CFA Society Melbourne

Royal Commission into the Misconduct of the Banking, Superannuation and Financial Services Industry: An Insight

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On February 01 2019, Commissioner Kenneth Hayne handed his final report on the Royal Commission to the Treasury. The report was released after the Commissioner completed over twelve months of investigation and enquiries into the practices of banks, superannuation and other financial service institutions. The Royal Commission was launched in December 2017 following claims of customer abuse, poor governance and unethical lending practices adopted by banks. The final report contains four key observations and seventy six recommendations with view of a structural reform in the financial services industry.

The report uncovers a range of issues that have affected the level of stakeholder trust and confidence in capital markets and the investment industry. In the course of the investigation, Commissioner Hayne observed that:

- The level of conflict of interests was alarming due to the constant pursuit of personal goals and the lack of an ethical remuneration structure,
- There was no separation of duties between the provision of financial advice and the sale/marketing of financial products,
- The lack of information transparency on financial products was unprecedented and that did not help clients in choosing a suitable product, and
- Parties who broke the laws and regulations governing the operation of the financial services industry were not adequately held accountable for their acts.

In light of his observations, Commissioner Hayne believed that individuals and institutions should not have been rewarded for selling the wrong product or providing an inappropriate advice to their clients. The integrity of capital markets has been significantly impacted consequently impairing the level of trust and confidence clients have in the financial services industry. In the absence of a comprehensive and transparent set of financial advice, the client was exposed to significantly higher risks than anticipated. This has led to important loss of the client's wealth and income. The financial advice would often result in the provision of a financial product that would be deemed unsuitable for the client. It is also more likely than not that the chosen financial product will attract significant commissions. Financial advice and the sale of the financial products were often marketed as one package. This led to the provision of an unsuitable product which would fall outside the boundaries of the client's risk-return profile. Moreover, financial institutions failed to comply with industry standards and legislations due to the absence of adequate internal integrity measures and controls. Consequently, no one was held accountable or responsible for breaking the law.

This continuous and never ending quest for achieving one's own interests at the expense of those of the clients was inspired by greed and selfishness. In his recommendations made to the Treasury to remedy the financial services industry, as a whole, Commissioner Hayne calls for a rigorous application of the law. Significant changes must be made in the organisational culture, governance and values of financial institutions to help restore the clients' trust. This will help enhance both the integrity of capital markets and the reputation of the investment profession.

In the final report, the 76 recommendations are categorised across seven different segments namely:

- Banking (17),

- Financial Advice (10),
- Superannuation (9),
- Insurance (15),
- Culture, Governance & Remuneration (7)
- Regulators (14), and
- Other Matters (7).

The rest of this document will look at those recommendations which are likely to significantly impact both the financial services industry and the Australian economy as a whole.

1. Banking

Recommendation 1.3 – Mortgage broker remuneration

Purpose: The current remuneration system impacts the mortgage brokers' independence and objectivity in their choice of mortgage lender and mortgage product for their clients i.e. the borrowers. Mortgage brokers owe a fiduciary duty of care to their clients and must hence act in their best interest. However, because lenders pay the brokers their commissions for selling the lenders' financial products, these brokers fail to protect the interests of their clients. In fact, it was observed that mortgage brokers are motivated to sell financial products that pay higher commissions. Lenders pay brokers the commission over the life of the mortgage. This somehow creates significant doubts over the preservation of the clients' interests which thus impedes on the integrity of the mortgage market.

Action: The report suggests that the remuneration structure should be modified. Lenders should not be allowed to pay any commissions to brokers for selling their mortgage products. Instead, mortgage brokers should be paid by borrowers who choose to use their service when shopping for a mortgage. Brokers would charge a fee based on a combination of factors including qualification, experience and market forces. It is suggested that the new structure takes effect in 2020.

Impact: This recommendation will result in a significant shift in the mortgage broker industry. It will help redefine the purpose of a broker and reshape his obligations towards his clients. This will allow for a clear identification of clients and hence it will ensure that adequate measures are taken to avoid conflicts of interests.

Recommendation 1.5 – Mortgage brokers as financial advisers

Purpose: The current legislation does not identify mortgage brokers as advisors despite the fact that they provide advice to their clients on the choice of mortgage products. Mortgage brokers undertake a wide variety of tasks of which some would be deemed financial advice. The brokers identify mortgage products and inform clients on the suitability of those products. There is currently no legislation in place to govern the actions of mortgage brokers as far as the provision of financial advisory is concerned.

Action: The report suggests that mortgage brokers should be required to comply with the relevant laws governing the provision of financial advice to retail clients. Hence they would have to comply with relevant provisions of the Australian Banking Association and ASIC.

