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A new era

Actions from the Hayne Royal Commission for each sector

8 February 2019

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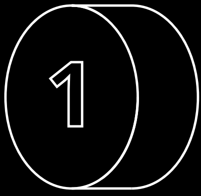
In the face of open banking, continued disruption, litigation, the Productivity Commission, Parliamentary reports and a Federal election and more, we are on the **cusp of a new era**



Banking

Forging a culture that sustainably balances responsibility to the community with duty to shareholders

Simon Pelletier
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Initial interpretations of the final report of the Financial Services Royal Commission are that the recommendations are 'measured' and 'pragmatic'.

It is fair to say that many leaders of our banks, especially big banks, did breathe a collective sigh of relief at first, over what was not included in Commissioner Hayne's final set of recommendations.

And the equity markets sounded their response loud and clear, delivering the banking sector its largest ever rally with $19bn of value being added to the Big Four the day after the report was released, suggesting they thought it could have been a lot worse.

Significant change ahead

While there is much to be relieved about – think responsible lending and vertical integration – there is also much being done and to do. Over the coming weeks and months, the banks' management teams will be working through complex operating model and process changes in response to the report and in anticipation of the reforms that are to come.

Key recommendations and impacts

Some of the key recommendations with the most impact for the banking sector are:

1) **Mortgage brokers:** The extension of best interest obligations and wholesale changes to commission models including the removal of trail commissions are among the most significant recommendations. Major banks may be likely to welcome the opportunity to lower costs associated with trail commissions.

   However, for smaller banks using the broker network as a means of both expanding their customer footprint without costly branches, and diversifying their exposure to customer credit the proposals will be a blow. Any reduction in the broker market will clearly impact these goals. It is in these entities' interests to ensure the continuing viability of the broker market.

2) **Consumer credit:** The story of the Hayne Royal Commission for consumer lending follows Hayne's consistent themes of simplifying the law through removing legislative exceptions, and a program of steady change, rather than revolution.

   Key recommendations that reflect removing legislative exceptions include aligning brokers to financial advisers' remuneration structures and requirements (dealt with in our chapter on Mortgage Broking), bringing retail dealers in scope of the National Consumer Credit Protection Act (NCCP) requirements, and including credit products in the Design and Distribution (DDO) and Product Intervention (PI) regimes.

3) **Regulatory environment:** The report does not spare the regulators, devoting a lot of attention to ASIC and APRA. The Commissioner calls for a change in approach, in particular for ASIC.

   It specifies that the starting point for enforcement should be to consider court action, and that infringement notices should only be used for administrative failings, and rarely for large corporations.

Greater cooperation also features strongly, with joint supervision of the Banking Executive Accountability Regime (BEAR), a statutory obligation to cooperate, and a cooperation memorandum between APRA and ASIC.

The tilt towards court action and away from infringement notices and enforceable undertakings (EUs), combined with a more rigorous approach to EUs, including admissions of guilt, will play out over time.

They will likely form one of the more lasting and fundamental changes for the industry from the Royal Commission.

Deafening silence

For the banking sector, what has been left out of the final report is almost as important as the 76 recommendations themselves. Key topics that banks may have been expecting the Commissioner to direct attention to include:

1) **Vertical integration:** Vertical integration received a lot of blame for causing conflicts before the final report. However, the Commissioner couldn't be sure that the benefits of breaking the nexus between product, advice and sales would outweigh the costs of losing scale and one-stop shopping. So, he marked that down for review at a later date and instead targeted remuneration as a vehicle for resolving conflicts.

2) **Responsible lending:** The report largely left untouched two long term responsible lending debates, being the 'not suitable' standard and the use of HEM – at least for now.

   Despite speculation that small to medium enterprises might receive retail protections through the extension of the responsible lending obligations to these borrowers, Hayne declined to do so due to the need to ensure small businesses have access to reasonably affordable and available credit.

3) **Directors' duties:** Debate has been fierce on the nature of the duties of Directors and Officers, and whether their duty to act in the interests of the company aligns solely with financial returns to shareholders.

   With Commissioner Hayne calling out the tension between the pursuit of short-term profit and banks making poor choices that led to these conduct issues, it seemed an opportune time to clarify the law once and for all.

   While Hayne has clearly reinforced the view that Directors and Officers must take a long-term view of value, which goes deeper than immediate financial returns, he made no recommendations about any reform to the statement of these duties.

   We will have to content ourselves with his view that, the longer the period of reference for considering interests of shareholders, customers, employees and other stakeholders, the more they are likely to end up coming together as one.

Rebuilding trust

While the report itself has been seen as a good outcome for the industry, few would question the significant impact that the commission has had on the banking sector. Clearly, the deeply distressing stories of customer pain and suffering exposed by the commission in such a public way have done much to already drive change.

As our banking community responds to the recommendations and closely watches the policy response from Canberra, there is no question that top of mind will be how to sustainably rebuild the trust that has been broken, ensuring that the promises made are the ones that can be, and are kept. And as our inaugural Trust Index showed – that the banks treat their customers with respect and in their best interests.

In this way it will be possible to forge a culture that sustainably balances their responsibility to the community with their duty to shareholders.

Consumer and SME credit

Hayne's proposals will require an uplift in product design, origination and monitoring activities for lenders and distributors

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As we pointed out in the Banking chapter, when it comes to the consumer and SME lending, the Hayne Royal Commission reflects consistent themes of simplifying the law through removing legislative exceptions, and instituting a program of sensible change rather than revolution.

