Resetting standards – now for the industry to deliver

Perspectives on the Financial Services Royal Commission Final Report

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Executive Summary

The Royal Commission[1] has issued its Final Report comprising 76 recommendations. To date, most market commentators have been underwhelmed, observing that the Commission stopped short of explicitly making some of the most prescriptive recommendations some had expected.

However we believe the Report and the Commissioner's approach to recommendations have significant merit. By focusing on the enforcement of existing law, articulation of clear principles and expectations of conduct, and lighting a fire under the regulators, the Commission sets a high bar around intent and customer outcomes. Rather than detailing everything to be done, this Report sets the standard of accountability and consequence (including for the supervisory regime), puts in place a number of carefully-chosen backstops, makes explicit prescriptions where warranted (such as in areas involving abuse or irreconcilable conflicts), then lays down the gauntlet for financial institutions and their regulators - to whom he assigns accountability to address identified issues and ensure the industry does not return to this point again.

When all is said and done, we expect this Report to catalyse changes to industry practice, culture and economics that may be as significant as any we have seen since the Wallis Report[2]. It now falls to the industry to deliver.

Principles, general rules and causal factors

Commissioner Hayne's Final Report, like the Interim Report which preceded it in September, demonstrates his signature style: depth, attention to detail, and ruthless logic. It restates the six principles for proper institutional behaviour (norms of conduct) which were shown to be inconsistently observed across the industry, and in some cases, observed to be in breach:

- Obey the law;
- Do not mislead or deceive;
- Act fairly;
- Provide services that are fit for purpose;
- Deliver services with reasonable care and skill, and
- When acting for another, act in the best interests of that other.

In the Final Report, these have been extended through the contemplation of six general rules:

- The law must be applied and its application enforced;
- Industry codes should be approved under statute, and breach of key promises made to customers in the codes should be a breach of the statute;
- No financial product should be hawked to retail clients;
- Intermediaries should act only on behalf of, and in the interests of, the party who pays the intermediary;
- Exceptions to the ban on conflicted remuneration should be eliminated; and
- Culture, governance and remuneration practices, both in the industry generally and in individual entities, must focus on non-financial risk, as well as financial risk.

Taken as a whole, these principles and general rules have the intent of significantly tightening the legal and regulatory framework within which institutions operate. They have the effect of: i) removing the degrees of freedom which have too often allowed the rationalisation of inappropriate practice, as well as ii) eliminating the exceptions which have been allowed to filter into the system in contemplation of specific groups of interests. Most importantly, they further embolden regulators.

This intent is reinforced through the Commissioner's summary of the four contributing factors to poor conduct - a particularly simple assessment of how we got here:

- Pursuit of private gain;
- Ability to engage in poor conduct;
- Intermediaries whose loyalties and accountabilities were unclear; and
- Insufficient accountability and consequence for poor behaviour.

1 The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

2 Financial Systems Inquiry Final Report, March 1997

At first, the recommendations appear underwhelming

Like the Interim Report, the Final Report has surprised those expecting the Commission to issue prescriptive instructions to the industry addressing the issues exposed by their work. Whilst the Interim Report stopped short of making any recommendations at all, the Final Report issued 76 recommendations, which generally align to the following imperatives:

Simplify the law so that its intent is met;

Address potential or perceived conflicts of interest;

Focus on the regulators and drive compliance;

Target culture, governance and remuneration; and

Support increasing consumer protection.

Many of these are material, but, with just a few exceptions, they do not prescribe some of the most controversial and potentially charged actions anticipated by many commentators.

A number of anticipated recommendations did not materialise

It is noteworthy that the Commission made only a few specific recommendations for legislative change. For instance, the Commission did not recommend changing the language around loan suitability in the National Consumer Credit Protection (NCCP) Act.

