Delivering sustainable stakeholder value in a post Hayne Royal Commission world

Future of Financial Services
Rebuilding community trust in the Australian Financial system

MinterEllison

Contents

1. Foreword

Delivering sustainable stakeholder value in a post Hayne Royal Commission world.

Following its review of misconduct of Australia's financial services sector, the 1068 page Report from the Hayne Royal Commission was made public on 4 February 2019.

In line with his commitment to simplicity over complexity, issues such as fee for no service, vertical integration, responsible lending and executive remuneration are addressed by Commissioner Hayne, within the bounds of the existing regulatory framework. Put simply, he expects industry participants to apply and obey the spirit of the law and to be accountable for doing so.

The Report speaks to the fundamentals of how ethical business should be done; and it is a powerful reminder that the successful delivery of long-term sustainable shareholder value is about balancing appropriately the needs of different stakeholders.

The Report's recommendation to periodically assess (as often as is reasonably possible) organisational culture and governance is one example of the need to look beyond compliance and the law. Moreover, post-Hayne, a 'set and forget' approach is no longer acceptable.

The Commission has already engendered change and the Report will force even more changes in an industry where a thorough airing of some issues has been much needed.

Our financial services industry is, for the most part, the envy of the world. So while the Report will be the catalyst to drive out behaviour that has undermined the community's trust in the industry − ineffective governance, some poor conduct, conflicts of interest, and inappropriate business and remuneration models − it will also help to support, extend, and solidify all that is already working.

Boards and management thus have an opportunity to play 'leap frog' by being bold and ambitious – rather than incremental – in their reform agendas. Fundamental to this is accelerating much needed investment in systems, processes, data and controls to help manage non-financial risks in a clear and effective way. Indeed, it is our strong belief that using data strategically in this way will define future winners.

The recommendations provide an opportunity for our financial institutions to address not just the symptoms, but the root causes

The Report of the Hayne Royal Commission is essentially a 'once in a lifetime' opportunity to drive future success for the Australian financial services sector through a renewed focus on the areas of trust and governance

MinterEllison has prepared its own perspectives on the Hayne Report in order to provide key thought starters and questions. Our specialist team, consisting of lawyers, risk and compliance professionals, data experts, bankers and consultants, provides a unique perspective on the immediate challenges and implications for your organisation to consider. We have outlined what we see as the important strategies that will enable financial services institutions and organisations in other industries to restore community trust.

We invite you to read our report and to join us in a conversation.