Key recommendations

Key recommendations for removing legislative exceptions include:

- Aligning brokers to financial advisors' remuneration structures and requirements *(Please see chapter on Mortgage Broking)*.
- Bringing retail dealers within the scope of the NCCP Act requirements.
- Including credit products in the proposed Design and Distribution (DDO) and Product Intervention (PI) regimes.

What Hayne chose not to do…

Hayne has also provided commentary on improvements for the market but largely left untouched two long-term 'hot issues', the 'not suitable' standard, and using the Household Expenditure Measure (HEM) – at least for now.

Despite the speculation that small to medium enterprises might receive retail protections through the application of responsible lending obligations, Hayne has declined to do so, preferring to maintain small businesses' access to reasonably affordable and available credit.

And what was included…

The key recommendations and responses related to consumer and small business lending.

1) Hayne does not want to disturb the current test for 'not unsuitable' in NCCP, although he clarified that this test should be applied by lenders through the lens of 'avoiding harm'.

2) Retail dealers (who provide intermediated lending for vehicles and other consumer goods), and are currently exempt from operating under the requirements of the NCCP Act, should be brought within the regime.

   This is to ensure conduct standards are maintained, responsible lending obligations are followed, and consumers are better protected. In Hayne's view, this will strengthen the lending process where both the lender and retail dealer are subject to the same level of expectations.

3) After Hayne questioned the rationale for not including all ASIC-regulated products in his final report, including credit, under the proposed DDO and PI regimes, the Government has confirmed that it will bring credit products in scope.

   DDO requires that both product issuers and distributors have a greater focus on determining their target market and monitor their dealings against this target market.

   PI will enable ASIC to intervene in relation to credit products, where there is actual or potential detriment to customers. The focus and accountability for product design and distribution

are further enhanced through specific inclusion as a prescribed responsibility within the BEAR regime.

4) Hayne wants the Australian Banking Association (ABA) to expand the customers that fall within the small business definition under the Banking Code. He recommends applying this definition to enterprises with up to 100 FTE, and loans of under $5 million, although he has not extended the application of the NCCP Act to this market.

5) Interestingly, and possibly a great relief for many, Hayne has not recommended the abolition of, or changes to using HEM.

   He does continue to emphasise the need to verify income and expenditure, which will involve more than just taking the customer at their word. HEM is not a substitute for that inquiry.

   Hayne attributes this preservation of the current position to a number of drivers. One is the changes already being made by the industry in how they use HEM. The other is his reluctance to express a view on the issues that are the subject of current court proceedings.

   It is worth noting that ASIC has recently announced that it is considering working with the industry on adopting an 'enhanced HEM', which is adjusted for income.

6) Other proposed changes applicable to agricultural borrowers appear in our earlier paper on *Vulnerable Customers*.

Impacts

Banks and other lenders will appreciate a reprieve from substantive changes to their responsible lending obligations. This will give them time to further develop and embed the enhancements that Hayne discusses in relation to serviceability assessments.

However, extending the NCCP to retail dealers and the explicit inclusion of credit products within the upcoming DDO and PI regimes, will require an uplift in product design, origination, and monitoring activities for lenders and distributors alike.

The most significant impacts:

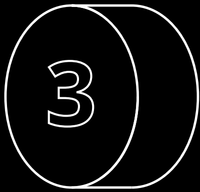
- Likely increased costs for consumers seeking credit through dealers. This is most likely to be felt by motor vehicle and consumer retail providers.
- Operating model implications for consumer credit manufacturers that distribute through dealers, including oversight and monitoring compliance and conduct by those dealers.
- Customer experience at point of sale will be significantly challenged without a high degree of data and technology investment driving automation and seamless integration with compliance requirements.
- DDO will introduce four new design obligations and five distribution obligations that will require credit products to be targeted at the right people so that the products match customers' circumstances. There is also an increased accountability for both issuers and distributors to understand and monitor dealings in the products.
- ASIC's PI powers will allow it to enforce the new arrangements, including the ability to request information, issue stop orders and to make exemptions and modifications, which further heightens the need for credit providers to focus on 'end-to-end' product governance.

Actions

It is important to get ahead of the proposed regulatory changes while they are being shaped for implementation, as stated by the Government. There are preparations that can be made now including:

- Assess existing product design and product governance frameworks to understand what uplifts will be required to meet the target market requirements of DDO.
- Understand the controls in place at chosen distributors and disclosures made to customers at point of sale, to align dealing in the products with the product target market.
- Understand how existing product monitoring can be enhanced to assess dealing in the target markets and other data points, such as claims, complaints and persistent usage.
- Manufacturers of consumer credit products will need to invest in systems and efficiency of processes to support dealers to meet their obligations, while balancing customer experience. Continued and extensive monitoring of dealers' compliance with new policies and processes should also be expected.
- End-to-end review of consumer credit origination, especially where reliant on retail dealers to automate as much of the process as possible, facilitating a better customer experience and enhanced product monitoring capability.
- Re-assess the application of policies as they relate to 'unsuitability' to ensure that they focus on 'potential harm'. Monitoring compliance and customer outcomes of these should be a priority for compliance and risk operating models.
- Perform an historical assessment of loans for 'potential harm' as a way of confirming that unsuitable loans have not been issued.

Ultimately, the broader reach of NCCP obligations and the extension of the proposed DDO and PI regimes should result in better, more suitable outcomes for customers. Issuers and distributors should focus on both the uplift in risk and compliance frameworks to meet these requirements as well as the necessary changes to maintain and enhance customer experience.