There was no explicit recommendation around responsible lending, including the assessment of serviceability, use of HEM (Household Expenditure Measure), or use of funds (such as for gambling), despite dedicating significant attention to such matters during the course of the hearings. Likewise, though executive greed, conflicted remuneration and perverse incentives are all significant themes in the Commission's diagnosis of what's gone wrong, the Final Report makes few specific recommendations, about either executive remuneration, consequence management or accountability[3].

The Commission also declined to make wholesale changes to the 'twin peaks' regulatory model, to recommend forced structural separation of major players by any criteria, or to recommend specific criminal sanction against specific individuals.

A focus on the effective delivery of existing service propositions

Of the 76 recommendations in the Final Report, only a few clearly present existential challenge to the viability of any incumbent business model or service proposition:

- The recommendation to remove the point-of-sale exemption for consumer credit, which presents a significant future challenge for the distribution of sales-finance;
- The requirement that brokers be remunerated directly by borrowers, which, notwithstanding its theoretical appeal, requires a non-trivial shift in the market's established remuneration model, a shift some small businesses in the industry worry may take longer than they can remain solvent; and
- The recommendation to prohibit the deduction of advice fees (except intra fund advice) from MySuper accounts, the introduction of an annual renewal requirement for accounts other than MySuper, and abolishing grandfathered commissions will, together with recommendations relating to improving the quality of advice, challenge the financial advice industry.

Other recommendations do, in total, present a number of potential challenges to the viability of current products and distribution channels, as well as structural choices.

However, for the most part, the bulk of recommendations target improvements in the operation of business models and delivery of service propositions as they exist today (and/or consequences for the breakdown of those operations), rather than call into question the legitimacy or sustainability of those propositions in the first place.

3 The Commission did recommend extending the scope of BEAR (Banking Executive Accountability Regime) beyond the banking sector, that regulated institutions design their remuneration systems around encouraging sound management of non-financial risks alongside financial ones, and of course that banks implement the recommendations of the Sedgwick Review.

