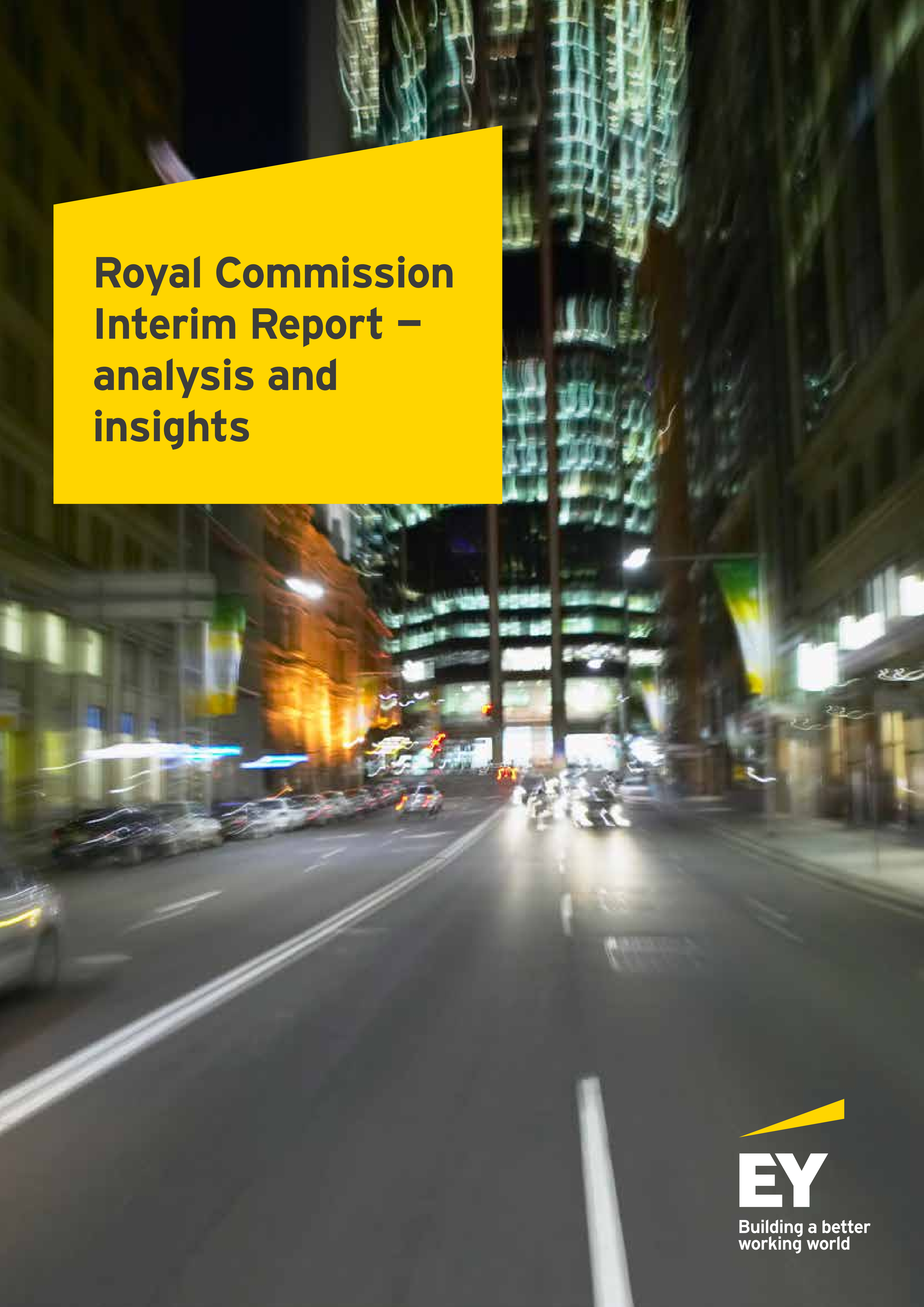


Royal Commission Interim Report – analysis and insights

Building a better working world

Contents

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry was established on 14 December 2017. The interim report was published on 28 September 2018 and covers the first four rounds of hearings: customer lending, financial advice, small- and medium-sized enterprise (SME) lending, agricultural lending, and remote community regulation. It focuses specifically on the banks and AMP. Importantly, the interim report has not made any recommendations, but, over three volumes, has posed a number of questions for consideration.

This document provides a summary of the interim report, focusing on the causes of misconduct, customer and SME lending, financial advice, and regulation and the regulator. It provides recommendations for market participants in advance of the final report.

