Royal Commission Final Report – Where to next?

Building a better working world

Introduction

On Friday 1 February 2019, Commissioner Hayne submitted the Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. The final report provides pragmatic recommendations that seek to build on or simplify existing laws and practices and strengthen the financial system while supporting economic growth.

The Commissioner's recommendations and the Government's response stop short of major structural reform. However, they do herald sweeping changes to current operating models in the financial services market – reshaping the financial advice, life insurance and superannuation sectors, and the distribution model for retail credit.

They will also transform the regulators, APRA and ASIC, into more accountable, collaborative and responsive institutions. Market participants can expect to feel the effects of more intensive supervision and enforcement, where misconduct will be denounced and punished.

This document summarises the key themes and their impacts to the financial services industry and its regulators. It provides guidance for how Australia's financial institutions should be preparing for an extended period of implementation as the recommendations make their way through the system.

The Commissioner has given Australia's financial services sectors a series of purposeful, practical and logical recommendations that will foster compliance with the spirit and intention of the law – and ultimately strengthen the financial services system.

Culture, Governance and Remuneration

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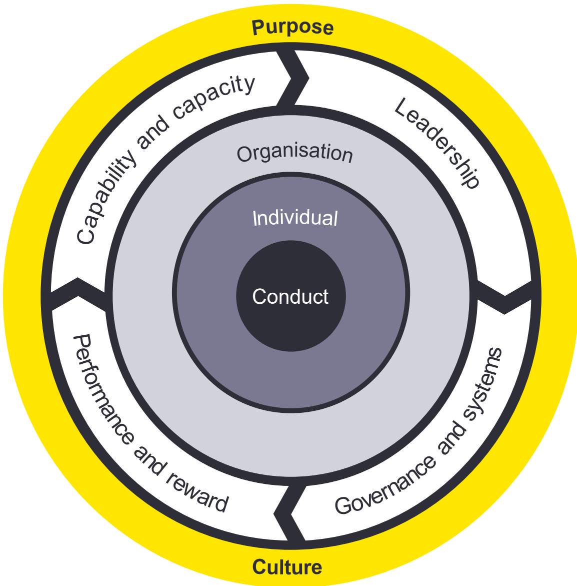
Failings of organisational culture, governance arrangements and remuneration systems lie at the heart of much of the misconduct examined in this Commission.



The Commissioner attributes much of the malaise affecting the industry to the prevailing cultural environment, governance arrangements and remuneration practices. He recommends strengthening regulatory oversight of culture, governance and remuneration and industry practices to achieve lasting change. This change will be challenging for both the organisations under scrutiny and for the regulators themselves, who are still developing the requisite supervisory capabilities.

To prepare for this shift in supervision focus, and to meet the Commissioner's broader recommendations for a public demonstration of a commitment to change, every organisation in the financial services industry must prioritise a coordinated and strategic view of organisational (and risk) culture, governance and remuneration.

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A culture that fosters poor leadership, poor decision-making or poor behaviour will undermine the governance framework of the entity.

Culture

In the past, financial services organisations have relied heavily on rules and systems to influence employee behaviour. Now, organisations must invest heavily in developing a strong, ethical culture, aligned to purpose, with boards and senior management setting the tone from the top. Leaders must take accountability for their behaviours and act with a greater awareness of their impact on others.

Boards, in particular, must take bold and decisive action in responding to the Commission's findings and push to develop tools and systems to monitor and assess organisational culture. They cannot sit back and wait for regulators or the market to move. Directors must move quickly to deeply understand their organisation's culture and have the courage to lead the changes that will have a meaningful impact on institutional behaviour.

The Commissioner outlines in detail the mutually reinforcing nature of culture, governance and remuneration – each are influencers of, and influenced by, the other. When responding to the recommendations, organisations must consider the complex interplay between these drivers. The Commissioner categorically views these three organisational drivers to be at the heart of the misconduct highlighted by his Commission.