Long term impact more substantial than market seems to appreciate

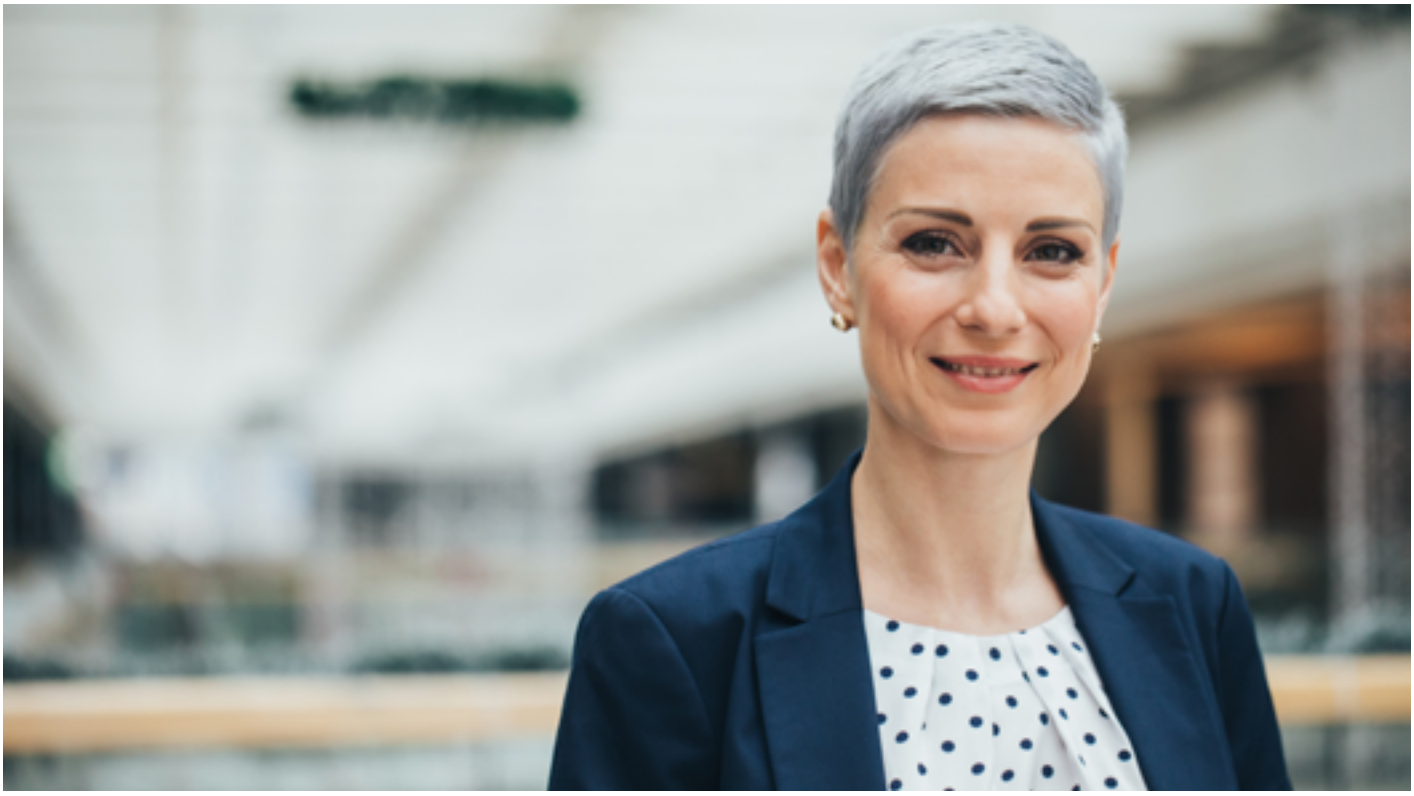
So far, observers have been either unimpressed or relieved. For instance, in the press, observers have described the outcome as a 'reprieve', 'pulled punch' or 'disappointment.' One editorial even called it a 'damp squib.'

However, in light of the logic demonstrated throughout the Report, a close read of the full text is critical to contextualise the recommendations and understand how they were considered (as we illustrate in the case study section, within the context of responsible lending, remuneration, insurance and vertical integration in wealth). It also helps us understand how and why the balance was struck between prescription and principle. In our view, the Final and Interim Reports may well become the handbook for the industry and regulators over the next decade.

Accordingly, we expect the reaction of stakeholders to evolve as they think more deeply about how the recommendations will play out. On the assumption that government will implement all recommendations and we see rational responses from market participants and regulators, the shift implied in the recommendations and Report taken as a whole should not be underestimated. In fact, by emphasising principles, the Commissioner has made it harder for vested interests to interfere with the implementation of recommendations.

In particular, the absolute prioritisation of customer outcomes by the Commissioner has led to a strong emphasis on the extended application of Best Interest obligations across the industry. This leads to a focus on *whether* customer interests are met, rather than the question of *how* they are to be achieved. The 'how' can be addressed through reference to principle, regulation and certain backstops such as hindsight reviews down the track. As a result, choice on structure and operation, executive remuneration and governance is left to individual organisations who must then prove how they meet customer interest and other legal requirements. If not achieved, the detection, enforcement and consequence management powers of the regulators will have been significantly increased at both the organisational, and individual level, to hold them to account.

Where the report is prescriptive, is in the simplification of the law, prevention of clear customer abuse, and, notably, to remove clear conflicts between interest and duty. The emphasis on conflicts of interest throughout the report lies, in many instances, on a move from *managing* conflicts to *reducing* or *eliminating* them. Indeed the Commissioner goes as far as to say that a number of present conflicts between interest and duty cannot be appropriately 'managed.' How far this goes is something to be closely watched over time.