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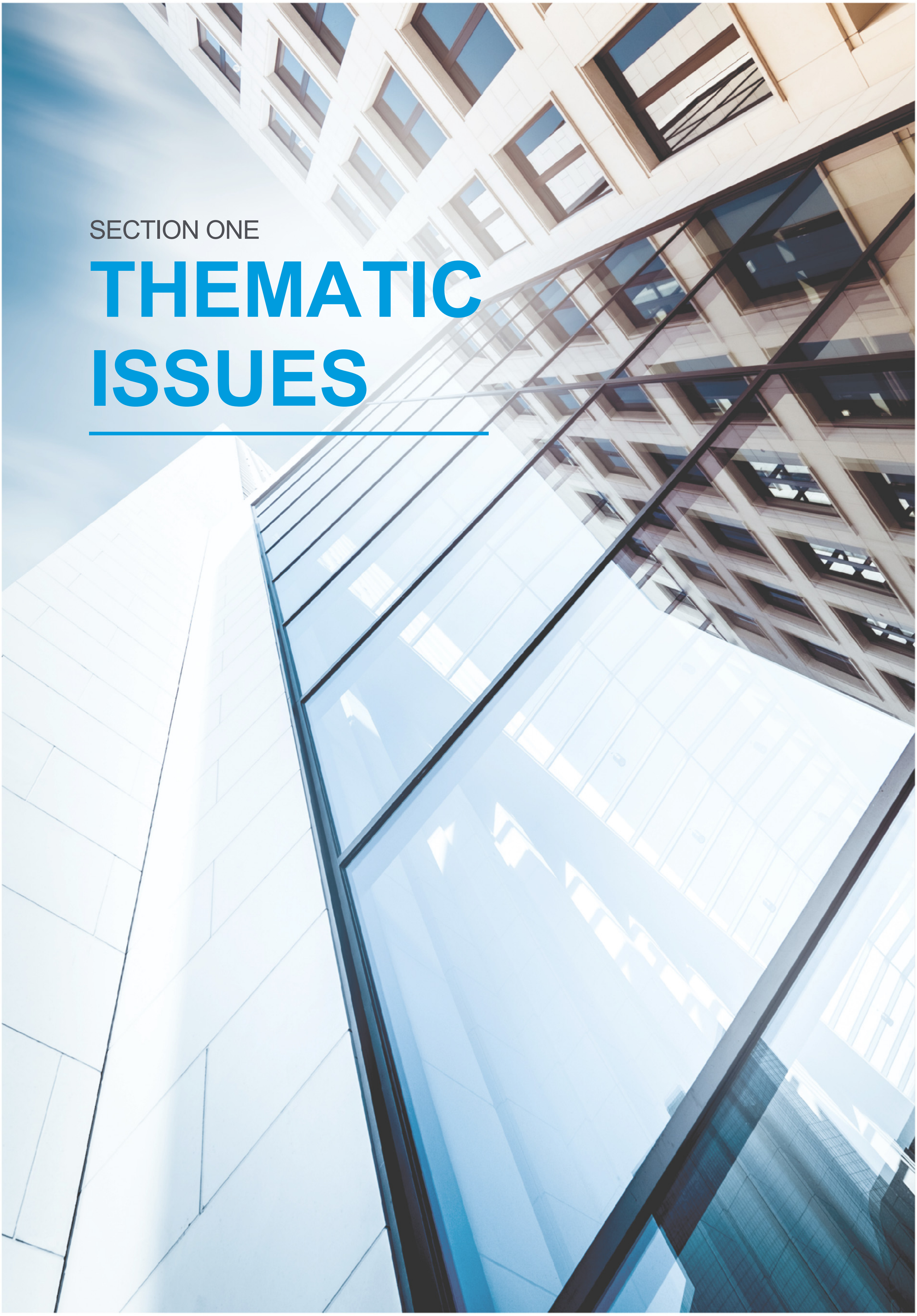
SECTION ONE

THEMATIC ISSUES



2. Cross cutting themes of the Hayne Final Report

A summary of the key cross cutting themes that impact the entire Financial Services industry.

The importance of non-financial risks

Australian banks enjoy financial soundness and are financially well-managed. One explanation for the widespread misconduct revealed at the Royal Commission is over-concentration on financial risk.

Non-financial risk has been downplayed and has affected customers. Non-financial risk manifests in a number of ways including: legal non-compliance, dishonest and misleading conduct, and unfair customer treatment. It is also seen in denying, and delaying, customer dispute resolution and remediation. It is also obvious in underdevelopment or absence of policies for vulnerable or disadvantaged customers. The prevalence of customer harm has led to loss of trust and large remediation payments. Customer exits from some wealth businesses and loss of funds under management added to remediation payments, mean that non-financial risks are monetised as financial risks – even existential ones.

Addressing non-financial risk is crucial because it involves both human cost and may threaten the financial soundness for which Australian banks have a deserved reputation. The Report addresses this non-financial risk as its central task.

Culture, governance and remuneration

Another cross-cutting principle of the Report is that 'culture, governance and remuneration march together': they reinforce each other, for better or worse.

This makes the influence of variable and conflicted remuneration central to the explanation of financial services organisation failings. It also identifies a starting point for putting things right for customers and wider risk management. Get remuneration right, Hayne argues and much of governance, culture and conduct will follow. Boards and senior executives have primary responsibility both for misconduct identified and for using the remuneration, governance and culture levers to turn their institutions around.