Mortgage broking

We don't believe that the recommendations sound the death knell for the industry... while there will inevitably be some pain in the journey, this is an opportunity for the broking industry in the long run

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The mortgage broking industry has been under an intense spotlight, with the ASIC remuneration review, the Sedgwick Review, and now the release of Hayne's Royal Commission recommendations. This does mark a new era for the Australian mortgage broking industry, and how it will change consumer access to housing credit in the future.

Key channel for consumers

According to recent data, 59.1% of all new home loans to Australian consumers originate via mortgage brokers. This indicates that while the Commission has made significant recommendations regarding the structure of the industry, consumers see a valuable service being delivered via brokers, especially in the current lending market.

What the Commission recommended

The Commission includes six recommendations that will impact the mortgage broking industry, including:

1) The NCCP Act will not be amended to alter the obligation to assess the loan's unsuitability for the borrower.
2) Mortgage brokers (but not aggregators) will have an obligation to act in the best interests of their clients. Breaches of this obligation will be subject to a civil penalty.
3) Mortgage brokers will, in the future, be regulated by similar laws to financial planners.
4) Mortgage brokers will no longer be remunerated by lenders for their services. Instead, Hayne's view is that they should be paid by the consumer that receives the service. This could be done by capitalising the fee into the loan balance. Existing trail commissions would remain unaffected.
5) A new Treasury-led working group should monitor and adjust remuneration models to ensure a level playing field.
6) Australian Credit Licence (ACL) holders, including mortgage brokers, will be bound by similar misconduct information and reporting rules as proposed by Hayne for financial advisers.

The Government's response

The Government has pledged to enact all of Commissioner Hayne's recommendations except, controversially, full adoption of no. 4, regarding payments of commission. The opposition is currently pledging full adoption of all recommendations.

A key pledge is that trail commission for newly originated loans be prohibited from 1 July 2020.

A further recommendation that commissions, other than trail, be prohibited in a further 12 to 18 month period, has been cautiously received by the Government. A pledge has been made instead that that the Council of Financial Regulators, along with the ACCC, should review the arrangements in three years.

Almost 60% of all new home loans to Australian consumers originate via mortgage brokers... consumers therefore see a valuable service delivered by brokers, especially in the current lending market

Many of these recommendations have already been debated extensively, and while the industry may disagree with the Commission's sentiments, the momentum for a shift is real. It will be critical for government to progress with care, and to focus on protecting robust and healthy competition in the market. This will in turn continue to deliver strong outcomes for consumers.

Impacts

Commissioner Hayne's proposed reforms will reverberate across the entire mortgage distribution chain.

Brokers

Mortgage brokers will have to act in the best interests of the intending borrowers, and this is likely to focus on demonstrable consumer outcomes. Reputable brokers would respond that they already do this, as the Combined Industry Forum (CIF) was already recommending a 'customer first' duty.

The obligation to detect, share and report information relating to misconduct was expected, and while it will need investment in infrastructure, through the CIF brokers have been working towards this for some time.

By removing trail commission on new loans, but retaining trail on existing loans, brokers will benefit from the revenues from their existing portfolios while the changes to commission structures are finalised. Although not expressly stated in the recommendations, the way that removing trail commission is managed must support the viability of the broker channel through increased upfront commission from lenders.

Removing trail commissions will resolve any conflict, inherent or perceived, of 'binding the borrower to the lender' or 'money for nothing'. While there are differing opinions on how true this statement is, and the potential impact on churn that removing trail commissions may have, it is important that the industry appreciates that receiving a payment when no actual service is provided is unacceptable.

Removing trail commissions may impact margins for brokers if not compensated by upfront customer fees. Experience in the UK has shown that some have compensated for this by diversifying their advice skills and combining with advisers. A number of Australian aggregators have already pursued this path.

If the upfront commissions are ultimately phased out and replaced with a 'consumer pays' model, the industry should welcome the delayed timeframe proposed by the government, and use that time to ensure that any transition to the new model ensures parity and transparency with the experience of obtaining a loan directly from lenders. Any failure to maintain a level playing field between broker and bank distribution will pose a serious threat to the industry, and the valuable services it provides to both consumers and lenders.

Consumers

The requirement for a broker to act in a consumer's best interests will ensure alignment between the law, and the current expectation of many consumers, which is clearly the Commissioner's intent.

Brokers will be held to a higher standard of care than lenders, demonstrating their independent status. A branch employee with a range of products will not be held to a comparable obligation.

However, the real impact on consumers comes if Hayne's recommendation that all commissions be phased out and the consumers pay fees for the service provided is adopted.

The Commissioner understood concerns regarding competition and access to credit, hence the recommendation to establish the Treasury working group to focus on:

- Changes in interest rate.
- Levels of competition between lenders.
- Levels of competition between lenders and brokers.
- Developments in the residential mortgage market.

Considerations include that:

- Mortgage brokers facilitate access to credit for consumers to a range of lenders, including smaller lenders, specialist lenders (some of which only distribute via brokers), as well as a range of products that is much wider than any one bank or provider.

- If a 'consumer pays' model is adopted, this will represent a fundamental shift in consumer expectations.
- Human nature means there will be a natural aversion to paying for a service that consumers are used to accessing without upfront cost.
- If banks are not required to charge a similar amount to customers, access to lending services will tilt towards those banks with the largest branch networks. As many customers will likely default to the 'free' option rather than incur the cost associated with a broker.
- Recent reports indicate only a minority of customers may be willing to pay a fee for service.
- Commissioner Hayne suggested the customer's upfront fee for service could be capitalised into the value of their loan, thereby increasing the debt owed (and incurring interest).