Clear principles impact priorities, practices, people and oversight

By directly addressing the precepts of proper institutional behaviour, the recommendations have the potential to engender far reaching changes to industry structure and economics. Just because structural reform has not been mandated does not mean it won't arise. This is likely to be a key consideration in all parts of the industry and, in broad terms, we see impacts in four particular respects: priorities, practices, people and oversight.

More balanced priorities

Prioritising profit and shareholder returns over customers and legal compliance is roundly rejected. Directors must act in good faith in the interests of the corporation and for a proper purpose. That duty is owed to the corporation, not the shareholders. It follows that the Board needs to consider its social licence to operate including balancing the interests of shareholders, customers, employees and any systemically important role in the economy. Non-financial risks are just as important as financial risks.

Improved underlying industry practices

There are a number of specific improvements in the way financial services are provided which the Commission clearly anticipates, and in some cases explicitly prescribes. The most important examples are the enforcement of industry codes of practice, prohibitions on hawking, the enhanced supervision of remuneration, and the treatment of borrowers under financial hardship, especially in the case of farmers during drought. In this way, the Commission, where it was deemed that the need was sufficiently tangible, explicitly abolished some practices and prescribed others. Elsewhere the Commissioner is relying on the industry to meet the priciples he has outlined.

People operating under heightened scrutiny and accountability

Beyond specifically prescribed processes and behaviours, the Commission's recommendations and even more its commentary and rhetoric, will likely influence the attitude, attention and sense of personal accountability of industry insiders for years to come. Leaders, individuals and the cultural ecosystem are all impacted.

The degree to which specific directors and senior executives were called out for attention (and possibly future criminal prosecution) is not entirely unprecedented in Australian history, but is certainly unusual. Among this cohort, the sense of increased accountability has become almost palpable, not to mention the reputational exposure associated with such leadership roles.

The complexity of leadership required and the culture they must create to rebuild trust, navigate through this era of costly compliance and re-balance priorities will require them to inspire their people with fortitude, humility and a strong moral compass. The imperative for this leadership given the psychological fallout on people cannot be underestimated.

While the construct of culture is pervasive throughout the report, at first glance, the obligations to manage it do not appear dramatic. Unsurprisingly, the Commissioner reinforces the fact that the primary responsibility for managing culture lies with the financial services entity itself. However, with the Prudential Inquiry into CBA and the subsequent self assessments carried out at other institutions, a new precedent for visibility into cultural drivers of misconduct, accountability and other outcomes has been set. The Commission recommends a revision to the prudential standards and guidance to enable APRA to directly assess and supervise the evolution of culture. How invasive and interventionist a role APRA will play remains to be seen, but the call for greater culture expertise and capacity could be indicative.

Oversight undertaken with greater urgency and edge

The recommendation for a formal 'supervisor of supervisors' will drive regulators to be more proactive, than they were on the course to become already. The expectation of more assertive regulators will likely drive the behaviour of both financial institutions, as well as that of customers, disruptive competitors and other stakeholders. There will also be much greater focus on regulator capability and performance.

Significant work to be done

No real clarity on future policy any time soon

Notwithstanding the significant changes anticipated and the government's stated commitment to implement the Commission's recommendations with urgency, the current political realities make it highly unlikely that we will see any real change to the regulatory or legal landscape until the end of the year.

Industry and Regulators ultimately accountable to work out what must be done

Regardless of the political timing, one consequence of the Commission not making explicit recommendations on such matters as the suitability of vertical integration, responsible lending obligations or individual criminal liabilities is that now someone else has to work through how to align and implement in line with the principles set out.

In many cases, the responsibility falls on the industry itself, with the Commissioner saying:

Here are the outcomes required. You figure out how to deliver them. Just know you'll be held accountable, in a way you have never been before.

For these reasons we envision a post-Hayne world looking very different to the one that preceded it, but in ways that won't be fully apparent for a number of years to come.