Remuneration, conflicts of interest and vertical integration

As well as governance and culture marching with remuneration, in Hayne's view remuneration marches with conflicts of interest. The conflict between legal duties and self-interest has for Hayne too often been resolved in favour of self-interest.

Conflicts are the immediate mechanism causing misconduct and poor management of non-financial risks. Accordingly, he makes recommendations throughout to ban conflicted arrangements in intermediary remuneration. He also limits the value of variable pay for frontline staff and senior executives. He does this by limiting the quantum of pay related to financial metrics such as sales, revenue or group performance.

Avoiding conflicts of interest for intermediaries along with extending best interest duties and limiting variable pay, provided the justification for leaving vertical integration in place as a business model.

The recommendations will nevertheless result in a continuation of the trend away from vertical integration in the industry, even in the absence of forced structural separation – death by a thousand cuts?

Consequently, although the Royal Commission recommendations fall short of mandating structural change within financial services entities, we anticipate divestment and capital management initiatives to dominate the strategic thinking of the boards of some of the larger players in 2019.

Apply, obey and enforce the law

The Hayne Report places a lot of weight on application and enforcement of the law to meet the misconduct and failures of community expectations uncovered by the Commission.

In a democratic society no one is above the law. Hayne places responsibility for application of and obedience to the law by banks and bankers squarely on bank boards and senior management. He places responsibility for enforcing the law on the regulators APRA and ASIC. ASIC in particular, being an enforcement regulator and not relying on persuasion as prudential regulators do, is tasked with litigating enforcement and public denunciation where appropriate.

Clarify the principles underlying financial services laws and simplify the rules

Understanding the purposes of financial regulation so there is clarity about the intent of rules and what is expected is fundamental.

This improves application, obedience and enforcement. Hayne identifies six principles or purposes all of which are established, accepted and easily understood in their financial regulatory context:

- obey the laws
- do not mislead or deceive
- act fairly
- provide services that are fit for purpose
- deliver services with skill and reasonable care, and
- when acting for another, act in their best interest.

He recommends the removal of different and special rules which govern financial sub-sectors. This is to promote financial consumer understanding of their rights, and to make application, compliance and enforcement easier. Where is the public interest Hayne asks, in having different rules for intermediaries which provide functionally similar economic and financial functions?

Banking and financial services should professionalise

Using financial advising as an example, Hayne argues for sub-sectors of banking and financial services to put in place the structures and practices of professions. This is seen as a further measure, over and above the law, of proper conduct towards customers.

The indicia of professionalism he encourages are improved education, ethical and conduct codes, banning conflicted remuneration and institutionalising professional disciplinary arrangements. True to his reliance on legal approaches, Hayne recommends underpinning professional codes and discipline with statutory powers of enforcement. He argues for the extension of a best interests duty to mortgage brokers.

Make the recommended changes carefully and simply

The recommendations should be implemented with further expert research and advice where needed. The changes should be implemented observing the principles of simplicity and connection to well-understood underlying purposes already mentioned.

Our insights and considerations in relation to the key matters in the Report are discussed in the following pages.

3. A way forward – prioritising the priorities

Strategies to build sustainable stakeholder value

There is a clear set of strategies and questions that need to be asked which will help financial institutions build sustainable stakeholder value.

1 Follow the blueprint

The Hayne road map is here and it clearly outlines expectations. The sheer volume, complexity and breadth of the requirements coupled with undefined timeframes will require organisations to 'prioritise the priorities'. The hard decisions to change for the better must be made – and made quickly.

2 Adopt a transformative mindset

Organisations should not be tempted to take the path of least resistance nor adopt an incremental approach, when implementing these recommendations. Instead, organisations should learn from the lessons of the past. Emphasis needs to be placed on the rebuilding phase to ensure the successful, sustainable transition evolves into 'business as usual'.

3 Deliver an end-to-end approach where an organisation clearly connects profit with purpose

A key aspect of this approach is to ensure there is ‘conduct becoming’. That is not only about setting the right tone at the top, it is also about ensuring it flows through the organisation.

