

FINANCIAL SERVICES ROYAL COMMISSION HANDS DOWN INTERIM REPORT

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Over the past 10 months or so, the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry has placed Australia's big banks and financial services entities under intense scrutiny.

Two hours ago, and two days ahead of schedule, Commissioner Hayne delivered his 1,000-odd page Interim Report (in three volumes) to His Excellency General the Honourable Sir Peter Cosgrove AK MC (Retd) Governor-General of the Commonwealth of Australia.

The Interim Report confirms what had become apparent as the Royal Commission continued and the headlines started to pile-up. Over many years, financial services entities in Australia have conducted themselves in ways which do not accord with community standards or expectations and, in many cases, the law.

The Royal Commission has shone a light on that conduct – flushing out example after example of misconduct and questionable practices, bringing such conduct firmly to the public's attention and exposing financial services entities to widespread condemnation.

It is clear that some of this conduct was known to regulators and the public generally before the Royal Commission – much would not have yet come to light but for the Royal Commission process.

The Interim Report is lengthy and complex, and will take time to digest in full, however by way of a high-level guide we provide below a brief summary and snapshot of the key elements we've identified in the Interim Report.

Notably, the Interim Report does not contain any identified draft recommendations (as might have been expected) instead, the Interim Report focusses on two high-level questions at this stage namely, in the face of the various conduct (and misconduct) which has been identified over the course of the year - why did this happen and what can be done to prevent it from happening again?

Why?

The Interim Report clearly points to the pursuit of short term profit as sitting at the core of the conduct which have come to light as a result of the Royal Commission.

The Interim Report is highly critical of the “sales culture” which has been allowed to pervade the banks and financial services entities, an environment where staff are measured and rewarded by reference to profit and sales at the price of honesty and ethical business practices.

This, the Commissioner says, has manifested itself in several forms - for example, selling institutions selling financial or insurance products to those who do not need it or charging commission to clients who have

died are picked out as two of the more startling examples.

The Commissioner poses the following poignant question *"Why do staff (whether customer-facing or not) need incentives to do their job unless the incentive is directed towards maximising revenue and profit?"*. It seems that the Commissioner certainly considers that a *"remuneration revolution"* is required to ensure that misconduct is not allowed to flourish in the future.

The Interim Report goes on to suggest that, even when it had been identified in the past, misconduct has not historically been properly investigated, prosecuted or punished by those charged with doing so. In particular, the Interim Report lines up APRA and ASIC for particular criticism:

"The conduct regulator, ASIC, rarely went to court to seek public denunciation of and punishment for misconduct. The prudential regulator, APRA, never went to court. Much more often than not, when misconduct was revealed, little happened beyond apology from the entity, a drawn out remediation program and protracted negotiation with ASIC of a media release, an infringement notice, or an enforceable undertaking that acknowledged no more than that ASIC had reasonable 'concerns' about the entity's conduct. Infringement notices imposed penalties that were immaterial for the large banks. Enforceable undertakings might require a 'community benefit payment', but the amount was far less than the penalty that ASIC could properly have asked a court to impose.

In a decade where ASIC's infringement notices to the major banks amounted to less than \$1.3 million (an amount some 7,000 times less than the CBA's profit for the period) – the Interim Report suggests that ASIC has preferred negotiation over punishment, settlement over litigation. In the darkness, misconduct has been allowed to bloom.

It appears relatively clear now that the Commissioner's final report will devote a considerable amount of time to the regulation of the financial services industry and the regulators themselves. A shake-up of the powers and remit of ASIC and APRA appears most certain. Providing the regulators with teeth (or ensuring that they use them) appears to be one area that the Commission is very much focussed on.

[What can be done to prevent the conduct happening again?](#)

The interim report acknowledges that, in the face of headline after headline, both regulators and financial services entities have been taking voluntary steps over the past year to get their houses in order – in a sense, pre-empting the recommendations they consider likely to be made in the Final Report next year.

The Interim Report clearly views the fact that those pre-emptive steps have been taken already as a positive – for example, announcements about new programs for refunds to consumers affected by entities' conduct, the abandonment of products or practices, the sale of divisions of businesses and changes in industry remuneration policies.

However, it is also clear that the Commissioner considers there to be much more work to be done. The tenor of the Interim Report makes it clear that self-regulation and belated voluntary steps to remedy past misconduct will not be sufficient to remedy the problems outlined in the report.

Instead, the Interim Report makes it clear that changes will need to be made to force financial services entities to:

"apply basic standards of fairness and honesty: by obeying the law; not misleading or deceiving; acting fairly; providing services that are fit for purpose; delivering services with reasonable care and skill; and, when acting for another, acting in the best interests of that other..."

The Interim Report's suggestion that it ought to be mandatory for ASIC to prosecute all instances of identified misconduct (unless it can show that doing so would be contrary to the public interest) is a particularly clear indication that the Commissioner considers far more visible, stringent and punitive regulation of the industry is required. The question is, are ASIC and APRA (in their current form) the entities to do so.

For those keen to explore the content of the Interim Report in detail, I would direct you to Chapter 10 of the report, which provides the most accessible snapshot of the Commissioner's current thinking at this point in

the Royal Commission.

In a fairly concise chapter, the Commissioner identifies each of the areas which have been the focus of the initial phases of the Royal Commission and, in respect of each, sets out the key areas of concern which have arisen to date.