Introduction

‘Banks have a special place in our economy. To participate in the Australian economy, in everyday life, every Australian needs a bank account.’

Source: Interim Report

Within this context, the interim report of the Royal Commission examines and identifies the critical drivers of misconduct within the sector. These include:

- Culture and governance were shaped by the primacy of profit and shareholder returns over good customer outcomes.
- Inherent conflicts of interest were exacerbated by lack of clarity from intermediaries (mortgage brokers, financial advisers, and introducers) as to whom duties and obligations are owed.
- Remuneration structures were focused on sales and maximising financial performance, which contributed to behaviours misaligned with long-term best interests of both customers and the institution.
- Regulatory oversight failed to deter misconduct, as misconduct either went unpunished or the consequences did not match the seriousness of what had been done. The regulator brought few civil penalty proceedings, and thereby, failed to test, and clarify for the sector, many key provisions of the complex financial services legislation.

Regulatory reforms are imminent

The interim report does not make recommendations, but asks a series of questions that provide a guide to possible eventual recommendations, including:

- **Reforms to better align commercial and customer outcomes:** This may include structural separation of vertically integrated businesses, further restrictions on conflicted remuneration, heightened prescription around the best interests duty, and application of the best interests duty to intermediaries. Any reforms are likely to complement the proposed financial product design and distribution obligations, and product intervention powers in recently released draft legislation.
- **Reforms to enhance the effectiveness and capability of Australian Securities and Investments Commission (ASIC) and Australian Prudential Regulation Authority:** This may include reforms to simplify the legislative regime that applies to the financial system, and enhance the powers and penalties available to regulators. It may also include a direction for the regulators to enforce the law more vigorously and be resourced to do so. Any reforms are likely to complement the suite of reforms that the Government has accepted from the ASIC Enforcement Review, including increased penalties for financial and corporate misconduct, power to enable ASIC to direct that a remediation programme be established as well as other breach reporting obligation reforms.

Regulatory reforms alone will not be sufficient

Shifting the sector from one that puts 'people before profit' and asks 'should I do this?' rather than 'can I do this?' – as the interim report puts it – will require cultural change. Cultural change cannot be regulated into existence; it may not be easy and will take time. Achieving such a change will require vision and commitment, underpinned by constructive industry-wide initiatives.

We anticipate that boards of financial institutions will:

- **Revisit with management the purpose, values, and strategy of the institution:** This is a prerequisite for defining the desired state culture of the institution and developing a plan to move from current to desired state. Without such alignment and investment, cultural change will flounder.
- **Take a stronger leadership role in developing and overseeing an appropriate culture:** This will begin with an honest reflection of the board's operating effectiveness and its effect on the broader organisation.
- **Obtain a better understanding of the current state of culture in the institution:** They will move beyond traditional metrics (e.g., employee engagement) and the review of systemic drivers of behaviour, drawing on a diverse range of data points (e.g., social network analytics, oral history, observations, and customer outcomes as well as satisfaction scores).
- **Reconsider expectations for senior executives (and, subsequently, remuneration) around changing behaviours and 'doing the right thing' for the customer:** Companies need to resolve how they can align customer, community, and shareholder expectations. Without such resolution, the current challenges will continue.
- **Work with management to objectively assess the conflicts between commercial and customer outcomes:** This will be done with a view to eliminating or better managing conflicts. This may be achieved by, for example, enhancing controls and oversight; and changing remuneration, payment, and incentive structures.
- **Continue to invest in simplification, customer analytics, and enhanced risk management capabilities:** This will enable the institutions to better control, monitor, and proactively manage incidents within the risk appetite.
- **Consider business model changes to support cultural change and simplification:** This will be done through the divestment of non-core activities, streamlining of products and services, and reassessment of distribution methods.

In the following sections, we discuss the key issues highlighted by the interim report and provide actions for banks and others to consider while preparing for the final report due in February 2019.

Culture, governance and remuneration

Remuneration and incentives are at the heart of the interim report. As Commissioner Kenneth Hayne states:

"The culture and conduct of the banks was driven by, and was reflected in, their remuneration practices and policies."

The report acknowledges other associated themes that need to be part of the broader approach to address the culture and conduct issues highlighted — governance, risk management, and a better focus on customer outcomes.