Impact: Mortgage brokers will be expected to take reasonable care upon advising their clients on their choice of mortgage products. By adhering to the financial advice legislation, mortgage brokers will put their clients' interests ahead of their own.

Recommendation 1.8 – Amending the Banking Code

Purpose: The current banking code provides that banks must assist vulnerable customers in finding a suitable way to access banking. However, the code states that these customers should be able to explain their circumstances and what makes them vulnerable. The legislation does not provide protection for vulnerable customers who are not in a position to explain why and how their current circumstances have made them vulnerable.

Action: The banking code should be require banks to work with customers "who live remotely or who are not adept in using English" to help them access banking. Where customers have difficulties in proving their Aboriginal or Torres Strait Islander identities, banks need to follow Austrac's guidance in that regard. Moreover, the banking code should not allow banks to provide informal overdrafts and charge dishonour fees on basic accounts.

Impact: Through the enactment of those changes to the banking code, vulnerable customers will be able to enjoy a better banking experience. The amendments will cater for those vulnerable customers who are not able to explain those conditions that make them vulnerable. Hence they will not feel like they have been unjustly treated.

Recommendation 1.10 – Definition of 'Small Business'

Purpose: The Banking Code's current definition of small business is too limited and too specific. A small business is defined as one that meets the following three part test:

- Annual turnover of less than $10 million
- Less than 100 Full Time Equivalent (FTE) employees and
- Total debt of less than $3 million

Where the above test is met, the Banking Code will govern all under $5 million loans made to those small businesses.

Action: It is suggested that the current three-part test that defines small business be removed and replaced by a one part test. Small business will be redefined as businesses with less than 100 FTE employees. Hence the Banking Code will govern under $5 million loans made to all businesses with fewer than 100 FTE employees.

Impact: Modifying the small business test will result in another 20,000 businesses having to comply with the provisions of the Banking Code; should they seek to obtain loans fewer than $5 million.

Recommendation 1.12 – Valuation of land

Purpose: The current prudential standard APS 220 does not provide any guidance over the need for an independent appraisal of the value of land. Currently, upon measuring land value, internal appraisals are not required to stay independent of loan origination, processing and decision making process.

Hence the internal appraiser might be influenced by the loan's documenting and underwriting area upon conducting his work.

Action: The APS220 should require internal appraisers to act independently in the performance of their duties at all times. They should not be allowed to interfere nor be involved in the loan origination, loan processing and loan decision making process.

Impact: By amending APS220, the land value will be independently appraised; hence minimising the risks of conflicting interests between the appraiser and the loan underwriting process.

2. Financial advice

Recommendation 2.4 – Grandfathered commissions

Purpose: This recommendation aims at removing all forms of conflicted remuneration structures. In July, the Future of Financial Advice (FoFA) provisions were introduced to address conflicts of interest in the way financial advisors were remunerated. As part of the reform, all conflicted remuneration schemes other than grandfathered commissions were banned. The current co-existence of grandfathered commission is damaging the image of the financial services sector. Financial advisors are still receiving commissions on unsuitable and conflicting financial products that they sold prior to the enactment of the FoFA.

Action: It is suggested to place a ban on all grandfathered commissions to remove this co-existing conflict of interest.

Impact: Removing grandfathered commissions would mean that there won't be any form of conflicted remuneration structure left. Hence this will reinforce and enhance the integrity of the financial services sector.

Recommendation 2.9 – Misconduct by financial advisers

Purpose: In order to retain their AFSL license, financial advisory firms must ensure that their employees comply with all relevant laws. It was observed that AFSL holders failed to adequately review the work of their financial advisors. In the absence of a rigid audit process, law breaches often went unnoticed. And if these malpractices were identified, hardly any remedial actions were taken.

Action: AFSL holders must review and enhance their control systems to ensure that their employees adequately comply with the relevant laws. These ASFL holders are required to have a proper reporting system to identify and address any form of misconduct by their financial advisors. Where there has been a breach in law compliance, AFSL holders have a responsibility to report the matter to regulators. Their clients must also be advised of the misconduct that their financial advisors engaged into. Adequate measures must then be taken to address the problem and new controls must be put in place to ensure that such misconduct can be averted.

Impact: This will help improve the integrity of the financial advisory market but more importantly restore trust among clients.