Where to from here

Make no mistake, Commissioner Hayne is very clear with his expectations. This is evident in both the Interim Report, where he questions the validity of a 'first-mover disadvantage' argument, and in this Final Report where he disparages the use of 'unintended consequences' as a reason to oppose change.

Whichever interpretation you have of the level of rigour and extent of the recommendations raised, we believe there can be no debate that now is the time to be doing the right thing - to revolve around your customers and empower your teams to act in accordance with the norms of conduct. This will enable and support the industry in rebuilding trust with the community.

With so much to be done, and so many degrees of freedom still available, now is the time to understand and make the difficult, but well informed prioritisation decisions necessary to align key stakeholders and teams. Execution against transformation objectives must be renewed, refocused and accelerated.

No-one should miss the fact that what the Commissioner has done in delivering a Report of this content and style, is to provide institutions with what is potentially a final opportunity to have power over their own destiny.

Appendix – illustrative examples of future impacts

Case Study 1: Responsible lending

The Commission's recommendations regarding responsible lending came well short of many expectations raised by the tenor of the hearings and the language of the Interim Report.

Of course, the Commission (alongside government's proposed actions) did make material recommendations in areas germane to responsible lending, including:

- Material changes to the broker remuneration model coupled with an explicit 'best interest' guarantee
- Removal of the so-called 'POS exemption' to the licensing regulations associated with the Credit Act (NCCP)[4], which permits the intermediation of sales finance by unlicensed sales representatives), and
- The potential extension of BEAR to all AFSL and ACL holders[5].

At the same time, the Commission could have, but chose not to make recommendations to:

- Strengthen NCCP to include the requirement for positive verification of suitability rather than the imperative to merely determine that a product is 'not unsuitable' for a customer;
- Extend the 'consumer' protections of the NCCP Act to include SMEs;
- Add explicit detail to the requirement to verify borrower financial circumstance, including guidance on acceptable use of HEM, borrower interview guides and/or advice; and
- Remove the 'Introducer Exemption' to the NCCP licensing regulations, as they recommended for the 'POS Exception.'

Obviously, the additional potential recommendations *not made* could have had significant incremental impact on lending businesses at traditional banks at a time when these businesses are already under some strain. For this reason, some commentators (though not brokers) have been initially inclined to take a sanguine view of the recommendations, at least relative to what could have been.

As mentioned, we suspect that this view will evolve over time. When one takes into consideration the full suite of recommended actions alongside the articulation of the Commissioner's logic, the case for complacency goes away.

For example, consider the legal environment. Why did the Commissioner recommend no change to legislation? On this he has been clear in both the Interim and Final Reports: it is because, in his view, the existing legislation is entirely adequate. The problem, in other words, rests entirely with the industry and its inability or unwillingness to comply with existing laws. In fact, the Commissioner was downright dismissive of arguments making reference to cost or difficulty in taking the necessary steps to comply with what he views as non-negotiable legal obligations. In short, the Commission's satisfaction with in-situ legislation should hardly provide comfort, especially in the face of amplified supervision and enforcement activity in the years ahead.

In such an environment, does it matter that the Commission declined to specify changes to requirements for serviceability assessment, product suitability or advice? Any lender not already taking a hard look at every element of the consumer-lending value chain from a responsible lending perspective is courting significant regulatory risk, potentially personal legal risk, and, in this economic environment, probably also significant commercial risk as well.

All this is even more the case for mortgage brokers. They will have to deal not only with the challenges of complying with the requirements of the 'best-interest' obligation mentioned above, but may also find their fundamental business model and social-value proposition under additional scrutiny should they be required to execute a highly-complex transition from one remuneration model to another.

4 Formally known as the National Consumer Credit Protection (NCCP) Act, 2009

5 Australian Financial Service Licence and Australian Credit Licence

Case Study 2: Remuneration

In the case of remuneration there were not as many prescriptive recommendations within the Final Report as some had anticipated.