The Interim Report does not contain any draft proposed recommendations or solutions at this stage, perhaps an indication of how much work is still to be done by the Royal Commission. The Commissioner does, however, pose a number of questions which appear to be the best indication of the direction in which the Commission is heading – and the recommendations which are likely to be made in the final report.

To save you having to digest the Interim Report over the long weekend in NSW, we have extracted below the key areas of concern identified by the Commission in respect of each market sector – as well as the key questions posed by the Commissioner in relation to each sector.

| Market sector | Key areas of concern and questions posed |
|---------------------------|---|
| Consumer Lending | <ul style="list-style-type: none">■ Intermediaries and confusion of roles.■ Communication with customers.■ Responsible lending. |
| Financial Advice | <ul style="list-style-type: none">■ Culture and incentives.■ Conflicts of interest and duty, and confusion of roles.■ Regulator effectiveness. |
| Small & Medium Businesses | <ul style="list-style-type: none">■ Should there be any change to the legal framework governing small and medium enterprise (SME) lending?■ Should any lending to SMEs come within the reach of the <i>National Consumer Credit Protection Act 2009</i> (Cth) (the <i>NCCP Act</i>)?■ The content of Code of Banking Practice obligations■ Third party guarantors■ Dispute resolution approaches by the Financial Ombudsman Service (FOS) and the Australian Financial Complaints Authority (AFCA). |
| Agricultural Lending | <ul style="list-style-type: none">■ How are borrowers and lenders in the agricultural sector to deal with the consequences of uncontrollable and unforeseen external events?■ Does the 2019 Banking Code of Practice provide adequate protection for agricultural businesses? If not, what changes should be made? |
| Remote Communities | <ul style="list-style-type: none">■ Do financial services entities have in place appropriate policies and procedures to assist Aboriginal and Torres Strait Islander people? |

| Market sector | Key areas of concern and questions posed |
|--------------------------|--|
| Regulations & Regulators | <ul style="list-style-type: none"> ■ Is the law governing financial services entities and their conduct too complicated? ■ Is the regulatory regime too complex? Should there be radical simplification of the regulatory regime? ■ Is ASIC's remit too large and are its enforcement practices satisfactory? ■ Should ASIC's enforcement priorities change? In particular, if there is a reasonable prospect of proving contravention, should ASIC institute proceedings unless it determines that it is in the public interest not to do so? ■ Are APRA's regulatory practices satisfactory? If not, how should they be changed? ■ Does the conduct identified and criticised in this report call for reconsideration of APRA's prudential standards on governance? ■ Should industry codes relating to the provision of financial services be recognised and applied by legislation like Part IVB of the <i>Competition and Consumer Act 2010 (Cth)</i>? |
| Entities | <ul style="list-style-type: none"> ■ Should changes be made to the remuneration practices of banks? What would they be, and how could change be required? ■ Should intermediaries be subject to rules generally similar to the conflicted remuneration prohibitions applying to the provision of financial advice? ■ Do the events that have happened suggest that manufacturers of financial products should not be permitted to provide, whether by employee or authorised representative, personal financial advice in relation to products of a kind it manufactures? |

Summary

The Interim Report reads, in many ways, as a fairly stream-of-consciousness document at this point – no firm (or even draft) recommendations are contained within it at this point. The areas of focus identified by the Commissioner, and the 'questions' posed by the Commissioner do suggest, however, that the Commission's final report will focus on three key areas:

- culture and incentives;
- conflicts of interest and confusion over roles and duties in the financial services market; and
- regulator effectiveness.

In particular, the Interim Report devotes considerable time and attention to the last of these points. Although the big banks and financial services providers have taken up most of the headlines over the past year – it now seems clear that the regulators will not escape the Commission's attention.

Given the level of public interest in the Royal Commission (fuelled by some eye-popping headlines over the past year) a visible Government response is all but guaranteed once the final report is handed down. A shake-up of the regulators is guaranteed to form a key part of that response.

From the insurers' perspective, the Interim Report contains relatively little in the way of concrete findings or recommendations which might provide insight into the industry's ultimate exposure to this Royal Commission (and the claims likely to follow).

Perhaps the only positive for the banks (and their insurers) in the Interim Report is in relation to the various allegations raised against the Commonwealth Bank in relation to the Bankwest acquisition. Commissioner Hayne rejects, in the Interim Report, the suggestions that the CBA had engineered defaults (during the financial crisis) to allow it to "claw back" the amount it had paid for the company. Those interested in this particular issue should head straight for Chapter 5, which is entirely devoted to it.

Otherwise, it appears that the industry will need to await the conclusion of the Royal Commission before it can get a final handle on any potential exposure it may have. Expect discussions surrounding the insurability of fines and penalties and deliberate misconduct to continue in a relative vacuum for now.

It will be interesting to see whether, given the scope of the matters set out in the Interim Report and the amount of work which the Commission still intends to do, whether the Commissioner will ultimately appeal for additional time to complete its report. While that is entirely possible, and the Government is unlikely to be able to resist a request for such an extension by the Commissioner.

That said, Commissioner Hayne has shown himself to be focussed and organised to date – for what it's worth our gut feeling is that the Commissioner will remain focussed on delivering his report in February of next year, rather than ask for additional time.

The Interim Report, in its entirety, can be found [here](#).

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