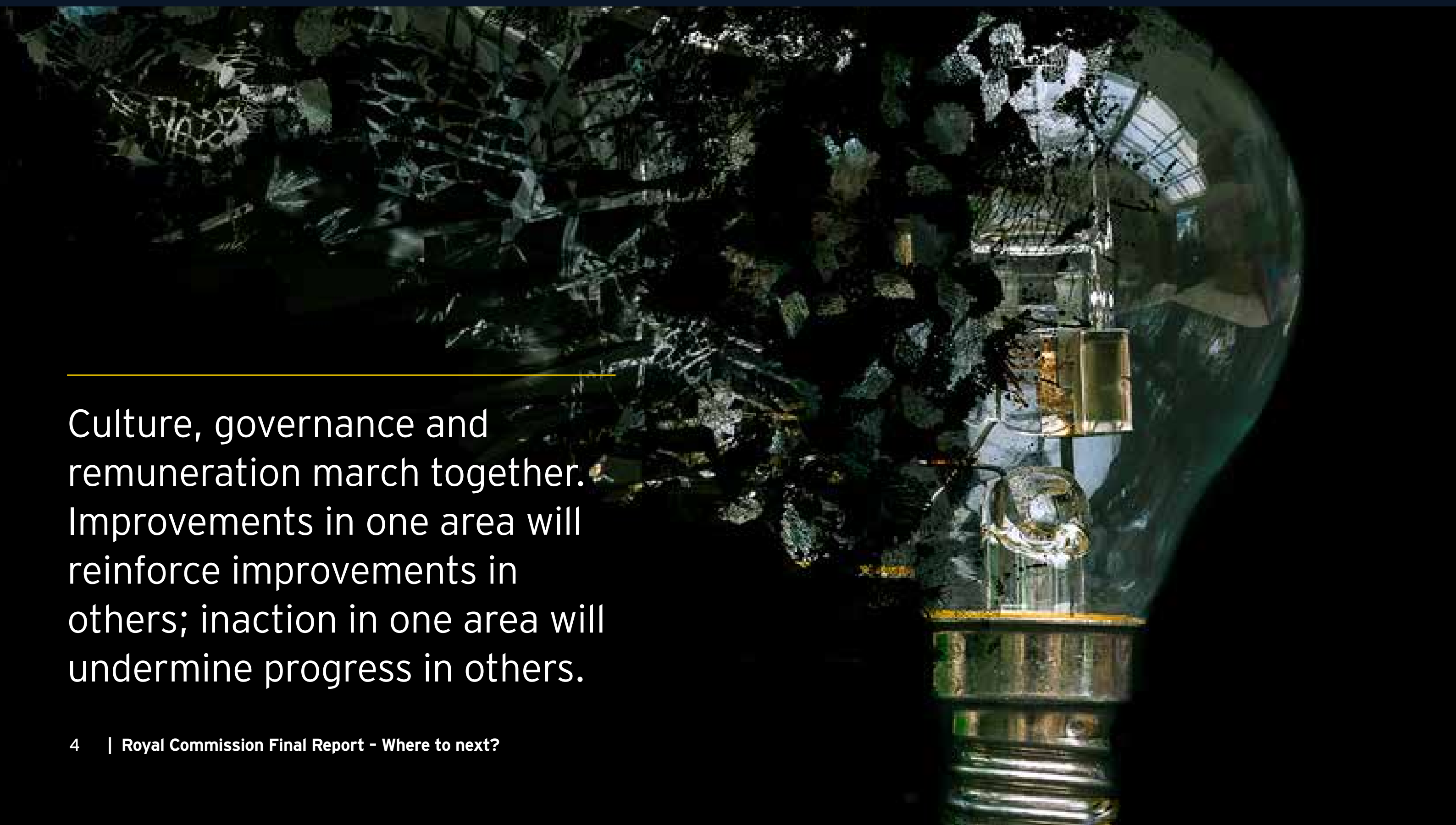
To address them, the Commissioner advocates for a regular, careful and detailed assessment of culture and governance, overseen by APRA. This must be an early priority, which will help leaders to understand the relationship between culture and conduct – and shine a light on potential cultural stress points before they manifest into misconduct.

Remuneration

Remuneration signals what an organisation measures and values. It's a key lever to reinforce behaviours, integral to supporting the cultural transformation the industry needs. To prevent remuneration from encouraging misconduct, the Commissioner has suggested enhancements to existing regulatory bodies or frameworks, including proposing remuneration framework design changes to be integrated in revised Prudential Standards.