The Interim Report came close to calling into question the viability of performance-based remuneration. Of the four key observations summarised at the start of the Final Report, the connection between misconduct and reward is called out first, setting up an expectation that the Commissioner would come down hard on pay. However, none of the five recommendations related to remuneration in the Final Report directly prescribe any change to variable pay beyond limiting the use of financial metrics for long term incentives and introducing claw-back provisions.

Rather, in the spirit of continuing with a principles-based approach, the focus is on governance practices such as effectiveness assessments and improving the quality of information provided to the Board about risk management performance and remuneration decisions. Done well, they could better align pay with performance and result in some of the very same structural changes to pay structures that the Commission pointedly refrained from explicitly recommending.

Having said this, we don't envision wholesale changes in the *near term*. There are three reasons for this.

First, many financial institutions have very recently made changes to remuneration and governance practices to address the link between conduct and rewards through such things as the implementation of Sedgwick recommendations[6] and will continue to do so in addressing actions following on from their prudential self assessments. We expect the industry and its regulators need time to allow these changes to take effect. It is too early to conclude if such changes have not gone far enough.

Second, the immediate responsibility for effecting remuneration recommendations has been placed with APRA, and there is no recommendation as to the level of prescription or accelerated timing expected in incorporating this into the prudential standard.

Finally, whatever changes are to be made will be somewhat constrained by the ongoing requirement to recruit and retain talent in the ever increasing competitive global market for financial services professionals.

Considering the above, it would seem quite unlikely that Remuneration Committees, or management teams, would pass through any substantial changes if they are not required. For example, introducing a bonus or a total reward cap to address the quantum of pay; reducing or removing variable pay for some roles; removing all volume-based measures from incentive arrangements to further minimise conflicts of interest; deferring more substantial proportions of pay for longer periods of time.

However, following what may have been an initial feeling of relief by institutions and Boards with the remuneration related recommendations, there is a real need to consider how reward frameworks can ensure different outcomes given the heightened focus on the customer and accountability. Financial institutions should be feeling anything but complacent about pay in a post Royal Commission world.

6 e.g. reducing the focus on volume based measures, increasing the focus on customer

Case Study 3: Insurance

In the case of insurance, the Commissioner recommendations continue the broad thrust of change already underway in the sector, bringing it into line with the rest of the industry in terms of ASIC's conduct oversight. The recommendations focused on three things:

- Delivering more valuable products and services;
- Clarifying accountabilities; and
- Consistency in operational delivery.

Though there was some surprise at the deferral of the question of life commissions for three years, the recommendations overall were not unexpected, and are seen as broadly supportive of the drive toward a more mature approach to managing conduct risk and accountability for good customer outcomes.

In addition, changes to sales practices will ensure that channel representation is focused on building better customer relationships anchored in products and services being sought. This includes the treatment of funeral-expense insurance (now subject to ASIC oversight), the application of a deferred-sales model to vehicle add-one insurance, as well as recommending a Treasury working group to develop an industry-wide model for deferred sale of add-on insurances more generally.

Consistent with the Commissioner's views on simplification and enforcing standard norms, he recommends consideration be given to removing exceptions to the ban on conflicted remuneration for life and general insurance (including consumer credit); however, decisions on this have been delayed to 2022.

Rather than forcing a fundamental reorientation of efforts towards transformation already underway, we see this Report as reinforcing and prompting their acceleration over the the next few years. Life insurance in particular will need to move more overtly from a focus on outbound selling to creating intrinsic appeal that will invite customer interest and inquiry. In the language of the industry, the product will need to become one that is increasingly 'bought' not 'sold.'

Making this happen will require new kinds of data, tools and capabilities in customer-facing staff so that they can empower customers with the information they need to make their own decisions with confidence. It will require operational consistency, clarity of accountability, transparency of outcome and consequence management. Extending BEAR to the sector will help, as will its extension to regulatory bodies (which may have the additional benefit of enabling regulators to better understand the impact they have on regulated entities).

