takers and introduce a deposit insurance scheme, which will insure deposits up to $50,000. Cabinet has also made in-principle decisions including:

- to increase the accountability of deposit takers' directors by imposing various positive duties upon them, with civil pecuniary (monetary) penalties as the primary redress. This "strengthened director accountability" regime is designed to improve the status quo by sharpening the incentives for directors to manage risk.
- to ask officials to develop an "executive accountability regime" that extends the individual accountability framework beyond directors to senior employees (i.e. senior executives). This regime will apply to deposit takers and insurers, and cover both prudential and conduct matters.

IoD comments

Our submission is mainly focused on Chapter 5 (Liability and accountability) of the consultation document. The chapter discusses the proposed approach to liability for deposit takers (entities and directors) in relation to breaches of the Deposit Takers Act and breaches of prudential standards made under the Act, including the appropriate split between civil and criminal liability. Key elements of the proposal to strengthen the accountability framework for deposit takers' directors

are:

- a decoupling of key director responsibilities from disclosure requirements and the attestation process through the creation of new high-level director duties that will apply in an ongoing manner. These duties would be applied through a "positive accountability framework" in which directors would take certain actions separate from the regulated entity, such as "reasonable steps" to ensure the entity is run in a prudent manner.
- a shift in the individual liability framework, away from criminal penalties as the primary redress towards civil penalties (with criminal penalties reserved for very serious cases of recklessness or intent).

The proposed director accountability regime is set out in the following table from the consultation document:

	Status quo	Strengthened director accountability regime
Focus of accountability	§ Board directors of registered banks	§ Board directors of all licensed deposit takers
Suitability checks	§ Fit and proper framework implemented through secondary legislation	§ Framework for fit and proper requirements outlined in primary legislation, detail provided for in a prudential standard (see Chapter 4)
Obligations	§ Generic obligations on directors under the Companies Act 1993 § Specific attestation requirements tied to signing of disclosure statements	§ Positive duties imposed on directors (in addition to existing duties) § These duties supported by clarification/guidance from the Reserve Bank
Sanctions	§ Criminal sanctions on directors for contraventions of attestation requirements § Applicants for director (and senior executive) positions may be rejected on basis of fitness and propriety (note the Reserve Bank cannot remove directors on fit and proper grounds once appointed)	§ Civil sanctions on directors who fail to meet obligations (criminal penalties in very serious cases) § Removal of a director (or senior executive) by the Reserve Bank, once appointed, where they do not meet fit and proper requirements

Our comments are divided into the following sections:

1. General Comments;
2. Criminal and civil liability;
3. Director accountability - proposed duties and obligations;
4. Director accountability - indemnities and insurance;
5. Executive accountability;
6. Deemed director liability;
7. Penalties; and
8. "Fit and proper" person assessment.

1. General comments

As noted in our earlier submissions, it is critical that any additional regulation of New Zealand's financial services sector is a proportionate response to issues arising here and designed to augment the existing framework. New Zealand's current system of prudential regulation is internationally respected and, in the main, operating effectively. It has not experienced some of the issues motivating change overseas and that should be reflected in the nature and extent of any strengthening measures.

One of the key threats identified by Deloitte in its (generally positive) assessment of the current system was the reliance on high quality directors.[1] New Zealand already has a small pool of suitably qualified candidates. Increasing responsibilities and liability on directors may deter well qualified directors from seeking appointments with deposit takers. Our 2019 Director Sentiment Survey found that the scope of director responsibilities is more likely to deter directors from taking on governance roles now than 12 months ago (40%, up from 33% in 2018).

Director personal liability should be used sparingly, as suggested by directors in the Productivity Commission's report New Zealand boards and frontier firms (supported by the IoD):

> "Policy makers should be aware that any increase in regulatory compliance burden can compromise these objectives by crowding out time and resource that could be spent on growing and developing the company. This is particularly the case for director liability, which should be used sparingly. While directors generally accept that liability for organisational health and safety appropriately rests with boards, some responsibilities would be better placed with management, who are more likely to have the knowledge and levers to manage the risks."

We also note that the impact of increased director liability adds to boards' growing regulatory burden and means they can spend disproportionally more time on compliance rather than strategy and performance – a core part of the board's role. We know directors are already struggling under the weight of compliance, especially in the financial sector. In the 2019 Director Sentiment Survey, 80% of directors said they spent more time on compliance related activities than in the previous year (up from 71% in 2018).

2. Criminal and civil liability

In principle, the IoD supports an approach which reserves criminal sanctions for intentional wrongdoing or recklessness on the part of the individual.

Civil sanctions in our view would be the more appropriate for breaches of prudential standards. However, we consider that individual directors should not be accountable for breaches of prudential standards, other than to the extent it can be proved that they have breached one of the new proposed duties for directors (discussed below).

Regulatory sanctions imposed on individuals will have significant reputational consequences.