The challenge in implementing these recommendations should not be underestimated. Changes to remuneration need to be aligned with organisational purpose, strategy and culture. The recommendations will require fundamental change to recruitment, recognition, performance management, career development and managerial capability to fulfil the spirit, not just the letter, of regulation. They involve:

- **Assessing remuneration practices, not just structures** – Both the design and operation of remuneration frameworks are important. The transformation cannot be achieved through new structures alone.
- **Addressing "how" as well as "what" is achieved** – This requires good performance management, career development and recognition, as well as aligned remuneration plans. Organisations should consider what "good" performance looks like, with a particular focus on customer outcomes.
- **Systemically incorporating non-financial performance and risk** – Organisations need to invest in defining, measuring, tracking and reporting on non-financial performance and risk, together with linking performance outcomes to remuneration, including long-term incentives.
- **Fully implementing Sedgwick across the industry** – While implementing the Sedgwick recommendations on scorecards is important, organisations will need to focus on recommendations relating to ethical decision making and removing bias towards sales over customer outcomes. The Sedgwick recommendations need to be considered and implemented, as appropriate, by organisations across the financial services industry.
- **Reaffirming the role of variable remuneration** – Variable remuneration will remain important. Organisations need to revisit the role of variable remuneration, which (appropriately customised) remains useful for most roles. The exclusions are those with key control/risk and ethical/compliance responsibilities.
- **Implementing real clawback policies** – Organisations need to develop structures to allow boards to clawback vested remuneration during and after employment. Boards must be prepared to reduce payments to zero.
- **Conducting regular framework reviews** – Reviews should be completed across multiple timeframes (e.g., in year, end of year and multi-year), with various elements tested during each review. Adjustments should be made as soon as possible to improve alignment and effectiveness.



Culture, governance and remuneration march together. Improvements in one area will reinforce improvements in others; inaction in one area will undermine progress in others.

> Too often, boards did not get the right information about emerging non-financial risks.

Governance

How boards respond to the Commissioner's report will be key in starting to re-build trust and confidence in the sector. Boards and senior management need to take immediate action in responding to the Commission's findings. Applying more rules and processes will be ineffective. As a priority, boards need to:

- **Review organisational, management and governance structures** – to clarify role definition, management breadth and accountability to ensure these are not causing poor customer outcomes. An effectiveness review should also assess the board's operating remit.
- **Take ownership for non-financial risks** – Supported by robust and objective measurement and reporting frameworks, boards must look at a broader range of non-financial risks, including reputation, brand, sustainable performance and innovation, to assure good customer outcomes are being delivered. Boards cannot assume the absence of conduct issues is indicative of good conduct or a healthy culture.
- **Measure and monitor culture and customer outcomes** – Boards must measure and monitor culture (through lead and lag indicators) and the value delivered to customers.
- **Use consequence management to enforce accountability** – Boards must have the courage to publicly hold senior management to account for delivering on strategy in a way that is ethical, sustainable and aligned to the principles of the Banking Executive Accountability Regime (BEAR). Consequence management must be applied consistently, sending clear messages to the organisation that poor behaviour will not be tolerated.
- **Empower employees to focus on good customer outcomes** – Organisations need to use their governance framework to encourage principle-based decision making, asking "Should we?" in moments that matter.

Tackling these priority areas may require boards to become far more active in performing their oversight role. This challenges boards to ensure they continually update and maintain their capability and capacity to perform this role effectively.

The Commissioner recognises the sheer volume of information directors are expected to consume to adequately perform their oversight role. He recommends improving the quality of information provided – rather than the quantity. This may change the way information is presented, how meetings are run or who attends the meetings. Insights from big data, ad hoc interactions and detailed case studies may be used to validate and challenge the information presented.

The report requires boards to re-examine the range of matters they are required to oversee, how they will perform that oversight and whether the board has the necessary skills. Where board commitments have significantly increased, a review of board and committee fees may be required. Boards should look at individual directors' broader commitments to ensure each person is able to commit the time and attention required to effectively discharge their duties.

> “…making the promises made in the Banking Code more meaningful

Banking

As expected, the Commissioner’s focus – and the biggest source of disruption for the sector – are recommendations that will fundamentally and rapidly reshape the distribution models for mortgage and retail credit products. Notably, the Commissioner is not recommending amendments to the National Consumer Credit Protection Act (the Credit Act). Instead, he focuses on ensuring compliance with the existing requirements and strengthening the enforceability of industry codes.

New models for mortgage origination

The recommendations impacting distribution models for mortgage and retail credit products represents one of the biggest source of disruption to the sector. Retail intermediaries will be required to comply with the Credit Act. The mortgage broking industry will be subject to new professional standards, lose its trail commissions, and potentially move to a ‘user pays model’ for commissions (subject to the findings of a review to be conducted by the Council of Financial Regulators and the ACCC in 2022).

These recommendations will fundamentally reshape the distribution model for consumer credit products. Removing trail commissions eliminates annuities for the broking industry and may in turn reduce the ‘stickiness’ of mortgages, with brokers no longer incentivised by a flow of income on the back book. The extension of the Credit Act, the treatment of mortgage brokers as financial advisors, and potential recourse against bad apples in the industry will all converge to dampen the volume of intermediate market participants.