We believe it is imperative that if a fee is to be charged to a customer for housing credit advice, it be agnostic to the distribution channel and consistent to protect competition.

Banks

How banks respond to these recommendations will depend on their own distribution strategy. Major banks are likely to welcome the opportunity to lower costs associated with trail commissions. However, smaller banks often embrace the broker network as a means of both expanding their customer footprint without costly branches, and diversifying their exposure to customer credit. Any reduction in the broker market will clearly impact these goals. It is in these entities' interests to ensure the continuing viability of the broker market.

If the recommendation regarding a customer-funded fee for service is implemented, the Commissioner has clearly contemplated the introduction of a Netherlands-style model.

This would require that both the bank and the broker charge the customer a similarly structured fee (whether fixed or variable), which should be clearly linked to the cost of arranging the home loan. Fixed fees need care, as arguably customers with more complex needs could potentially be under-served.

Any fee should be transparent to the customer to enable a true comparison of distribution channels. Given the complexity and lack of clarity over mortgage pricing (see the ACCC report), it will be imperative to competition and the ongoing health of the broker industry that this fee is not lost or offset within the wider bank pricing. We therefore believe, if this recommendation progresses, that careful X-industry consultation is critical to protect consumer outcomes and competition.

The government is clearly cognisant of this, with a stated position that implementing without due care could result in less competition and choice in the market. We welcome this cautious approach.

Aggregators

The Commissioner recommends aggregators provide valuable services to both brokers as well as lenders. Aggregators monitor and oversee the activities of brokers, and help provide consistency, training and compliance tools.

It is important that the significant progress made in recent years is not destabilised by the response to the Hayne report, and that aggregators are suitably remunerated by both lenders and brokers for these important services.

Actions

Fight, flight or embrace?

Some in the mortgage broking industry will be tempted to fight the Commission's findings and recommendations. It may be that changes to remuneration structures, combined with additional process and infrastructure requirements, will make some brokers decide to work elsewhere.

What still needs to be explored:

- Is it right that lenders and brokers are held to different standards?
- If trail is removed, how can brokers be fairly remunerated?
- Will the banks be forced to compensate for this change through upfront customer fees?
- How do you ensure the competitive health of the market, enabling equitable access for consumers across all market participants, in both a 'lender pays' or a 'consumer pays' environment?

However, unlike some, we do not believe that these recommendations necessarily sound the death knell for the industry.

While there will inevitably be pain in the journey, this is an opportunity in the long run for the broking industry to demonstrate to consumers, regulators and lenders that they will embrace the opportunity to demonstrate impartiality and separation from product providers to fully align to customer service and outcomes.

For as long as the playing field is level, and it is as easy and cost effective for a consumer to arrange a loan via broker as it is with a lender, the customer service proposition that has underpinned the broker industry for many years should see the industry remain robust.

It is imperative that it does so, and that it is supported by lenders, regulators and government to ensure the health of competition in the mortgage market, access to credit, and that consumer outcomes align to their preferred distribution model.

4

Financial advice

The Royal Commission's work will reshape the business models for many in the financial advice community, and be likely to lead to wholesale exit of practices and practitioners, and the radical professionalisation of others

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Commissioner Hayne has directed some of his most substantive recommendations (and the greatest volume of analysis of any sector in his report) to financial advice, focusing on the reforms he considers necessary to rapidly evolve a profession. These include:

- Ongoing fee arrangements.
- Truthful disclosure for a lack of independence.
- Quality of advice.
- Conflicted remuneration.
- Professional discipline of advisers.

Each of these recommendations speaks directly to expectations of professional behaviour and building a system of regulation and oversight that will embed the necessary components for trusted professionals to emerge.

Some are long overdue and have been consistently called for by industry participants (such as individual licensing/ registration arrangements), while others will have a more profound effect on issues of business model and structure. For instance:

- A positive requirement for all advisers to disclose to their client, in writing, their lack of independence, if they do not meet the current definition in s923A. Some in the industry estimate this could affect more than 90% of the 28,000 advisers.
- The safe harbour arrangement for the Best Interest obligation in s961B is for the moment 'safe' in light of other reforms progressing. Considering Commissioner Hayne's preference for established law, it was widely considered that he would prefer the adoption of a formal fiduciary model of professional obligation. Continuation of the Best Interest (with Safe Harbour) provision is on a short leash though, with the caveat of recommending its removal after a review to be completed before 31 December 2022.
- Conflicts of interest and the failure to sufficiently respond to the FoFA expectations for 'management' of them drew sharp criticism.

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'All too often advisers have preferred their own interests against the interests of clients, despite having an obligation to pursue the best interests of their clients'.

—

'Providing a service to customers was relegated to second place. Sales became all important.'

- Hayne's clear preference is that all conflicts, and conflicted remuneration, should be eliminated. This extends to the current exemptions for life insurance commissions, which he argues should be removed after ASIC's scheduled review of the Life Insurance Commissions program in 2021.He has also proposed that the current exemptions for grandfathered commissions should be removed *as soon as is reasonably practicable* and that ASIC conduct a review of the current reforms before the end of 2022. This should consider whether any justification remains for the continuation of commissions for general insurance and consumer credit insurance, as well as non-monetary benefits.