4 Embed accountability and transparency

Taking individual and collective ownership of outcomes, ensuring lessons are learnt and those responsible are held to account. Adopt the BEAR principles even if not currently mandated.

5 Listen to and advocate for customers

Across all levels in the organisation, including those in the community who are most disadvantaged.

6 Upgrade risk and compliance capabilities

Upgrade non-financial risk management capabilities and the compliance function. Strong compliance should be viewed as a competitive advantage, not a cost of doing business.

7 Invest in enhanced support structures

Ensure that systems, processes and controls are fit for purpose and enable effective risk and compliance management.

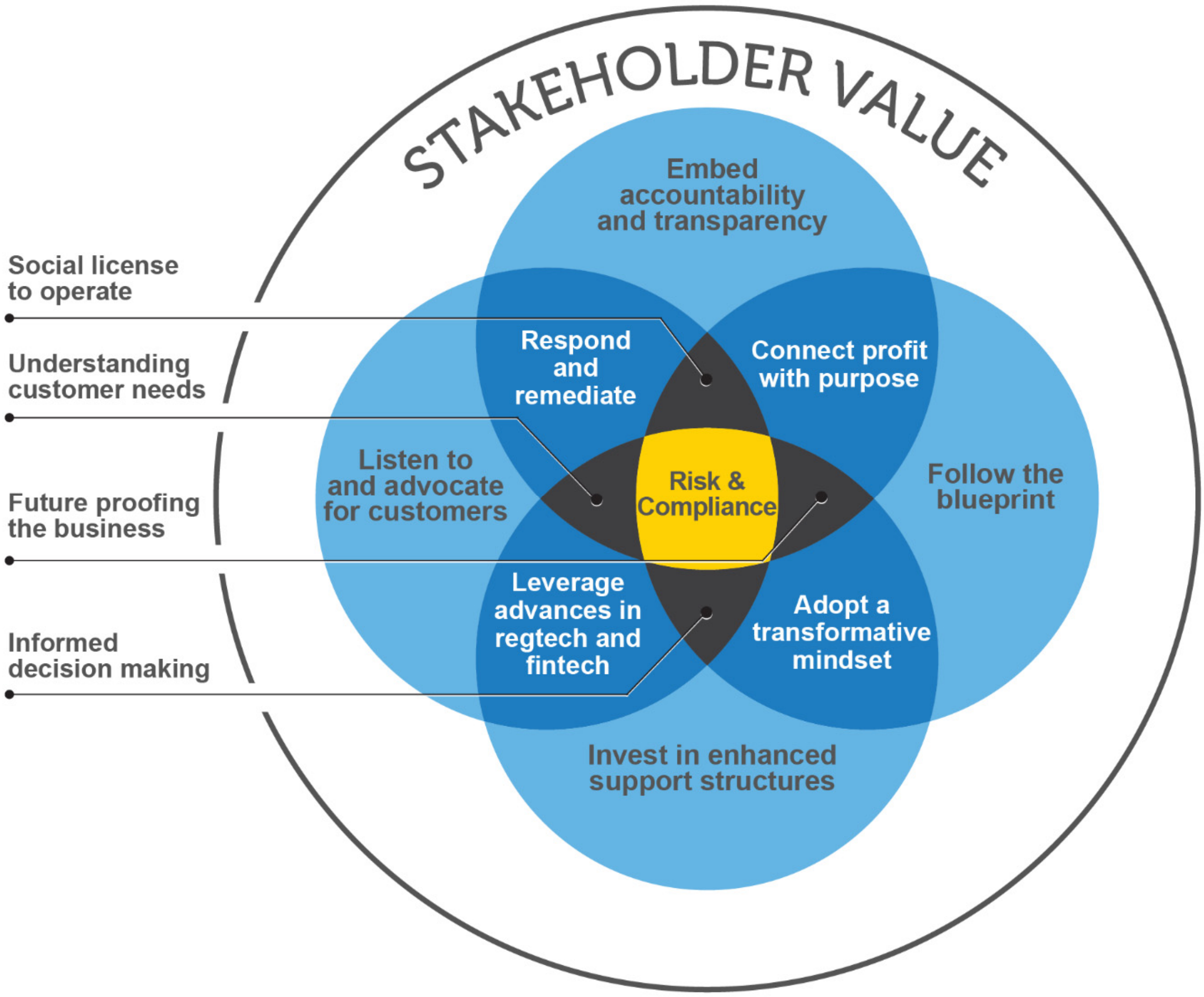
8 Leverage advances in the regtech and fintech sectors