The recommendations concerning mortgage brokers, who account for more than half of all residential loans settled, will fundamentally alter the industry. The Commissioner is steering the market towards a user pays model, with customers paying for a broker’s services. Moving to a fee for service model will change the future relationship between lender, broker and aggregators, with big questions over the future effectiveness of the current broker model.

Intermediated auto lending

Removing the point-of-sale exemption will dampen the demand for household goods financed by credit at the point-of-sale.

Enforceable industry codes

Together with other market participants, banks will be subject to mandatory financial services industry codes. The ABA and ASIC will make the provisions that govern the terms of the contract made or to be made between the bank and the customer or guarantor designated as “enforceable code provisions”. Significantly, ASIC will gain powers to approve codes of conduct, with contraventions of enforceable provisions to constitute a breach of the law.

Extension of Banking Executive Accountability Regime (BEAR)

This change, to cover *"all steps of design, delivery and maintenance of all products offered to customers"* will require institutions to rethink the way that product governance and lifecycle models work in the industry. Some institutions are in the early stages of identifying a single point of accountability, but many have not commenced this work. Given responsibilities are often distributed across multiple divisions and functions, implementing a clear accountability statement across the end-to-end product lifecycle will be challenging.

This recommendation is strengthened by the Government's announcement that it will be expanding the scope of the upcoming product design and distribution obligations to all financial services products – including credit. This will encourage the development of financial products designed to meet the needs of specific target consumers and put in place distribution controls to prevent them being sold to people for whom they are not appropriate.

Financial institutions can prepare for these obligations by critically examining their product suite and strengthening their product governance framework. Key issues will be:

- How the 'target market' of a product is identified and monitored over time
- The level and quality of oversight and interaction with distributors
- How complaints and other data are incorporated into the product review process

Re-thinking compliance and regulatory engagement

In the post-Commission era, institutions will be required to rapidly identify and report on their compliance obligations. They will need to be able to:

- Identify who is accountable for each obligation
- Identify the controls in place to ensure that obligations are being met
- Report on deficiencies in the control environment
- Demonstrate meaningful progress in remediation of those deficiencies

To achieve these objectives, Compliance functions will require ongoing funding and support from senior management and the board.

> “…Once [the proposed] changes have taken effect, it may be possible to ask again whether the financial advice industry has truly changed from an industry dedicated to the sale of financial products to a profession concerned with the provision of financial advice.

Financial Advice

The Commissioner’s recommendations, while expected, bring significant disruption to and accelerate necessary changes to business models, specifically:

- Removing grandfathered conflicted remuneration
- The suggestion that life insurance commissions be reduced to zero
- Requiring annual consent to fees

With the potential to gain first mover advantage, organisations must immediately focus on the viability of a fee for service model. Although much of this work is already underway, timelines have been accelerated.

New distribution models required

Shifting to a yearly ‘opt in’ advice model and removing carve outs, exceptions and grandfathering provisions will challenge the economics of advice businesses.

In the short term, anti-hawking requirements may narrow the focus of advice practices, potentially encouraging the growth of niche advice businesses.

Longer term, the recommendations may lead to industry convergence given diminishing commissions and comparable professional standards. The coming Open Banking regulations will also act as a disruptive force in this sector, by making information easily transferrable. This will allow new entrants to quickly understand a customer’s financial position and product needs.

Operating costs will also be increased by the effect of The Commissioner’s recommendations, including for example:

- Higher training requirements
- New reporting obligations and controls
- A significant uplift in internal compliance

Organisations will need to consider their positioning within this new market dynamic and appropriate fee models that provide perceived value to customers and commercial outcomes. Independent advisers will have significant opportunities to gain market share. These will be businesses that provide truly independent and quality advice – not tied to any product issuer – and that exhibit the professionalism demanded by the reforms and the new regulations.

The changes are likely to accelerate the evolution of roboadvice models and digital delivery to mass customers. There is a real possibility that financial advice splits between robo-advice for the majority of Australians and a face-to-face service only affordable to high net worth individuals.

The 2021 government-endorsed review of the effectiveness of measures to improve advice quality will be an important opportunity to ensure the recommendations have been effective.

