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

Seminar 19 Feb 2019

Agenda

1 Royal Commission: The Big Picture
Shemira Jeevaratnam

2 Vertical Integration and Conflicts of Interest
Bill Fuggle

3 The Regulators
Alan Darwin

4 Remuneration, Culture and Governance
Antony Rumboll

1 Royal Commission: The Big Picture

Royal Commission: The Big Picture

Treating the symptoms

Regulating the regulators

Greater structural changes needed

Royal Commission: Timeline

2017

14 Dec

Launch
The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry is established

2018

Jan - Feb

Submissions on initial request
Entities provided Commission with information concerning cases of misconduct in the banking sector over the past ten years.

13 Mar

23 Nov

Public Hearings
Seven rounds of public hearings occur across locations in Melbourne, Sydney, Brisbane and Darwin.

Round 1: Consumer lending
Round 2: Financial advice
Round 3: Loans to SMEs
Round 4: Issues affecting Australians living in remote ore regional communities
Round 5: Superannuation
Round 6: Insurance
Round 7: Policy questions

28 Sep

Interim Report
The Interim Report of the Financial Services Royal Commission is submitted to the Governor-General of the Commonwealth of Australia.

26 Oct

Submissions on the Interim Report close
A number of submissions are made from across the sector including banks, ASIC, APRA, and research bodies.

2019

4 Feb

Final Report
The final report is submitted to the Governor-General on 1 February 2019, and is subsequently tabled in Parliament on 4 February 2019

4 Feb

Australian Government Response
The Hon Josh Frydenberg releases the Australian Government's Response to the Royal Commission

ASIC Response
Statement on the Royal Commission from ASIC Chair James Shipton. "The Royal Commission report identified ASIC's enforcement culture as the focus of change needed at ASIC"

11 Feb

APRA Response
Further to its 4 Feb statement, APRA releases updates on its plans relating to recommendations of the Final Report

Implementation

Regulatory Perspective: How did we get here?

- Wallis Inquiry
- Murray Inquiry
- Early Scandals
- FoFA

The Final Report

Volume 1

1 Introduction

2 Recommendations by subject matter
- Banking
- Financial Advice
- Superannuation
- Insurance
- Culture, governance, remuneration
- Regulators
- Other important steps

3 Recommendations: Answering the key questions

4 Conclusion

Volume 2

1 Case Studies - Superannuation

2 Case Studies - Insurance

Volume 3

1 Appendix 1 – Letters Patent

2 Appendix 2 - Hearing dates

3 Appendix 3 – Public engagement

4 Appendix 4 – The Commission team

5 Appendix 5 - Witnesses

6 Appendix 6 - Submissions

7 Appendix 7 – Background Papers and Research Paper

2 Vertical Integration and Conflicts of Interest – Bill Fuggle

Vertical Integration and Conflicts of Interest

The final report of the commission has not recommended direct regulation of vertical integration, however, there are aspects of the report which could indirectly have a very material impact on vertical integration depending on how they are implemented.

Themes identified

Culture and incentives.

Issues on how industry participants are paid e.g. calculation of bonuses and other incentives.

Structural issues surrounding financial advice.

Consideration of consequences stemming from or appearing to stem from vertical integration (where an entity manufactures and sells financial products whilst also advising clients which of their products to buy/use) of some financial services entities.

Vertical Integration and Conflicts of Interest

Themes identified

Conflicts of interest and duty.

Issues about the confusion of roles and responsibilities e.g. mortgage brokers and aggregators and about FOFA's treatment of conflicts of interest that can and should be managed.

Cross selling.

Cross selling of financial services particularly by way of "hawking" should not be permitted or be severely limited.

Vertical Integration and Conflicts of Interest

FOFA – Vertical Integration - Impact of Mortgage Brokers

FOFA – best of intentions.

FOFA was implemented with the best of intentions to reduce conflicts of interest by eliminating conflicted remuneration.
Instead FOFA has been an aggressive driver of vertical integration which in turn drives conflicts of interest.
This outcome is due to a failure to support prohibitions on conflicted remuneration with prescribed consumer paid distribution fees or similar.

Extension of FOFA to Super, Life and Mortgage Brokers.

It is now proposed to extend FOFA to super and life by removing or reducing previous FOFA exemptions.
The proposed changes to mortgage brokers remuneration and addition of duties of care would make mortgage brokers subject to a FOFA like regime.
Will this drive more vertical integration? Or does it take us to a tipping point where prescribed distribution fees will kick in.