Enhance quality and consistency of data to provide informed strategic decisions, better customer outcomes and support proactive risk management, especially non-financial risk. This will mean ensuring that customer related data is as robust as financial related data.

9 Respond and remediate

In a timely and compassionate manner to customers.

Strategies to build sustainable stakeholder value



4. Governance & the role of the Board

Governance and the role of the board were significant focuses of the Report, impacting many recommendations. Boards may need to consider changes to meet community expectations.

Boards cannot justify pursuit of profit (at the expense of all other considerations) on the basis that they are ultimately accountable to their shareholders. Acting in the long term best interests of the organisation they serve demands more from directors than optimising short term financial returns to shareholders, and cannot justify prioritising the interests of shareholders above the best interests of customers. Rather, increasingly, directors will be expected to take a longer term and more holistic view of what is in the best interests of their organisations and to act accordingly.

Board priorities

Given the Commissioner's observations, APRA is likely to be much more active in supervising how entities manage non-financial risks and remuneration, and both ASIC and APRA will take a much more litigious approach to enforcement. Boards should take immediate steps to assess their culture, governance and remuneration practices and to implement recommendation 5.6 without waiting for additional guidance from the regulators.

Other board priorities and behaviours

- review the organisation's purpose, vision, values and goals
- keep stakeholder interests in balance
- ensure that Hayne's six rules are embedded at all levels of the organisation
- ensure clear ownership and accountability
- resolve issues in a timely manner
- focus on non-financial risk and conduct risk
- avoid negative outcomes for customers by providing suitable products and services designed to achieve fair outcomes
- act diligently, follow up and interact with management, adopt a 'don't tell me, show me' approach
- focus on long term shareholder value.

Clarity on ethical behaviour

Boards need to give effect to their own understanding of what constitutes ethical behaviour. They and executive management will need to ensure that the organisation's stated purpose, vision and values are reflected in practice. The embedment of these behavioural expectations into 'business as usual' practice will require adjustment to decision making processes impacting the customer but will extend to all aspects of how business is conducted. Organisations will also be seeking this clarity from their business partners.

Banking and Finance Oath

Financial institutions will do well to ensure that the Banking and Finance Oath is widely adopted at all levels throughout the organisation.

Well-informed boards

Boards need to ensure that they are equipped with the right information to effectively challenge management and be prepared to do so. Reporting to boards will need to be more comprehensive in relation to customer related issues and the organisation's conduct and culture. Metrics will need to be further defined and additional data sources accessed to provide a holistic picture of conduct and culture across the organisation. Predictive analytics are likely to play an increasing role. Reporting will be required on a more 'real time' basis, driving discussion about underlying technology and data improvements.

The elimination of conflicts

Elimination − as opposed to the management − of conflicts, wherever they occur is a theme running through the Report which informs many of the recommendations and observations included in the Report. Boards would be well advised to consider this in the context of the Commissioner's observations with respect to board effectiveness.

Remuneration

Boards will need to regularly assess the appropriateness of remuneration frameworks, ensuring that variable components have regard to both financial and non-financial risks, and clawback provisions are implemented where necessary. Quality of reporting to boards and remuneration committees will need to be lifted.

Managing non-financial risks

Boards need to ensure there is increased focus within the organisation on managing non-financial risks. This will require an uplift across the 3 Lines of Defence in both capability, frameworks and supporting systems. The demand for operational risk expertise will remain high, escalating supply and demand challenges in the market. Organisations will need to continue to invest in development of risk expertise and consider alternative resourcing models, such as outsourcing.