- Another central vein of the recommendations relates to radically accelerating the evolution of a financial advice profession because he does not *"....believe that the practice of giving financial advice is yet a profession."* Tellingly, he argues that, even completing the current reform initiatives (such as FASEA and FoFA) will not be enough to shift that, and he calls for a number of new initiatives including:
  - Clearer disclosure on the adviser's independence, or lack thereof.
  - Mandatory individual registration.
  - A single, central disciplinary body.
  - Mandatory (and voluntary) AFSL notifications to the disciplinary body.

Reflections

There appears to be two critical challenges informing Commissioner Hayne's perspective on the wealth sector.

Firstly, identifying conflicted remuneration as the poster child of industry inertia, self-interest and avoidable regulatory complexity.

His recommendations for a swift repeal of ongoing grandfathered commissions in the financial advice sector, and reducing the cap on life insurance commissions to zero, will have profound effects on the shape and size of the industry.

In a semblance of a silver lining, forced closure of commission payment models will allow many more advisers to satisfy the s923A definition of independence, but it will also drive a large number of advisers to exit the industry as their business and revenue models change irrevocably.

Secondly, officially calling out that financial advice is not yet a profession and nor will it ever be (even with the current reform initiatives such as FASEA), while it relies on financial arrangements that can give rise to conflict, and clings to professional standards systems informed by well-intentioned, but flawed alignments with industry associations (as private bodies).

Hayne's call for a new disciplinary system that might replace the current FASEA regime of code monitoring bodies (or sit above them) acknowledges the need for a bright line for legal clarity that can give confidence to consumers.

The fact that he uses the legal profession as an example is telling, given that the field works on a two-tiered system of professional association (Law Society) and statutory disciplinary body (Legal Services Commission). By contrast, a simple reading of the proposal, which both sides of Parliament have already agreed to adopt, is that financial advisers would be subject to at least five tiers of oversight, four of which are currently proposed to be mandatory:

1) Licensee (mandatory)
2) Professional association (voluntary)
3) ASIC approved code monitoring bodies (mandatory)
4) Statutory disciplinary body (mandatory)
5) ASIC – as the responsible regulatory agency (mandatory).

Add in the requirements for External Dispute Resolution membership and compensation, and this crowded field is unwieldy for any participant. And certainly confusing for consumers.

It might be reasonable to conclude that the code monitoring body structure is the least needed from a statutory perspective, especially as, in the spirit of professionalisation, associations should be responsible for policing their own codes and professional expectations.

Impacts

In our *'Thick Edge of the Wedge'* paper, issued in response to the Interim Report, we suggested that *everything would* change as a consequence of the Royal Commission, including:

- Products and services.
- Business models and licensing arrangements.
- Advice quality.
- Compliance and regulatory facing functions.
- The size and shape of the industry.
- The role and obligations of the professional adviser.

The Royal Commission's final report reinforces those proposals, and potentially goes further.

By removing grandfathered and commission models, the business models for many in the financial advice community will be reshaped. This will likely lead to a wholesale exit of practices and practitioners, and the radical professionalisation of others.

Both sides of Parliament have agreed to action the recommendations. It is notable, however, that Labor has committed to *accelerating* the reform in financial advice with the *immediate* removal of grandfathered commissions, a preference to *legislate for zero commission* on life insurance, and *repealing* the safe harbour provisions in the best interest duty.

Actions

In light of the way the combination of recommendations will cumulatively work, firms should be thinking beyond a tactical, individualised consideration of each of the recommendations.

They should instead be carefully considering the full extent of the recommended changes. In setting a clear vision and strategy for success in the new era, they should do so in combination with the impact of upcoming FASEA initiatives and other known regulatory reforms.

These forces of change will be substantial for all advice organisations. For many, they will threaten the sustainability of existing practices. The old recipe of success will no longer work and the need to survive will give rise to the discovery of new opportunities to deliver value to advice clients and success in the future.

As important as the destination and future vision is, the method by which change will take place is critical. In an environment where advisers may be feeling vulnerable, defensive and, in some cases, let down by their industry, this requires a well-designed and executed change strategy that helps identify, retain and recruit advisers best aligned to the culture and vision of the firm.

Comment

It is worth noting that, despite the inevitable scale of changes that will emerge from the changes brought about by the Royal Commission, Hayne has openly approached the cumulative effect of current changes and reform activity with caution.

The fact that he did not recommend structural reform of financial services institutions is based on a recognition that, not only is the change already underway, it also means that costs in the system are going to rise and so mechanisms for efficiency will need to be encouraged.

This will be seen by some as a bias to institutional environments, but it should perhaps be seen as the Commissioner's recognition that finance is the lifeblood of the market economy.

Without access to financial services, individuals and businesses are effectively excluded from that economy.

By weeding out misconduct that has caused widespread consumer detriment, the Royal Commission is largely concerned with ensuring that access to financial services is 'appropriate'.

However, its recommendations will have implications beyond access to financial services, including for financial advice, market structure and competition.

That said the value of *good advice* seems to have been underplayed in the debate so far. The opportunity and importance of establishing a professional, well-regulated system that encourages good advice should not be underestimated.

We encourage the Government and regulators' response to the recommendations to focus on the long game – how to ensure all Australians can be guaranteed access to better advice.

5

Superannuation

The moment a trustee tries to wear two hats, conflicts will arise

Deborah Latimer
Partner, Governance Regulation and Conduct, Compliance, and joint Corporate Governance and Superannuation sector leader

For the superannuation sector, Commissioner Hayne's Final Report focuses on some important themes:

- The financial promises trustees make to members.
- The fundamental duty of a trustee to act in member best interests.
- The centrality of both of these things to achieving the best possible outcomes for members.
- The potentially derailing effects of conflicts of duty and interest.