There is an acknowledgement throughout the report that people management needs to be more robust. This would include performance management, career development, coaching and capability development, and driving the right behaviours. The Commissioner points out that reward and remuneration have taken precedence over these people management constructs. This will need to be reversed — people management should be reinforced by reward rather than driven by reward.

Consistent with these themes, we expect that shorter-term implications will be:

- The removal of Future Of Financial Advice (FOFA) grandfathering, an extension of FOFA principles and the removal of all value or volume based remuneration elements in incentives for advice roles
- Extension and enforcement of the application of the principles laid out in the Retail Banking Remuneration Review — those relating to incentives and, critically, those relating to culture, performance management, and leadership and management capability
- A heightened focus on intermediary value- or volume-based incentives to require the industry to address this simultaneously
- Further consideration of how the Banking Executive Accountability Regime will apply and to whom

- Consideration of different ways to structure variable remuneration throughout the organisation, including:
  - Reconsideration of the use of variable remuneration for certain roles or for the whole population
  - The appropriate use of other types of reward — not just remuneration or incentives
  - Different approaches to rewarding the method used to achieve the results, and the results themselves
  - The selection and quality of performance metrics, whether financial or non-financial (such as customer outcomes)
  - The method used to apply appropriate levels of discretion and governance
  - The role of management in ensuring the right outcomes in line with culture risk and customer ambitions, encouraging good conduct rather than merely reducing misconduct

Consumer lending

Responsible lending

The interim report observed that the introduction of responsible lending obligations represented a critical step towards fostering a competitive and fair consumer lending market. Key to responsible lending is the requirement that the lender assess whether a credit contract is 'not unsuitable' for the customer. Before making this assessment, the lender must make reasonable inquiries about (and take reasonable steps to verify) the customer's financial situation, and their requirements and objectives in relation to the credit contract.

The interim report referred to a 'body of evidence', indicating that, in some circumstances, lenders have not made inquiries about their customers' circumstances, requirements or objectives. Some lenders have seen responsible lending obligations as satisfied when they form the view that the customer is unlikely to default (i.e., that the credit risk is acceptable to the lender).

In response to this evidence, the interim report asks a series of questions about the practical application of the responsible lending obligations, culminating in the question 'should the test to be applied by the lender remain "not unsuitable"?.'

Regardless of the ultimate recommendations of the Royal Commission, we expect that financial institutions will continue their efforts to strengthen responsible lending practices. This is likely to include the following:

- Ensuring current policies and procedures are in accordance with the responsible lending obligations as well as community expectations
- Enhancing due diligence requirements, particularly at the application and fulfilment stages, to prevent and detect responsible lending breaches, and fraudulent applications (among other things)
- Strengthening conduct risk frameworks to help ensure that instances of inappropriate unethical or unlawful behaviour by employees (or authorised representatives) are identified early:
    - Where such behaviour is identified, swift and comprehensive remediation will be required.
    - Root causes will need to be identified and addressed.
    - Financial institutions should also be prepared to review their back book for potential exposures.
- Enhancing reporting and disclosures to help management and the board understand and react to issues earlier in the cycle