Vertical Integration and Conflicts of Interest

FOFA – Vertical Integration - Impact of Mortgage Brokers

FOFA and Prescribed Distribution Fees

Recommendation 1.4 states that a Treasury led working group will "***monitor and…adjust the remuneration model … and any fee that lenders should be required to charge to achieve a level playing field***"

This could end up being a game changer.

Page 80 of the report further elaborates:

"it may be that to create a level playing field between banks and brokers, banks should be required to charge a fee to direct customers based on the costs that are incurred by the bank when there is no broker…. ***if brokers are to charge a fee for their services, then it may be necessary for the purposes of maintaining competition, for banks also to be required to do so*** when directly originating a loan…If only brokers end up charging a fee, customers may cease to use their services, which would eliminate any potential benefit that brokers can have on competition in the residential mortgage market"

Vertical Integration and Conflicts of Interest

FOFA – Vertical Integration - Impact of Mortgage Brokers

Prescribed Distribution Fees for Mortgage Brokers could spread

If recommendation 1.4 and the page 80 statements are needed to make FOFA like requirements for mortgage brokers work properly, then this might also be applied to all FOFA affected sectors.
If this were to occur, vertical integration would be less attractive and reduce the pressure for its direct regulation.

Conversely failure to address the level playing field issue would mean a “doubling down” on the current flawed FOFA model which could be expected to drive more vertical integration and increased pressures for direct intervention.

Vertical Integration and Conflicts of Interest

FOFA – Vertical Integration – Other Cures

Cross Selling Restrictions Recommendations 3.4 and 4.1 –

Hawking of superannuation or insurance products to be prohibited.

Statements of Independence Recommendation 2.2 –

Disclosures as to lack of independence and the reason the advisor is not independent.

3 The Regulators – Alan Darwin

Key Recommendations
Royal Commission and the Regulators

Recommendation 6.1 – Retain twin peaks

- Retain the dual regulatory structure for the financial system
- Originally adopted by the Wallis Inquiry and continually endorsed

Recommendations 6.4, 6.5, 6.6 - Not identical twins

- ASIC to be the regulator of conduct in the financial system
- APRA to be the prudential peak
- Joint administration of BEAR

Recommendation 6.2 – ASIC's approach to enforcement

- Why not litigate?
- Other forms of enforcement such as infringement notices and EUs

Key Recommendations
Royal Commission and the Regulators

Recommendation 6.9 & 6.10 – Twins must co-operate

- Statutory obligation to share information
- Co-operation Memorandum

Recommendation 6.11 to 6.14 – Management and oversight of the twins

- Improved Governance structures, capability reviews (APRA immediate)
- BEAR to FEAR to REAR
- New oversight body to assess the performance of ASIC and APRA

Recommendation 7.2 – Implement Enforcement Review Recommendations

- Breach Notifications

Some Implications
Royal Commission and the Regulators

ASIC's Approach to Enforcement

- More litigious ASIC means more litigation and greater risk for licensees
- Compliance measures will need to be cognisant and escalation policy reviewed
- Legal professional privilege and record retention