These core themes have particular significance given the purpose of superannuation is to facilitate a safe, fair and secure retirement for all Australians through the compulsory and long–term nature of superannuation for individual Australians. This has led to the size and importance of the superannuation system to the nation.

The promises made, trustees' fundamental duty, achieving best possible outcomes for members and the potential derailing effects of conflicts of duty, also reflect the key recommendations made by the Productivity Commission in its final report on the efficiency and competitiveness of the superannuation system, released in December.

In exploring these themes, Commissioner Hayne's Final Report makes recommendations regarding conduct and accountability in superannuation in nine key areas:

- Prohibiting RSE trustees from assuming any other role or office.
- Prohibiting the deduction of advice fees from MySuper accounts.
- Limiting the deduction of advice fees from choice accounts.
- Prohibiting the hawking superannuation products.
- One default account to be 'stapled' to an individual.
- Prohibiting trustees from inducing employers to nominate their fund as default, or having one or more employees apply or agree to become fund members.
- Civil penalties for a breach of the trustees' and directors' covenants and certain obligations in relation to MySuper.
- Retaining the 'twin peaks' regulatory model, but adjusting the roles of APRA and ASIC. ASIC will assume responsibility under the SIS Act (SISA) for oversight of conduct and to protect the interests of members.
- Prioritising the introduction of a similar regime to the Banking Executive Accountability Regime (BEAR) to RSE licensees, potentially impacting larger RSE licensees before other APRA-regulated entities.

The other recommendations that will impact superannuation include:

- Standardising default MySuper group life policies, additional scrutiny for RSE licensees engaging a related party to provide group life insurance, and fair and reasonable rules for status attribution.
- The requirement for entities to take proper steps to assess culture and governance, and for APRA to supervise these assessments.
- Introducing a compensation scheme of last resort.
- Supervising the design and implementation of remuneration systems.

Impacts

At the heart of the recommendations for superannuation, Hayne's focus is on the promise made to a beneficiary of the trust. This promise is that the *'trustee will meet the reasonable expectations of a beneficiary in providing their retirement benefits'.*

The impacts of this are to:

- Reinforce that the primary responsibility for conduct and operation of a fund sits with trustee boards and senior management. This is to be established through new consequences by enforcing trustee covenants as civil penalty provisions, and a BEAR type regime to clarify the accountability of trustees and senior management.
- Ensure the trustee board is appropriately skilled and efficient in the proper supervision of a fund in the members' best interest. In meeting that obligation, all directors must give priority to the members' best interest above any other interest.
- Revise the trustee governance models to better balance financial and non-financial risk, focusing on preventing misconduct.
- Renew the focus on trustee performance of the member 'best interests' duty and carrying out the sole purpose duty as the central principles governing superannuation. Hayne noted that it is 'compliance with' and 'understanding of' the duties, which is the problem.
- Avoid conflicts between duty and interests, through preventing trustees from undertaking any obligations that do not arise out of its holding of the office of trustee.
- Force avoidance of certain conflicts of RSE trustee duty owed to members and other 'opposing' interests (for example precluding trustees acting as dual-regulated entities).
- Prohibit and restrict certain conduct said not to be in member best interests (i.e. unnecessary default accounts, deduction of advice fees from member accounts, and inducement of employers to use a default fund).
- Increase regulatory focus on outcomes delivered to members through adjustment to APRA/ASIC powers.
- Increase consumer protections through introducing a compensation scheme of last resort, and ensuring ASIC can supervise and enforce relevant consumer-related SISA provisions.

Immediate actions

Important actions centre on accountability and transparency.

Superannuation trustees and fund executives should refocus on what Commissioner Hayne calls a 'norm of conduct' and a 'fundamental precept' that 'a person or entity acting for another must act in the best interests of that other'. This should be the unifying principle that informs all action.

The first action of superannuation trustees should be to ensure they will not fall foul of the recommended prohibition on other obligations or offices.

This recommendation reflects the section 52 SISA covenant not to enter into any contract, or do anything else that would prevent the trustee from, or hinder the trustee in, properly performing or exercising its functions or powers [52(2)(h)].

Importantly, Hayne notes that the effect of the SISA section 52A is that the governing rules of an RSE with a corporate trustee are taken to contain covenants by each director individually.

The second action should be the positive identification of all interests that are opposed to the trustee duties to act in the best interests of members. In this way, they will be able to maintain the fund for the sole purpose of providing retirement benefits for members. Real consideration must be given to whether these conflicts of duty and interest should be eliminated, rather than 'managed'.

Special attention needs to be paid to potentially opposing interests of members on the one hand, and retail fund parent entities, or industry fund shareholders, or nominating organisations, on the other.

Also between member interests and other interests in relation to related party engagements for group life insurance in superannuation.

Similarly, there can be opposing interests between fund members and scheme unit holders for trustees who are also the Responsible Entity of a managed investment scheme (dual-regulated entities).

Thirdly, trustees should review the defensibility (consistently with the proper performance of duty) of decisions to engage related entities to carry out administrative, investment, or insurance functions for the trustee.

The decision process should be enhanced for the future and at a minimum, include sound market comparisons.