Recommendation 2.10 – A new disciplinary system

Purpose: Financial advisors have engaged into serious misconduct by advising their clients to buy unsuitable and risky financial products. They are under no obligations to obtain an AFSL licence as long as they work for an AFSL holder. Consequently they are not directly covered by the standards and regulations imposed by ASIC and APRA. On the other hand, AFSL holders are required to meet all relevant laws and regulations to retain their AFSL; hence their responsibility to closely monitor and supervise the work of their financial advisors. If its financial advisors breach the law, the AFSL holder can immediately lose its license if no remedial action is taken fast enough. Hence by establishing a new disciplinary framework for financial advisors, they will be compelled to behave in a professional and ethical manner at all times.

Action: A new disciplinary framework would contain code of ethics, values and standards of professional conduct that financial advisors will be required to adhere to. This system should be structured in a way that spells out the obligations of financial advisors and the consequences of not complying with regulations. For any breach of conduct, the financial advisors should be reported to a disciplinary committee that will review the impact of his behaviour and take the required actions.

Impact: This will allow AFSL holders to monitor the conduct of their financial advisors more effectively and timely report any serious breaches to the regulators.

3. Superannuation

Recommendation 3.2 – No deducting advice fees from MySuper accounts

Purpose: The current advice fee charged from MySuper accounts is a source of conflicting interest. The fee actually relates to the provision of information about particular existing or intended superannuation investments including consolidation of super accounts, selection of super funds or asset allocations within a fund. It does not in any way provide advice about how a member can provide for his retirement or maximise his wealth. In other words, the member is being charged for a non-advisory service.

Action: It is suggested that this fee be banned because it does not serve its purpose of providing broad financial advice to the member.

Impact: This will provide greater transparency to clients in terms of what they are being charged for.

Recommendation 3.4 – No hawking

Purpose: Superannuation funds have often solicited their members to positions in certain specific types of financial products including managed investment vehicles and options. These products are often unsuitable given the members' risks and return profiles. Moreover, some members have been encouraged to have more than one account.

Action: Members should no longer be solicited into superannuation products. Hawking should be banned. Superannuation entities should be required to have controls in place to ensure that their

employees don't market unsolicited products to members unless the members have specifically enquired about the products.

Impact: This will restore trust and confidence among members as they will not feel under pressure to buy certain financial products for which they are not comfortable with.

Recommendation 3.7 – Civil Penalties for breach of covenants and like obligations

Purpose: Currently the SIS Act does not provide for any penal consequence where a person has contravened the covenants of the trustees or directors. If a person suffers a loss or damage as a result of a breach of fiduciary duty, that person may seek compensation. But if he were to seek compensation due to the director's breach of covenants, he will only be able to do so if he is granted permission from the court.

Action: Civil penalties must be enforceable for breaches of the trustees' or directors' covenants.

Impact: This will remove any abuse of power that currently protects the directors or trustees against any civil actions. The person who suffers the loss, as a result of the directors breaching the covenants, will be able to take class actions against those directors without seeking permission from the court.

Recommendation 3.8 – Adjustment of APRA and ASIC's roles

Purpose: APRA and ASIC have not taken any enforcement actions in respect of covenants breaches.

Action: To allow for civil prosecutions mentioned in recommendation 3.7, APRA and ASIC will have to review their respective roles.

Impact: This will enhance stakeholders' confidence in the work of regulators as they effectively punish unlawful acts.

4. Insurance

Recommendation 4.1 – No hawking of insurance

Purpose: Companies have for far too long solicited their clients into buying unsuitable and risky insurance products. The current legislation does not prevent these insurance companies from contacting customers to offer their unsolicited insurance products. The sale of unsolicited products is an inappropriate and unethical practice.

Action: Hawking of insurance products must be banned in line with anti-hawking provisions.

Impact: This will minimise the risk that unsuitable insurance products get sold to clients and hence avoid the risk of additional conflict of interests.

Recommendation 4.4 – Cap on commissions

Purpose: Currently there are no regulations governing the commission paid on the sale of add-on insurance on motor vehicles. Car dealers regularly offer add-on insurance to their clients. Upon selling those insurance products, the car dealers receive commissions from the insurance companies. It was observed that these commissions were in excess of the claims paid to the customers. Moreover, consumers are at risk of considerably worst outcomes than the market because car dealers would adopt unfair sales practices to sell them those add-on insurance products.

Action: To avoid any customer abuse, a cap should be placed on the commission car dealers receive upon selling those insurance products.

Impact: A cap on commission will help ensure that car dealers don't oversell add-on insurance to their customers. This can help avoid any abuse of customer rights and also prevent the sale of unsuitable products to customers.

Recommendation 4.8 – Removal of claims handling exemption

Purpose: The handling of insurance claims is excluded from the definition of financial service. Hence insurers are not governed by the legislation when making a decision about a claim, conducting negotiations in respect of settlement amounts, preparing loss estimates and making recommendations about loss mitigation.