Reporting to ASIC – suspected breaches to bad apples

- More proactive reporting
- More difficult to manage the process now

Superannuation Trustees

- Meet ASIC – your new regulator

4 Remuneration, Culture and Governance – Antony Rumboll

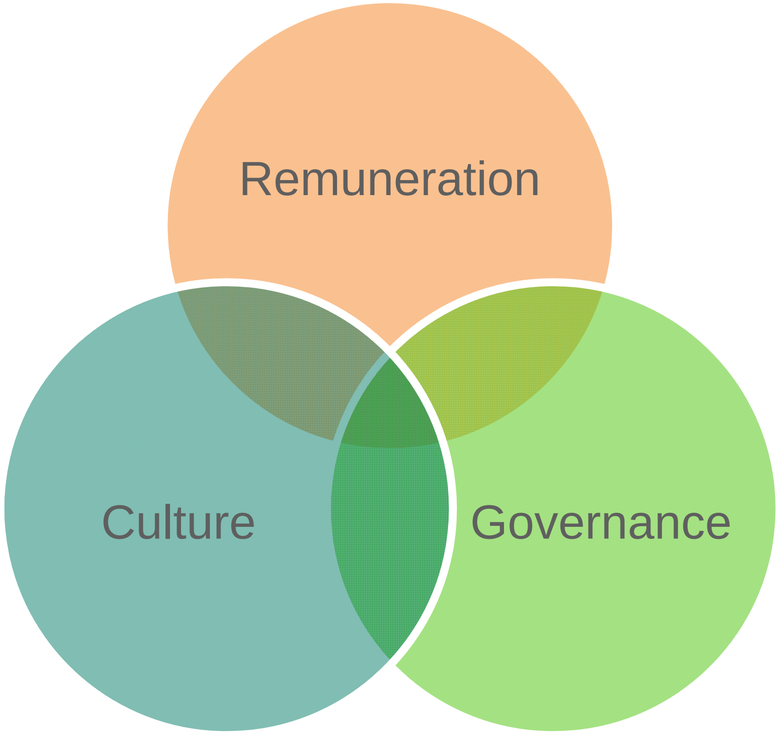
Summary of key findings

- In providing its 76 recommendations, the final report noted that:

  "failings of organisational culture, governance arrangements and remunerations systems, lie at the heart of much of the misconduct examined in the Commission".

  "the primary responsibility for misconduct in the financial services industry lies with the entities concerned and with those who manage and control them: their boards and senior management".
- Overall, Australia's corporate governance model is sound
- Bi-partisan support to take action in relation to all of the recommendations
- Delays in application likely but "time waits for no man" …

Independencies



"Positive steps taken in one area will reinforce positive steps taken in the others. Failings in one area will undermine progress in the others."

Remuneration

- Remuneration affects and reflects culture
- Must be used to reflect accountability
- Summary of the recommendations
  1. Prudential standards must encourage sound management of non-financial risks.
  2. Boards (or its remuneration committee) must make regular assessments of the effectiveness regarding their remuneration system.
  3. Regulators must to more to gather information as to how remuneration systems are being applied in practice.
  4. All financial services entities should review at least once a year the design and implementation of their remuneration systems for front line staff.

Remuneration – What this means

- Remuneration of senior management and front line staff in focus
- Design
  - should encourage sound management of non-financial risks
  - focus on misconduct, compliance and other non-financial risks
  - fixed v variable, long-term v short term
  - focus on variable remuneration, especially LTIs
  - availability of clawback
- Implementation
  - ongoing and effective supervision required
  - annual review for front-line staff
- “Two strikes” rule may come under review
  - used as more of a general protest vote and focuses remuneration on financial measures

Culture

Three general points regarding culture:

1. Culture of each entity is unique, and may vary widely within different parts of the entity.
2. There is no single “best practice” for creating or maintaining a desirable culture.
3. Culture cannot be prescribed or legislated.

Recommendations on culture and governance

Changing culture and governance

All financial services entities should, as often as reasonably possible, take proper steps to:

- assess the entity's culture and its governance;
- identify any problems with that culture and governance;
- deal with those problems; and
- determine whether the changes it has made have been effective.

Supervision of culture and governance

In conducting its prudential supervision of APRA-regulated institutions and in revising its prudential standards and guidance, APRA should:

- build a supervisory program focused on building culture that will mitigate the risk of misconduct;
- use a risk-based approach to its reviews;
- assess the cultural drivers of misconduct in entities; and
- encourage entities to give proper attention to sound management of conduct risk and improving entity governance.

What does this mean for… Corporates

- Boards
    - Change of approach
        - actively assess and drive culture and set strategic direction
        - focus on financial and non-financial risks and all stakeholders
    - Active challenge of management
    - Information flow will change – less material, more information
- Regulators (not just ASIC and APRA)
    - Change of approach here as well
        - greater supervision of culture
        - more aggressive and litigious in enforcement
- Extension of BEAR – becomes FEAR, and maybe even EAR?

What does this mean for… In-house lawyers

- Culture
  - tone from the top
  - role in assessment process and implementation
- Legal advice
  - simplification of many laws anticipated so the “law’s intent is met”
  - black letter legal advice goes out the window
  - must bring all their insight and experience to the role
- Company secretaries need to adjust
  - information flow and materials (board papers, minutes etc.)
  - corporate governance – challenge
- Legal to merge with compliance and/or risk?

Contact details

Antony Rumboll
Partner, Sydney
+61 2 8922 5102
antony.rumboll
@bakermckenzie.com

Bill Fuggle
Partner, Sydney
+61 2 8922 5100
bill.fuggle
@bakermckenzie.com

Alan Darwin
Special Counsel,
Sydney
+61 2 8922 5114
alan.darwin@bakermck
enzie.com

bakermckenzie.com

Baker McKenzie.