Fourthly, action should be taken to:

- Ensure that governance models for superannuation provide for a trustee board that is, at all times, skilled and efficient in the proper supervision of the fund and the members' best interests.
- Ensure that there are clearly assigned executive accountabilities, including both financial and non-financial risk.
- Embed regular assessments of the effectiveness of the model in terms of preventing, or at least mitigating, misconduct.

Superannuation trustees should also implement enhanced member protection measures to stop and prevent future hawking of products that seek to influence the way employers choose default funds. They will also need to stop the proliferation of unnecessary multiple accounts and any erosion of member balances through charging ongoing advice fees.

Commissioner Hayne signalled a renewed attention and enforcement of trustee duties to the superannuation sector, to ensure they align with the trustee's promise to members, and are in the interests of members and member outcomes.

Insurance

Hayne's Report does not provide a complete list of actions to identify, prevent or manage any misconduct or conduct fails to meet community expectations. It does however set a roadmap for future change

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The 15 recommendations Commissioner Hayne made specifically for the insurance industry cover a number of industry issues already known to the sector.

They include introducing a cap on the amount of motor dealer commissions, a deferred sales model for add-on insurance, and a possible reduction in life risk insurance commissions.

There are also a number of additional recommendations that will both directly and indirectly affect insurers.

Implementing these will most certainly impact the end-to-end insurance value chain. So much so that they may well require redesigning products, systems, processes, and controls.

This does not necessarily mean going back to the drawing board, but they will result in a huge amount of operational change and increased administrative burden.

So what stood out?

- Hayne wants to eliminate historical regulatory carve-outs and exclusions across the industry. This is with a view to drive consistency across financial services, and make the law simpler.
- He wants to ensure that the balance of power shifts toward the consumer, for example, by applying the unfair contracts terms rules to insurance contracts, and amending the existing duty of disclosure.
- Creating the equivalent BEAR for all APRA financial institutions, including APRA-regulated insurers.
- Changes to SPS 250 will mean increased scrutiny in the group life market.

In summary

Product-related impacts include:

- Bringing funeral expense policies under the AFSL regime and ASIC Act.
- Capping commissions for vehicle dealers.
- Ending grandfathered commissions, and an ASIC review of commissions for life insurance, general insurance and consumer credit insurance, with downward pressure on those amounts to zero.
- Changing the duty of disclosure to a 'duty to take reasonable care'.
- Amending the avoidance provisions related to non-disclosure and misrepresentations.
- Applying unfair contract terms provisions to insurance contracts.

Distribution and selling impacts include:

- A clearer prohibition on hawking insurance products.
- Introducing a deferred sales model for all add-on insurance.
- A range of recommendations related to financial advice that will impact disclosure around adviser independence, changes to the annual renewal process, and increased reporting and compliance obligations on advisers and licensees.

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More on these can be found in the Financial Advice *chapter of this paper.*

Impacts to the governance and culture of insurers, and how they interact with customers include:

- Ensuring claims handling is regulated under the AFSL regime.
- Enforcing insurance codes of practice along with the introduction of a sanctions power for breaches.
- Recommendations on data and group life arrangements in superannuation.

The impact on the value chain of the recommendations

On product

Removing the financial product carve-out for funeral expenses insurance

Hayne observed that these types of products are especially poor value for consumers, and place Aboriginal or Torres Strait Islander people at a particular disadvantage given the way they are sold.

- Once funeral expense policies are a financial product, manufacturers and distributors will need to have an AFSL, and be subject to the related regulatory requirements.
- This will mean a substantial increase in consumer protections, including access to AFCA, and should provide better support to vulnerable customers, and increased ASIC scrutiny.
- When combined with the anti-hawking recommendation, it will become increasingly challenging to sell funeral expense insurance.
- A question that remains is whether there is the need to remediate for misselling and targeting vulnerable customers related to historical sales on these types of products.

Introducing universal terms for MySuper Group Life policies

To date the industry has been unable to reach a consensus on this issue. However, because of this measure, the Government may legislate for universal key definitions and so force the industry's hand.

- A key challenge will be how insurers derive their value proposition, and how competition is assured, if there are standard terms.

Duty of disclosure, avoidance changes, and unfair contract terms

The new duty to take reasonable care is similar to a change made in the UK in 2012.

Replacing the duty of disclosure with a 'duty to take reasonable care', changes in the avoidance provisions, and the application of unfair contract terms provisions to insurance contracts will:

- Shift the balance of power back to the consumer by lowering the onus on them when disclosing issues on inception of insurance policies.
- Place the burden on insurers to elicit the information that they need, rather than require the customer to guess or determine what this information might be.
- Potentially have a considerable impact on pricing, underwriting and claims assessment. Hayne was unconcerned about the pricing impact. In his view, ensuring insurance will be effective is worth the cost.
- Put more of the onus of proof onto the insurer by changing the anti-avoidance provision to show that the insurer would not have entered into the contract on any terms where there was non-disclosure. To deal with this, insurers may choose to apply a loading to such a contract or not offer a contract at all. Adopting this recommendation will unwind a 2013 reform, for which the industry had long lobbied.
- By applying the unfair contract terms, insurers will need to review their customer-facing documents, including applications, PDSs, claims forms, acknowledgements, exclusions and loadings. This change could be challenging. For example, how will insurers deal with updates to medical definitions across the years, multiband strategies, and issues around flood, to determine whether they are unfair?
- Mean that insurers will need to consider how this will interplay with the upcoming product design and distribution obligations (DDO).

On product commissions…

Introducing a cap on commissions for vehicle dealers selling add-on insurance.