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[1] Deloitte, *Reserve Bank of New Zealand Review of the bank directors' Attestation Regime*, August 2017

The risk of overusing such sanctions can drive risk aversion at board level and an exaggerated compliance culture.

3. Director accountability – proposed duties and obligations

The proposed new duties for directors are:

- to act with honesty and integrity, and with due skill, care and diligence;
- to deal with the Reserve Bank in an open and honest manner; and
- to take reasonable steps to ensure that the deposit taker is being run in a prudent manner.

It appears from the consultation document that directors of all licensed deposit takers would be subject to these duties.

The consultation document states that the duties (as outlined above) would be owed to the Reserve Bank (acting on behalf of society at large). It also states that the new duties "are obligations owed to society as interpreted by the Reserve Bank in its role as a prudential regulator with a statutory objective to protect and promote financial stability."

In relation to the interaction of the new proposed duties with director duties under the Companies Act, the consultation document acknowledges that "It is possible that the interface between the two regimes will create uncertainty and a lack of clarity, and a court will have to reach an interpretation in the case of legal challenge."

The IoD has serious concerns about the proposed new duties and does not support them in their current form. It is important that the legislation explicitly states that the director duties are owed to the Reserve Bank. If they were owed to society, this would be a fundamental shift and one that should be underpinned by robust analysis and subject to meaningful debate. We are also particularly concerned about the lack of clarity and certainty around the interaction between the new proposed duties and director duties under the Companies Act. It is vital that directors are clear about their core duties and how to discharge them. Leaving matters to the courts to determine does not help directors discharge their duties. Clarity and certainty is needed at the outset.

As noted above, there is a real risk of boards being weighed down by compliance and this is especially the case for smaller entities in the financial sector.

The other jurisdictions referred to in the consultation document have encountered issues with their financial and prudential framework not evident in New Zealand. In that context, it is difficult to see why broader or more onerous duties would be justified here. It is essential that any new duties are appropriately calibrated to the New Zealand context.

Other issues with the proposed new duties that would need to be addressed include:

- the concepts of honesty and due care are quite distinct (a failure of the latter involves no intent). If both are necessary, it is critical that they are separate duties.
- a duty to deal with the Reserve Bank in an open and honest manner is, effectively, a subset of a duty to act with honesty and integrity. There should be one duty, expressed to apply "in respect of all obligations under the Act" or similar.

- a duty to take reasonable steps to ensure a business is "run in a prudent manner" is broader than those of other jurisdictions and overlaps with a duty to exercise skill, care and diligence (which also overlaps with existing duties under the Companies Act 1993). It may be more useful, having regard to any future executive accountability regime, for that duty to refer to the business being "controlled effectively" (similar to the UK).

It is critical that there are appropriate mechanisms to protect honest and diligent directors. To the extent possible, we consider that the approach to liability should align with the Financial Markets Conduct Act 2013. This includes ensuring that there are clear defences such as taking reasonable steps to prevent breaching director duties (i.e. "due diligence" defences). Guidance will also be vital for directors.

The consultation document considers it may be necessary "to verify directors are meeting these obligations" (to comply with the new duties) and the potential reporting of board minutes and 'other relevant information'." We are particularly concerned about the potential regulatory overreach by requiring regular disclosure of minutes of board meetings to the Reserve Bank. This could also have unintended consequences such as inhibiting open discussion in board meetings.

4. Director accountability – indemnities and insurance

The consultation document proposes that directors should not be able to be indemnified or insured against personal financial loss arising from breaching the new positive duties or unsuccessful defences of criminal proceedings generally.

We strongly oppose the prohibition on indemnities and insurance in relation to the new positive duties. There should not be restrictions on indemnities and insurance in circumstances where there hasn't been deliberate wrongdoing or similar behaviour. It is important that indemnities and insurance are available for a failure to exercise skill, care and diligence and to ensure a business is run in a prudent manner/controlled effectively. Such duties are typically insurable given they are, by their nature, unintentional. As with the Companies Act, the entity should be permitted to indemnify or insure a person for civil liability and the cost of defending a civil proceeding (either successfully or not), except in the case of a breach of a duty to act honestly (or equivalent). Separating the duty to act honestly from a duty of care (as discussed above) should allow for insurance in the case of a failure to exercise skill, care and diligence. As currently drafted, the prohibitions will also likely serve as another reason to deter well qualified, experienced directors from governing deposit takers.

The cost of D&O insurance has risen significantly in recent years and, as noted in our report Under pressure: D&O insurance in a hard market, Australia and New Zealand are in the midst of the most volatile and restrictive D&O insurance market in its history. There are a number of factors that have contributed to this market including:

- the board's role and responsibilities have expanded in recent years;
- policy-makers continue to target directors for personal liability in reforming regimes;
- regulators are more active and well-funded;
- class actions are on the rise and litigation funding is prevalent; and

- there have been substantial court awards against directors and organisations.