Rebuilding trust in financial advice

The sector must re-build trust and demonstrate value, which will take time and effort.
To achieve this, the Commissioner is recommending:

- **A new disciplinary body** to bring financial advisers into line with other professions. Financial institutions should review how they currently monitor and manage their financial advisers. They also need to uplift their training and improve internal procedures for identifying and dealing with misconduct and compliance issues.
- **Compulsory training and a new Code of Ethics** to be agreed and established across the industry.
- **Reporting compliance concerns.** When adviser misconduct is detected, organisations will be required to determine the nature and extent of the misconduct and remediate clients promptly. This requirement will be a condition of their licence.
- **Reference checking and information-sharing.** Organisations will have a responsibility to ensure rigorous recruitment and reference-checking processes for advisers seeking to operate under their licence.

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The superannuation sector of the financial services industry is important, not only to the many individuals who participate in it as members of superannuation funds, but also to the nation.

Superannuation

The overarching theme from the report is the primacy of the covenant of trustees to act in members' bests interests ahead of all other interests. The Commission does not see a case for imposing structural separation on Registered Superannuation Entities (RSEs).

Members best interests front of mind for Trustees

In the future, breaches of this covenant will be enforceable by civil penalty. A lack of action is not considered to be acting in members' best interests. Trustees will need to comprehensively review all decisions, inputs and key outcomes across their responsibilities to ensure they constantly put members' best interests duty at the forefront of all actions.

Death of the dual board roles

RSEs must avoid conflicts altogether and will not be allowed to use a dual entity regulated model. Directors on RSE boards must carefully assess their conflicts of interest and duty. There is no room for a director with conflicting duties to other companies in a vertically integrated group, creating perceived or actual conflicts of duty between members and shareholders. Indeed, trustees with interests in financial planning businesses, a PST or separate administration company will also be prevented from serving on the boards of these other businesses as well.

Rethink required on how to sell superannuation

Hawking is now banned and employers cannot be "treated" to induce them to nominate a fund as a default for their employees. Trustees need to immediately review and change any practice where a superannuation product is actively being sold – other than where a person has specifically solicited the encounter. Business models will also need to be reviewed in light of the requirement to default members only once.

Members will find it harder to get affordable advice

Trustees and advisers need to ensure that advice being paid from a choice-superannuation account is limited to purely superannuation related matters and not retirement or how to maximise wealth generally. Given the recommendations' impacts to finance advice in general, advice will become costly and possibly less obtainable for the average superannuation member, with robo-advice filling some of the gap. As a priority, trustees must focus on the need to better educate members and potential members to improve their financial literacy.

BEAR will be extended to all RSE licensees

Improved governance and accountability is to be further embedded in the superannuation industry with the later introduction of BEAR. Successful implementation goes beyond the minimum top-down strategic expectations for accountability documentation and remuneration changes. Instead, it requires a review of bottom-up operational and process components to more accurately map and foster a culture of accountability, including understanding any risk and compliance gaps to be addressed. Funds can learn important lessons from the banking sector, with banks well progressed in their implementation.

New governance requirements

The report highlights the challenge for directors of superannuation funds that form part of a larger organisation, particularly where the trustee board relies on information or product supplied by a related party. This is particularly relevant for related party group insurance. These directors may wish to consider how they obtain the assurance and information, possibly requiring subsidiary boards to have an attached secretariat to carry out the required research.

Insurance

> “Insurance, as a means for spreading risk, brings significant benefits for both individuals and for communities. But some changes should be made … to balance better the rights and obligations of insurers and insured.

The Commissioner’s recommendations seek to rebalance the rights and obligations of the insured and the insurer by: reforming sales and distribution practices, including a ban on hawking; and changing the duty of disclosure and the content of insurance contracts.

Other significant developments include confirmation that BEAR will apply to insurers and the introduction of mandatory industry codes for insurance, which will result in ‘enforceable code provisions’ that will apply in the contract between the insured and the insurer.

Deferred sales model for add-on insurance

The Commissioner recommends an industry-wide deferred sales model for any Life and General insurance products added to the sale of a primary product. For some product types, the deferred sales model will lead to a decline in revenue and profit levels for insurers. However, given that add-on insurance has been the subject of prior inquiry by ASIC and the Productivity Commission, product manufacturers and their distribution agents should be well advanced in redesigning distribution arrangements and developing new distribution models. The next step will be to ensure distribution models meet the high levels of governance and customer outcomes expected from implementing the Commission’s recommendation.

Replacing duty of disclosure with a duty to take ‘reasonable care’ not to misrepresent:

The Commissioner recommends the current duty of disclosure be replaced with a duty to “take reasonable care not to make a misrepresentation”. This is a significant change that moves the burden from the insured to the insurer to obtain the information it needs to assess an insurance risk.