- This recommendation is consistent with previous industry consultation, and resolves the challenge of first mover disadvantage. Commissioner Hayne proposes that ASIC would set the cap by legislative instrument.
- The key will be to determine the appropriate cap. Will it mirror the 20% limit that currently applies to CCI?
- Motor dealing profits are likely to be directly hit by this, which is particularly challenging given the corresponding changes to flex commissions.

Conflicted remuneration

- The Government agreed to stop grandfathered commissions by January 2022. This change and timing throws the value of financial advice business and the future of the remuneration model into disarray.
- The life insurance industry will have to anticipate the ASIC review slated for January 2021. After this, there will be a reduction to the cap, or the elimination of commissions, if there is no legitimate justification, such as a significant degree of underinsurance. This leaves the industry in an uncertain and precarious position, particularly with respect to its remuneration models and distribution channels.
- The future of commissions for general insurance and consumer credit insurance is also uncertain. They will be reviewed by the end of 2022 together with ASIC's review of the quality of advice measures.
- Any change to commissions will impact the broking distribution channel.

On distribution...

No hawking of insurance

- Hayne called for anti-hawking provisions to be made clearer and stricter by removing unhelpful exceptions. At the heart of his concern is that the consumers who receive unsolicited approaches to buy insurance are ill prepared for the transaction, and have insufficient information, leading to poor consumer outcomes.
- Hayne's view is that the provisions are complex and contain loopholes, allowing sellers to circumvent the true purpose of the anti-hawking rules and systematically missell.
- This is why he wants a blanket ban, which includes not permitting a provider approached by the customer about one product, to switch the conversation in an attempt to sell a different type of product.
- There is a potential that this will impact lead generation and customer acquisition channels.
- Hayne is most concerned about unsolicited sales made by phone. However, many providers have already stopped using outbound call centres.
- Considering the impact on distribution arrangements arising from the recent M&A activity in the life and general insurance sectors will be important. Particularly the bank branch sales and X-sell model, as well as bank cross-selling models in general.
- The impact could be significant given such a change will include meetings and other referral mechanisms, not just call centres.

Deferred sales model for add-on insurance

- Since add-on insurance is sold through its association with other products, consumers frequently buy these without understanding or even genuinely needing them.
- By placing time between the two related sales conversations will almost certainly lead to lower sales volumes for these products, as consumers will have more opportunity to consider the purchase with more clarity. On the flipside, this will result in better consumer outcomes.
- This requirement will not apply to comprehensive motor insurance. Presumably, this exception will need to be extended to CTP insurance where such policies are mandated.

On governance, culture and serving the customers...

Claims handling to be included as a financial service

- The need to bring claims handling under the AFSL regime, and under ASIC's direct scrutiny, has been foreshadowed for some time, including by ASIC.
- Providers will have to meet AFSL requirements and provide claims handling efficiently, honestly, and fairly.
- There is potential for increased licensing requirements for claims handling providers, assessors, medical providers, investigators, and others in the supply chain.
- Consumers will have access to the consumer protection provisions contained in the Corporations Act and ASIC Act.

Enforcing life and general code of practice, and extending sanctions' powers for breaches.

- The FSC and ICA are in the process of undertaking a review of the new codes to include enforceability provisions by 30 June 2021.Sanctions ought to give the Code more enforcement power.
- Recommendation 1.15 related to ASIC and its monitoring and approval of codes, indicates that insurance industry codes will be captured.

Accountability regime for insurance

- Hayne has endorsed a wholesale expansion of a BEAR-like accountability regime to ***all*** APRA regulated entities, including life and general insurance. Although health insurance was not within the scope of Hayne's review, it seems likely they will also be captured.
- With the banking industry as the test case for BEAR, we expect the regulations and practical approaches for implementation to be well understood and defined by the time the regime reaches the insurance sector. Commissioner Hayne has said that superannuation should move into this proposed regime first, which will also give insurers more time to prepare.
- More information on BEAR expansion is in our first paper, *Culture, Customer, Purpose*, on the key impacts of the Hayne Royal Commission.

Additional scrutiny for related party engagements in Superannuation

- Under this recommendation, RSE licensees that engage a related party to provide group life insurance will be required to obtain and provide APRA with independent certification. This certification needs to confirm that the arrangement and policies are in the best interests of members, and meet legal and regulatory requirements.
- Trustees should already be thinking about the best interests of members. This requirement is formalised in the SPS250 requirements. And will increase the level of scrutiny for such related party arrangements.

SPS 250 to be amended to require RSE licensees to be satisfied that the rules attributable to a member in connection with insurance are fair and reasonable.

- There could be potential data and procedural challenges to ensure member details are captured in sufficient granularity, and updated as needed.
- This will have a downstream impact on superannuation administrators for example that have not historically captured this information.

Other recommendations

We cover other recommendations that will drive greater regulatory oversight of remuneration effectiveness, culture and governance in more detail in our paper *'Culture, Customer, Purpose'.*

Final reflections

There is a lot to reflect on when reading the report and its recommendations. Many of the issues Hayne put under the spotlight are ones the industry has known about for some time, and improvements were already well underway. Hayne's Report will give the impetus to ensure they are finally addressed.

The Report is as much about what was left unsaid as what was called out. It does form a roadmap for future change, but should not be considered as a complete list of what needs to be done to identify, prevent or manage examples of misconduct and conduct falling short of community expectations.

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As Commissioner Hayne’s recommendations take their time to play out, there is no doubt of their intent – **to ensure ‘all Australians have adequate and appropriate access to financial services’**

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