Intermediaries: mortgage brokers

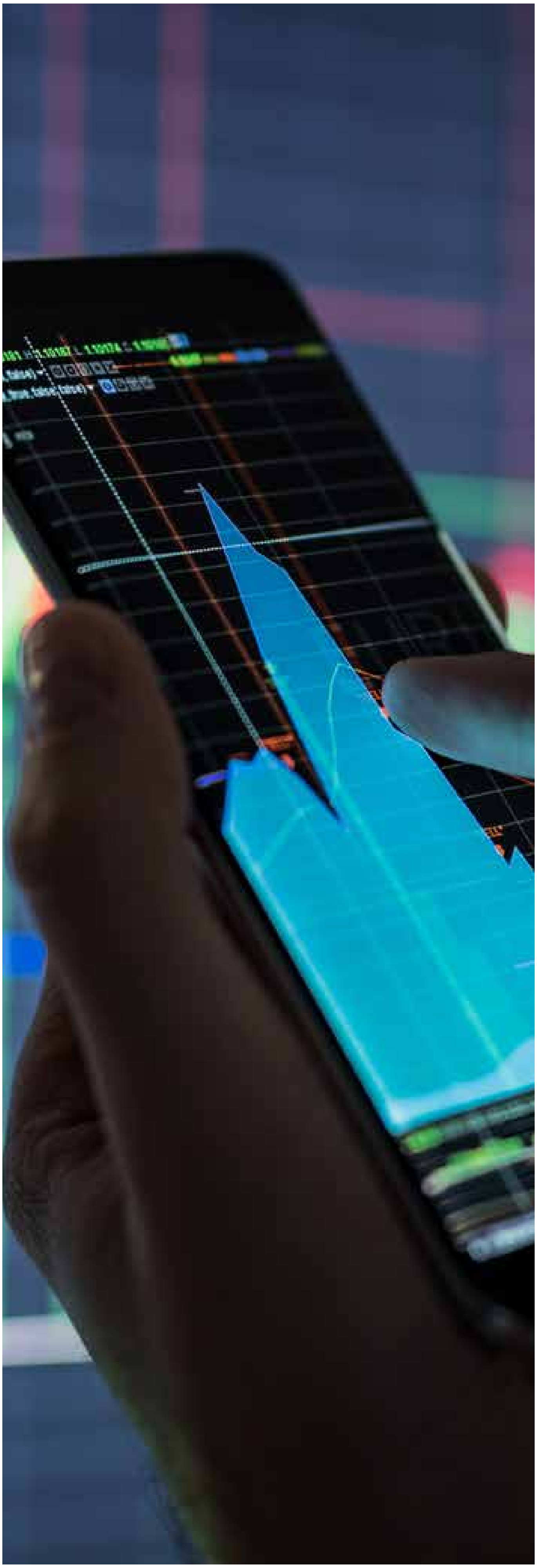
The interim report acknowledged the central role that mortgage brokers play in the residential mortgage financing market in Australia. It emphasised that the way brokers are remunerated is likely to result in conflicts of interest. For example, a broker may:

- Recommend a loan that is larger than what the customer needs or can afford in order to increase commission
- Recommend a loan from a particular lender to receive a higher commission
- Take steps to increase the likelihood of a positive lending decision

The interim report found that 'value- and volume-based remuneration for intermediaries in the home loan industry has been an important contributor to misconduct and conduct falling short of community standards and expectations and poor customer outcomes.' It posed some fundamental questions about intermediaries, including 'for whom does the [broker] act?', 'what duties should they owe?', and 'how should the [broker] be remunerated?.'

These questions suggest that the Royal Commission may ultimately recommend that mortgage brokers be subject to a duty to act in the customer's best interest. In the meantime, we recommend that financial institutions:

- Review remuneration and incentive structures to consider alternative payment arrangements such as upfront and flat fees
- Develop closer oversight across mortgage aggregators and broker franchises
- Revisit contractual arrangements to assess inherent conflicts of interest
- Improve transparency of ownership and payment structures to borrowers
- Improve transparency of broker performance and broker reviews across the banking sector



SME lending

According to the interim report, the evidence and submissions provided to the Royal Commission did not reveal any great appetite to change the law that applies to SMEs, particularly to bring some or all SMEs within the jurisdiction of the National Consumer Credit Protection Act, 2009.

However, the interim report did draw out a number of themes specific to SME lending, including:

- The challenges presented by third-party guarantors of SME businesses
- Disagreement about the bounds and content of two obligations in the Banking Code of Practice – first, the requirement that a bank providing a loan or limit increase will do so exercising the care and skill of a diligent and prudent banker (i.e., considering the question 'what inquiries should be made?'), and second, the requirement that a bank assess whether the small business customers can repay a loan on the basis of their financial position and account conduct

Consistent with these themes, we expect financial institutions to:

- Accelerate their preparations for meeting the obligations for the Banking Code of Practice, including those relating to SME lending
- Review their role in ensuring that SME borrowers sufficiently understand business viability and risks
- Define their appetite around the use of guarantees, particularly for guarantors with no direct interest in the business
- Implement measures to ensure that banks have satisfied themselves that the guarantors are appropriately advised and informed

Financial advice

The interim report observed that the issues that emerged in connection with financial advice — fee for no service, inappropriate financial advice, and adviser professionalism and conduct — related to culture, remuneration and incentives, conflicts of interest and duty, and regulator effectiveness. Culture, remuneration and incentives, and regulator effectiveness are addressed elsewhere in this document. In this section, we focus on conflicts of interest, and adviser professionalism and conduct.

Conflicts of interest

The interim report summarised the conflicts of interest and duty in financial advice thus:

'The interests of the client are to obtain the best financial advice reasonably available. More particularly, if the advice is for the client to acquire some financial product, it is in the client's interests to obtain the best product: best in the sense that it is fit for purpose but best in the sense also that it is the cheapest and (as far as can reasonably be determined) the best performing product available.