Awareness of significant matters

Boards should be aware of significant matters and be prepared, if necessary, to intervene and say 'fix this, and fix it now' where management fails to act in accordance with the long term best interests of the organisation, or if major issues have not been resolved in acceptable timeframes.

Conduct & culture

Although organisations have invested heavily in culture and conduct, especially in recent years, clearly more needs to be done. The more sophisticated organisations will set an unambiguous tone as to what conduct and culture looks like and will establish mechanisms to monitor and improve metrics to measure. Periodic checks by independent experts will support boards and executive management to regularly monitor the culture of the organisation.

Cutting through the "permafrost"

Boards will have to seek views from all levels and management will need to ensure that the tone from the top is supplemented by the 'tone from above' so that there is consistency throughout the organisation. Particular attention will need to be devoted to the 'permafrost' of apathy which exists to varying degrees in most large organisations.

Voice of the customer

Organisations should consider whether the forums that exist to test for customer perspectives and impact are 'fit for purpose' and if there are innovative approaches to embed the customer voice at all levels of the organisation. For example, a customer advocate role that extends beyond dispute resolution or listening forums to allow management and the board to hear a diverse range of customer experiences.

Right mix of skills and experience

Boards will need to ensure that they have the right mix of skills and experience required to execute their roles diligently. Superannuation boards in particular will need to ensure there is provision for regular and orderly board renewal and replacement.

Key questions to consider

- What attempts have the Board made to embed a 'don't tell me, show me' approach to information presented by management? Has the customer voice been adequately considered?
- How effective is conflict management in your organisation?
- Is the Banking and Finance Oath communicated and reinforced at all levels of your organisation?
- Is your organisation diligent in analysing themes of issues emerging from customer interaction, and is management doing enough to re-dress these?
- Is the Board and Management satisfied as to the breadth and depth of information and insights being presented on non-financial risks?
- Is the 'tone from the top' reflected throughout our organisation? How will it be measured and monitored to supplement root cause analysis?
- How sophisticated is your conduct and culture framework and how effective are your measurement metrics and monitoring mechanisms?
- Are your Internal Auditors trained to perform conduct and culture audits?

5. Executive accountability – BEAR

The Banking Executive Accountability Regime (BEAR) – has been in place for the large banks for less than a year, and is now likely to be extended to other financial institutions.

Implementation considerations

Implementing a BEAR program delivers significant upside via improved clarity of reporting lines and responsibilities, as well as executive engagement. However, smoothing out implementation issues can take some time (eg) accountability gaps, unnecessary overlaps.

Recruitment and talent retention

It seems almost inevitable that the personal consequence of BEAR (additional responsibilities and remuneration being deferred and at risk of forfeiture) will create challenges for regulated organisations in their recruitment and retention of senior executives as well as their management of internal relativities between regulated and non-regulated staff.

Co-regulatory arrangement challenges

There may be some difficulty arising from the proposed co-regulatory arrangement under which ASIC will be responsible for consumer protection and market conduct aspects of BEAR, and APRA for prudential aspects. For example, a single issue requiring the clarification as to the distinction between 'market conduct' or one of reputation and prudential standing, can become challenging. The Commissioner recognises that conduct can have prudential and non-prudential aspects. How the BEAR regime is ultimately amended to reflect the Commissioner's recommendation will be crucial to avoiding additional complexity for organisations seeking to identify and promptly report issues to the appropriate regulator.

Scope extension

The Report suggests that APRA regulated institutions such as Insurers (life and general) and Superannuation Trustees become subject to the requirements of the BEAR regime. The Government response is for BEAR to be extended even more broadly.

Decision making

There is a risk that decision making will slow down due to the need for additional input from risk, legal and key stakeholders before decisions are made and documented. This will put constraints on organisations who are working to become more agile in nature.

Personal accountability

Personal accountability will lead to heightened awareness of regulatory requirements and will increase the reliance on the legal and compliance functions within organisations to provide relevant, timely and tailored information for the accountable person in question.