Expanding the enforceability of industry codes of conduct will also help, along with ASIC's remit to oversee claims handling and insurance contracts, noting that this will require coordination and cross-sector collaboration between insurers, consultants, lawyers and other service providers to agree and encode common standards and expectations.

Case Study 4: Vertical integration in wealth

"The concept of acting in members' best interests is not hard to understand."

It was widely debated whether the Commissioner would include recommendations in his Final Report that would spell the end of the vertical integration model as we have known it. Public discussion suggested that banks might be forced to separate the wealth and advice businesses, with some calling for stricter regulatory obligations where default superannuation was offered by vertically integrated organisations.

The Commissioner acknowledges that a trustee, in fulfilling its obligations to operate a superannuation fund, is responsible for carrying out administrative, investments and insurance functions and dealing with members to deliver retirement outcomes. These functions can be undertaken by the trustee itself, a related party or a third party. Across the superannuation industry, trustees have adopted different business models over time to undertake these functions and fulfil these obligations. Notably, retail funds generally use related-party service providers and, in profit-to-member funds, the trustee itself, an associate or third party provides these functions.

The Final Report acknowledges that conflicts can arise in relation to all these models and flags particular considerations that arise in relation to each of these structures. Put simply, no structure is immune to conflicts of interest.

"The only way in which that conflict can be resolved is by the trustee fulfilling its duties."

In this context, it is unsurprising that the Final Report does not recommend a legislative prohibition on vertical integration, or a raft of detailed prescriptive recommendations, as many expected. Instead it emphasises that priority is given to members, makes specific recommendations to address particular issues identified during the Commission, and raises expectations of standards of governance and regulation. All will have significant implications for the industry, specifically in relation to the distribution of products, trustees' operating models, governance and oversight, and regulation of the sector.

Distribution of products

The Final Report includes recommendations that will fundamentally change how advice is provided to and paid for by superannuation fund members (e.g. the prohibition on the deduction of advice fees (except intra fund advice) from MySuper accounts, the introduction of an annual renewal requirement for accounts other than MySuper and abolishing grandfathered commissions). There are also additional consumer protections focusing on independent and quality advice and constraints on selling of super products via a ban on hawking and treating of employers.