'By contrast, the adviser's interest is to further his or her career and to maximise financial reward and the licensee's interest is to maximise profit. Where an adviser is employed by, or aligned with and acts on behalf of, a principal who manufactures or sells financial products, the adviser's interests (and the principal's) will be advanced by persuading a client to acquire one of the principal's products.'

Recognising the pervasiveness of conflicts of interest in financial advice, the Royal Commission posed the question 'can [these] conflicts of interest and duty be managed?', followed by a series of more specific questions directed at integrated business models, including 'how far can, and how far should, there be separation between providing financial advice and manufacture or sale of financial products?'.

These questions are likely to further encourage the disruption in the industry that is already occurring. The market for product manufacturing, both domestically and internationally, is likely to open up. Institutions may manufacture simple and safer financial products, reducing the need for financial advice. Heightened competition will require institutions to regularly review and update their product, platform offerings, and distribution channels.

Integrated business models are likely to use the following methods to respond to the questions:

- Assessing whether effective controls are in place to ensure that conflicts of interest are appropriately managed, such as, arranging remuneration, training and supervising advisers, and building ease of compliance into processes that support providing advice on external products
- Ensuring that mechanisms to collect and analyse data on the products recommended by advisers, both generally and individually, are in place; this reporting (ideally as part of a suite of conduct risk reporting) is likely to be considered by the board and senior management
- Adapting their business models if structural separation is enforced, such as platform providers who may consider incorporating technology-enabled advice in their offering
- Consider raising to the board where an institution has not yet committed to phasing out exempted commissions

Adviser conduct and professionalism: highlighting the value of financial advice

There is an opportunity for the industry to change perceptions about, demonstrate the value of, and expand the demand for financial advice by:

- Innovation driven by the removal of product or platform subsidies, including, for example, investment in robo-advice, or the development of basic, commoditised, personal or general advice offerings: This offers the opportunity to provide cost-effective financial advice to the mass affluent segments of the market.
- Thoughtful implementation of reforms to enhance the professionalism of financial advisers: This includes new professional, education, and training standards for advisers who provide personal advice on more complex financial products and an enforceable code of ethics.
- Genuinely prioritising the best interests of the customer in the provision of advice: It is possible that an outcome of the Royal Commission will be a more prescriptive best interest duty for advisers. Financial institutions may consider whether there is benefit in more clearly prescribing the requirements of the best interests duty in policy and providing practical training on that policy.

Regulator effectiveness and future areas of focus

The interim report was critical of ASIC's role in failing to prevent misconduct in financial services, specifically its apparent preference for resolving contravening conduct by agreement rather than by instituting proceedings.

The criticism of ASIC provides a signpost to the likely future areas of focus for ASIC to address the issues raised in the interim report. Two of the main criticisms are discussed here.

Treating contraventions of the law as 'no more than bargaining chips to procure agreement to remediate customers'

Whenever a financial institution delays compensating — or refuses to compensate — customers who have suffered financial loss as a consequence of misconduct, ASIC has generally prioritised the swift payment of compensation to customers over litigation, at least in the first instance.

This approach will change, with the ASIC Enforcement Review recommending — and the Government accepting — that ASIC be empowered to direct financial institutions to, amongst other things, establish a suitable remediation programme to address the impact of a breach on customers.

This will include, for example:

- Notification of customers about the programme
- Identification of potential claimants
- Processes for assessing claims

This change will heighten ASIC's scrutiny of remediation programmes and processes, and, in response, we anticipate that financial institutions may need to enhance:

- The governance of, accountabilities for, and reporting on remediation programmes
- Investment in remediation methodology in order to industrialise and standardise the process over time
- The analysis, and addressing, of root causes of past and current remediations to prevent repeat issues
- The 'customer experience' of remediation by incorporating behavioural insights into the process as appropriate (e.g., ensuring that the remediation process is 'automatic' and does not require customer engagement)

To reduce the need for remediation programmes, we expect that financial institutions will continue to strengthen conduct risk frameworks. Boards and management will require the right data and analysis to:

- Proactively identify individuals and teams demonstrating 'risky' behaviours, as well as systems, policies, and processes that might facilitate poor conduct or allow it to go unnoticed, with early intervention in response to this data and analysis being critically important
- Quickly identify instances of customer loss or harm originating from poor conduct, which will, in turn, enable early remediation