Life insurance underwriting practices will need to become more focused, using fewer and more specific underwriting questions to identify and assess risks. Life insurers will need to continue to redesign their underwriting tools, questions and approaches in light of the recommendations. We expect this will lead to fewer declined and disputed claims due to non-disclosure by customers.

Application of unfair contract terms to insurance contracts

Applying the unfair contract terms (UCT) provisions to insurance contracts may create a higher risk of additional claims or higher claim costs, as some of the terms used to limit an insurer's liability may not be permissible under UCT provisions. This may result in premium increases.

All insurance contracts will need to be assessed to determine what needs be rewritten or removed completely. Underwriting policies and procedures, as well as sales processes, will also need to be amended to prevent certain terms and conditions from being included in insurance contracts at the time of inception and/or variation.

Universal key definitions, terms and exclusions for MySuper group life policies

Legislating universal key definitions, terms and exclusions for default MySuper group life policies will significantly impact superannuation funds, group life insurers and their reinsurers in a number of areas.

We anticipate complications in agreeing the universal permanent disability definitions and eligibility criteria applicable across a broad range of insured lives and funds. Once the universal terms are agreed, we may see pricing implications across the entire industry. Some schemes may have insufficient data available to set prices appropriately for certain categories of risk. Also, transitioning current default members to any agreed universal terms will impact fund administration and claims management.

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Both ASIC and APRA recognise their approach to enforcement must change. That change cannot be effected by the passing of legislation. It must come from within the agencies.

Regulators and regulatory change

The Commissioner endorses the long-standing twin peaks model of regulation. While endorsing this model, the report contained recommendations to strengthen APRA and ASIC’s accountability framework, as well as encourage collaboration between the regulators. The Commission also recommends changing the regulators’ supervisory and enforcement approaches:

- **APRA – enhanced responsibilities to supervise remuneration and culture and governance.** These recommendations extend the shift in APRA’s supervisory approach that it embarked on several years ago with the creation of a Governance, Culture and Remuneration team.
- **ASIC – new approach to enforcement.** ASIC will begin by questioning whether a court should determine the consequences of a contravention – the “Why not litigate?” approach. This will be facilitated by the Government announcement that the jurisdiction of the Federal Court will be expanded to include corporate crime. Infringement notices and enforceable undertakings will be used less frequently.

In response, institutions will need to:

- **Consider whether their regulator engagement models are fit for purpose** in the current environment and focused on rebuilding trust with the regulators. Institutions will also need to balance the foreshadowed obligation to *“deal with APRA and ASIC in an open, constructive and cooperative way”* with, for example, ASIC’s “Why not litigate?” stance. This raises fundamental questions for senior leadership to consider; for example, what are the role and boundaries of legal professional privilege?

- **Focus on complying with the spirit and intent of the law.** The Commissioner recommends that *"legislation governing financial services entities should identify expressly what fundamental norms of behaviour are being pursued when particular and detailed rules are made about a particular subject matter"*. Institutions will need to encourage their employees to ask the question "Should we?", rather than "Can we?"
- **Consider how this more intensive supervisory and enforcement approach will influence management decision-making** in relation to the consequences of compliance breaches and funding allocations for Risk and Compliance. In addition, senior management will need to consider the reputational impacts of public enforcement action.

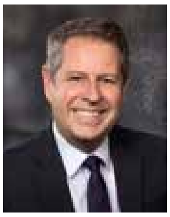
The report also contains recommendations – and the Government has itself committed to do certain things – designed to ensure that ASIC and licensees work to quickly report and remedy mistakes and breaches. These recommendations include a:

- New regime for reporting breaches to ASIC more promptly than in the past – and that ASIC publish breach data by type and by licensee
- Requirement that the licensees to take 'reasonable steps' to resolve disputes that are before AFCA
- New directions power for ASIC, to enable it to direct that licensees, for example, establish a remediation program to compensate customers

We recommend institutions prepare for these changes by:

- Harnessing the power of data to identify problematic trends and patterns, remediating root causes and sharing lessons learned. As well as making good business sense, this is increasingly becoming ASIC's strong expectation.
- Ensuring their breach reporting systems and processes are able to accommodate the compressed 30-day timeframe for reporting significant breaches to ASIC. The Commissioner recommends that ASIC publish breach reporting data annually by breach type and by individual licensee. This will require institutions to consider the robustness of their breach reporting data and whether correct data is able to be provided to ASIC efficiently.

Contacts



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