Action: The handling and settlement of insurance claims should no longer be exempted from the financial service definition and should hence be regulated by the relevant governing laws.

Impact: This will ensure that there is no abuse and conflict of interest in the way insurance claims are held and settled.

Recommendation 4.10 – Extension of the sanctions power

Purpose: Self regulation in the insurance industry is not enough to prevent breaches of existing code of conducts as not all industry participants believe they should comply with the code. Moreover the monitoring of the self regulatory code might be inadequate and the resulting sanctions for not complying with the code might not be effective.

Action: ASIC should review and approve the provisions of the industry code prior to it being endorsed by the industry participants. The Financial Services Council should empower the Life Code Compliance Committee to impose sanctions on industry participants that have breached the relevant code.

Impact: This will encourage all industry participants to comply with the relevant Code of Conduct.

Recommendation 4.12 – Accountability regime

Purpose: The provisions of the Banking Accountability Executive Regime (BEAR) are not currently endorsed by APRA-regulated insurers. All authorised deposit taking and registrable superannuation entities are required to comply with BEAR provisions.

Action: APRA-regulated insurers should uphold the provisions of BEAR.

Impact: This will improve their level of transparency and integrity when it comes to reporting on non compliance with the laws and regulations. The BEAR provisions will help them take responsibility over failure to comply adequately with relevant laws.

5. Culture, governance and remuneration

Recommendation 5.3 – Revised prudential standards and guidance

Purpose: APRA–regulated institutions don't currently have a remuneration system that encourages effective management of non-financial risks.

Action: By reviewing their remuneration systems, these institutions will be able to identify significant risks and avoid professional misconduct that would impair the level of client trusts. The board should review their remuneration system in a way that it is less oriented towards financial metrics.

Impact: This will empower these institutions with the ability to identify risks early and take adequate measures to minimise losses.

Recommendation 5.4 – Remuneration of front line staff

Purpose: Front line staffs are often responsible for generating revenue for these institutions. Their main objective is to sell as many products as they can to be remunerated accordingly. But the focus should be shifted away from what they are doing to generate revenue to how they are doing it. Often they are caught selling products that are not suitable for their clients just because they seek to achieve a particular sales target.

Action: In order to avoid the sale of unsuitable products, the remuneration strategy should be reviewed. The remuneration system should not merely focus on sales performance but rather on the risks associated to the way the sales are made.

Impact: This will help ensure that front line staffs are not focused only on performance metrics but also on how they do their jobs.

Recommendation 5.7 – Supervision of culture and governance

Purpose: Due to poor corporate culture and values, financial services institutions have failed to meet the evolving expectations of an evolving society. These institutions were poorly governed and consequently placed their own interests above those of their clients.

Action: APRA must design a culture and governance framework that will be endorsed and adopted by all APRA-regulated entities

Impact: This will ensure uniformity in compliance and avoid the risk of conflict of interests.

6. Regulators

Recommendation 6.4 – ASIC as conduct regulator

Purpose: Due to inadequate sanctions and the absence of civil penalties, financial institutions have engaged into professional misconduct that has impaired the level of trust in the financial services sector.

Action: ASIC and APRA should be empowered to enforce the provisions of the SIS Act. They should be allowed to impose sanctions and civil penalties accordingly.

Impact: This will encourage APRA-regulated institutions and financial advisors to refrain from engaging in professional misconduct.

Recommendation 6.14 – A new oversight authority

Purpose: Currently the activities of APRA and ASIC are not governed by an independent non-governmental authority.

Action: An independent authority should be formed and should comprise of three part-time members and a permanent secretariat. The new oversight authority should operate independently of the government and monitor the activities of APRA and ASIC.

Impact: This will help restore stakeholder trust and confidence in the work performed by ASIC and APRA.

7. Other important steps

Recommendation 7.3 – Exceptions and qualifications

Purpose: The current legislation governing the financial services sector consists of a number of exceptions that would qualify certain entities or financial advisors for an exemption from the application of the law.

Action: These exemption and qualifications should be removed

Impact: This will ensure that all financial institutions and financial advisors will be governed by the same law. Hence it will avoid the risk of professional misconduct and conflicts of interests.

Conclusion

The federal government will decide on whether to adopt all or part of the recommendations made. These recommendations will contribute towards enhancing the integrity of the financial services sector but will also help to promote the application of a strict code of ethics in the industry. This will help restore and promote the integrity of the investment profession. As CFA Charterholders, we are required to uphold the strictest code of ethics and highest standards of professional conduct to protect the integrity of capital markets.