'...entities have been treated in ways that would allow them to think that they, not ASIC, not the Parliament, not the courts, will decide when and how the law will be obeyed or the consequences of breach remedied'

This is a serious criticism that may prompt ASIC to alter its long-standing approach to enforcement. Even without such criticism, ASIC's approach to enforcement is likely to have evolved to the following (among other things):

- Increased penalties for financial and corporate misconduct will likely shape the type of enforcement action that ASIC chooses to bring. Draft legislation was released on 26 September 2018, providing for increased financial penalties for civil contraventions and court discretion to take away the illegally obtained gains of contraveners in civil penalty proceedings (disgorgement).
- Intelligence and insights gathered under ASIC's proposed 'close, continual monitoring' (CCM) of major financial institutions will help breach reporting, which itself is the subject of proposed reforms in the ASIC Enforcement Review, given that the current provisions are, according to ASIC, unenforceable in their current state.
- The Government has recently allocated AU$26.2m to 'accelerate and increase the intensity of ASIC's enforcement activities and enhance its capacity to pursue actions for serious misconduct against well-funded litigants, through the Enforcement Special Account.' This will allow ASIC to conduct (a small number of) additional civil penalty proceedings.
- Daniel Crennan QC has been appointed as Deputy Chair of ASIC to focus specifically on enforcement.

In light of the above, financial institutions should anticipate additional enforcement activity by ASIC, particularly civil penalty proceedings.

We expect that the focus of this enforcement (including surveillance) activity will include 'fee for no service' and 'breach reporting'. We have identified the steps that financial institutions may take in response to these areas of focus.

Fee for no service

Regardless of the recommendations proposed by the Royal Commission, financial institutions will need to — at a minimum — take a more proactive approach in 'offering' the annual review. They will also need to evidence the offer. Product disclosure statements will need to be more transparent, setting out in detail what service will be offered and how often. Investment in systems and processes may be required as the interim report observed, 'They had neither the systems nor the processes to know whether their authorised representatives were delivering what had been promised.'

ASIC has proposed that financial institutions invoice the fee for service to the customer. Payment must be specifically authorised when the service is provided, rather than being deducted automatically from the client's investment funds and only notified subsequently as a line in a fee disclosure statement or a periodic product statement. If ASIC's proposal is adopted, financial institutions will need to consider whether their processes are able to accommodate this — and, more generally, the impact of this change on their financial viability.

Breach reporting

Financial institutions should consider whether they are prepared for likely changes to breach reporting, as recommended by the ASIC Enforcement Review. Critically, institutions will be required to report breaches within 30 days of the licensee becoming aware of information that a breach has occurred or may occur — rather than 10 days from when the licensee determines that a breach has occurred and is significant. The new obligations will apply equally to financial services and credit licensees.

Financial institutions should consider ASIC's *Review of selected financial services groups' compliance with the breach reporting obligation*, released on 25 September 2018, and whether they are prepared for ASIC's CCM of breach reporting compliance and reporting. They should consider whether investment is required:

- In systems, processes and training to more quickly identify and investigate potential breaches
- In customer remediation processes to ensure that customers are paid within an acceptable time period after the breach is identified
- To enhance governance and escalation processes to support a sound breach reporting culture

Where to go from here?

Prior to the commission's final recommendations due on 1 February 2019, banks and other financial institutions may wish to take various steps related to governance and culture, frameworks, and remediation.

Governance and culture:

- Obtain a better understanding of the current culture and potential or likely barriers to reaching the desired culture in line with purpose, values, and strategy
- Examine the institution's overall governance frameworks and risk appetite to begin discussions on the balance of economic outcomes, compliance obligations, and customer outcomes; and how this links to executive expectations and accountability
- Ensure that there are appropriate channels for 'the voice of the customer' from frontline staff through to the board
- Revisit conflicts of interest frameworks
- Ensure that current compliance functions are able to identify and provide a position on the organisation's compliance obligations

Frameworks:

- Review financial and non-financial measures used in management reports, performance management, and reward systems
- Examine product design and review processes to ensure that there is a robust framework in place to examine financial and customer outcomes throughout the product life cycle
- Review current remuneration frameworks, incentive plans, and intermediary fee arrangements
- Make further investment in customer life cycle management, measurement, and related data and analytical capabilities

Remediation:

- Formalise the remediation frameworks to provide earlier identification, swifter response times, more formalised communication protocols and better root cause analysis
- Make additional investment to prepare for additional enforcement and surveillance activity

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