The dramatic rise in D&O costs and the turbulent market is deeply concerning and the impact of the addition of new duties and personal liability could be severe.

5. Executive accountability

We note the work on developing an executive accountability regime in the New Zealand context is ongoing and "will complement (and significantly build on) the Review's particular focus on improving the accountability framework for directors of deposit takers." It is likely that any new executive accountability regime will be underpinned by the new positive duties for directors currently under consideration.

We have a strong interest in the nexus between the accountability of directors and the senior executives they work with. The IoD would wish to provide feedback on any such proposals should the opportunity arise. In developing such a regime, having a clear problem definition and due regard to existing foundations will be important considerations.

It is vital that any new duties or obligations do not merge the role of the board and management, undermining the essence of corporate governance in New Zealand. As noted in the Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (2019) "Boards cannot, and must not, involve themselves in the day-to-day management of the corporation… The task of the board is overall superintendence of the company, not its day-today management." A core role of boards is to hold management to account through effective and independent oversight of performance and compliance matters. It is critical that this separation is maintained under any new regime.

6. Deemed director liability

The consultation document notes most individual director obligations proposed under the Deposit Takers Act would be met through positive duties, which suggests a more limited role for "deemed liability" (where an individual such as a director is deemed liable for their organisation's specific breaches of legislative and other requirements) under the current attestation regime.

In our view the introduction of new positive duties removes the need for deemed liability. This is because a false or misleading disclosure by a director will be covered by those duties, which will continue throughout their appointment.

7. Penalties

The IoD supports an approach to penalties under the Deposit Takers Act that is broadly consistent with similar legislation and consider that:

- it would be appropriate to establish a lower tier of civil penalties for lesser or more technical contraventions of prudential standards;
- any civil penalties for individuals should be significantly lower than those applying to bodies corporate and, in each case, flexible enough to address a range of contraventions; and

- criminal penalties should be reserved for knowing or reckless conduct without reasonable excuse and graduated depending on the seriousness of the offence.

8. "Fit and proper" person assessment

The IoD supports the proposal to develop a more fulsome "fit and proper" person framework.

In 2014, the IoD launched its Chartered Membership pathway to raise professional standards for directors in New Zealand and recognise members who reach those standards.

The Chartered designation offers stakeholders an assurance that the member has met professional standards of knowledge and skill and has committed to continuing professional development. To become chartered, members are required to:

- complete the IoD's Company Directors' Course (or equivalent);
- pass the Chartered Member assessment, which is comprised of a computer-based 75 minute examination and a comprehensive and detailed written assignment;
- make an annual commitment to uphold the principles of the Charter;
- attest that they are of good character and a fit and proper person through an annual confirmation;[2]
- complete an average of 20 continuing professional development points each year (60 points over their three year foundation period); and
- adhere to the Code of Practice for Directors (as with all members).

We encourage Treasury to recognise the designation of Chartered Membership as an effective way to support any "fit and proper" requirements for directors of regulated entities. They can bring professionalism and a commitment to continuing professional development to any board.

It is noted that the consultation document also proposes that the Reserve Bank could remove directors and senior managers who it determines are no longer fit and proper persons, with appropriate procedural protections. We highlight the importance of having robust and workable appeal rights and natural justice considerations. This power seems appropriate for the regulator, however we are interested in the finer details of how this may work in practice.

Conclusion

Regulatory reform imposing additional duties and personal liability on directors in New Zealand must be approached carefully. Any new positive duties should closely reflect the issues the Deposit Takers Act is trying to solve and be calibrated to New Zealand's context.

The IoD has serious concerns about the proposed new duties and does not support them in their current form. We note in particular:

- we are very concerned about the lack of clarity and certainty around the interaction between the new proposed duties and duties under the Companies Act. It is vital that

[2] See the annual confirmation at iod.org.nz/charteredmember

directors are clear about their core duties and how to discharge them. Clarity and certainty is needed at the outset, rather than leaving this to the courts;

- it is difficult to see why broader or more onerous duties than those in Australia for example are justified in New Zealand (given we haven't encountered the same level of issues);
- the proposed new duties need to be reconsidered and changes would need to be made (e.g. separating the duty to act honestly from a duty of care);
- we strongly oppose the proposed prohibition on indemnities and insurance in relation to the new positive duties. There should not be restrictions on indemnities and insurance in circumstances where there hasn't been deliberate wrongdoing or similar behaviour
- there needs to be appropriate defences to ensure that honest and diligent directors are not unfairly prejudiced (aligned with the Financial Markets Conduct Act) and guidance will be vital; and
- any civil pecuniary penalties for individuals must be proportionate and imposed equitably.

We reiterate that it is vital that high quality directors are not discouraged to remain involved in such an important sector. There is significant risk that a greater regulatory and compliance burden will shrink an already small pool of suitably qualified people, to the detriment of all stakeholders.

We appreciate the opportunity to comment on behalf of our members and would be happy to discuss this submission with you.

Yours sincerely

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