Operating models, governance and oversight

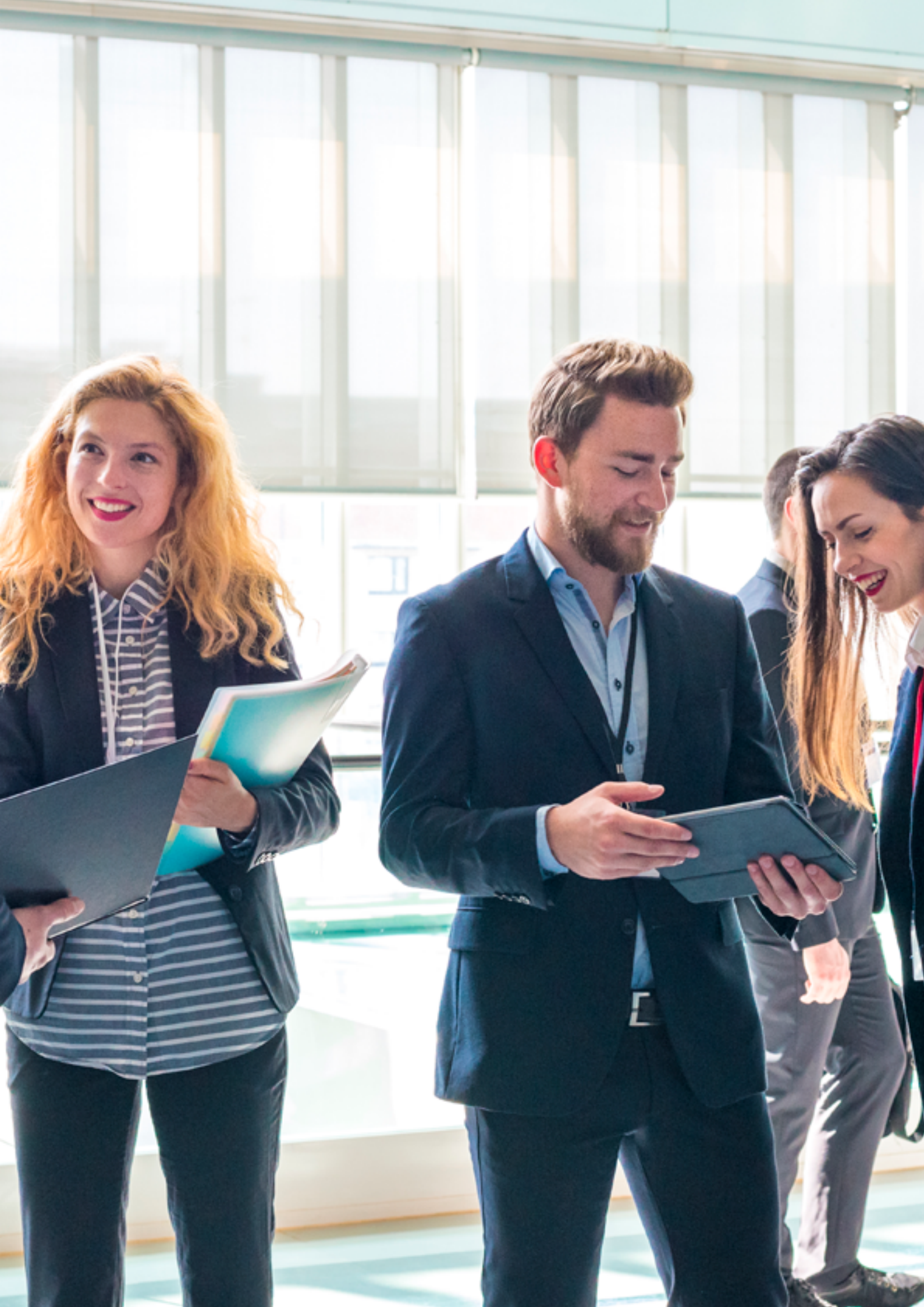
Trustees will be prohibited from holding any other role or office, which will require the separation of dual-regulated Registrable Superannuation Entity (RSE) and responsible entities businesses. There will also be greater scrutiny of related party arrangements (including comparing their offerings to others across the market, and the costs associated with them). BEAR will be extended to superannuation, which will require trustees to put in place clear accountability structures to support the achievement of outcomes that are in the best interests of members.

Regulation of the sector

The Final Report recommends industry codes be made enforceable, resulting in what was voluntary industry guidance becoming part of the suite of enforceable legal obligations for trustees.

It also recommends that a number of important reforms be reviewed in three years' time to ensure their objectives have been achieved, with respect to default MySuper group life policies and measures to improve the quality of financial advice, as well as periodic capability reviews of the regulators.

These recommendations, together with the introduction of civil penalties for breaches of covenants and regulators who are listening to calls for tougher action, will have significant implications for the financial advice and superannuation industries.



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Acknowledgement

We would like to thank the following PwC team members who have made a significant contribution to the development of this publication:

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- Michelle Kam
- Barry Trubridge
- Carolyn Morris
- Jamie Briggs
- Karen Evans-Cullen
- Lynda Reid
- Aloisa Aguilan
- Iain Tan
- Shad Ngam
- Laura Box
- Eloise de Cure-Ryan
- Gabriel Harris
- Katie Williams
- Debra Frances
- Jason Collins
- Hansjoerg Knieling
- Tom Novak
- Craig Stafford
- Nicole Scurrah
- Wayland Cheung
- Harry OMaille
- Joanna Lynch