Unintended consequences

We have noted in other jurisdictions, notably the UK, which operates under the Senior Managers Regime, senior managers taking an excessively risk averse and legalistic approach to business decision making, in order to protect themselves as individuals.

Corporate governance strengthened

Corporate governance will be further strengthened and broadened to reinforce risk management areas such as non-financial risk, financial crime and regulatory compliance.

More effective committees and meetings

Committees and meetings will become more effective at decision making with clarity around roles and responsibilities, detailed record keeping and follow up of actions.

Key questions to consider

- Do we have cohesive, 'end-to-end' accountabilities mapped out and understood across the organisation?
- Have we appropriately outlined our expectations to the accountable persons?
- Have we established a monitoring and reporting function to support both the organisational and individual objectives of the accountable person?
- Has our organisation considered how BEAR (particularly the necessary deferral arrangements) will impact our remuneration systems?
- How will we ensure that we do not adopt an excessively legalistic approach in conducting our day to day business?

6. Executive remuneration

Addressing executive remuneration is an important part of implementing the cultural change discussed in the Report. Boards need to consider a number of components when making changes to ensure community expectations are met.

Reinforce desired behaviours

Hayne made the point that executive remuneration, governance and culture 'walk together'. Executive remuneration is a very effective way to reinforce desired behaviours and boards will need to ensure that remuneration frameworks achieve this outcome.

Variable pay

The Commissioner stopped short of making some of the more extreme recommendations the industry was expecting. He has recommended no caps on pay, no rules about pay mix and no compulsory deferral (although the extension of BEAR may deal with that for some senior executives). That said, the Commissioner does recommend limits on the use of financial metrics in long term variable pay.

Shareholder expectation management

There is a heightened expectation that boards, CEOs and remuneration committees will continue to work hard to incorporate the lessons of Hayne in executive pay design and will engage with institutional shareholders and proxy firms during the design or review process (in particular on non-financial metrics). Recent remuneration report 'strikes' suffered by some financial institutions increases the pressure to 'get it right'.

Remuneration, audit and risk committees

More than ever, remuneration committees will require remuneration and performance governance expertise, proper understanding of remuneration risk, and access to technical remuneration governance advice.

Remuneration, audit and risk committees will need to formally engage with one another before the start of a performance period (to determine appropriate bonus pools, revenue targets, hurdles etc) and after the end of the performance period to determine outcomes (including any adjustments for conduct risk failure, non-performance, profit results etc).

Business strategy and operational systems

Because of the potential remuneration consequences, there will be a heightened focus by accountable persons on ensuring that business strategies and operational systems do not create or foster unacceptable non-financial risk.

Individual reputations risk

Boards will need to develop a policy for managing the disclosure of decisions resulting in reductions in executive pay due to poor conduct or risk taking because of the impact on the individual's reputation.

APRA has clear direction

The recommendations give APRA clear direction about expanding the scope of its supervision. APRA must add the supervision of behaviour, misconduct, compliance and non-financial risks, to its traditional role of supervising financial risk. The expanded scope reaches into boards' governance of the broadened risk agenda, from risk-adjustments when setting up the remuneration opportunities to end of year outcomes.

Revised Prudential Standard

We expect to see a draft of an amended prudential standard released for consultation by the middle of the year at the latest. Entities are already redrafting remuneration policies to comply with BEAR – the draft amended standard may require a second rework, and APRA will be asking for updated remuneration policies to demonstrate compliance.

Increased regulator scrutiny

An increase in supervisory visits and information requests from APRA certainly seem a possibility as they review remuneration systems and, in particular, how organisations are governing non-financial risk, and complying with BEAR.

Risk and compliance function and improved information

Remuneration, audit and risk committees will require an improvement in the quality of information about how non-financial risk is embedded in their strategies and operational systems, to better understand their risk management performance and make better remuneration decisions. These board committees will require much more from risk and compliance functions, to help them to make remuneration decisions covering non-financial and financial risks, which will need to be disclosed to APRA.

Key questions to consider

- Have the Board and CEO conducted a recent review of the behavioural drivers of the executive remuneration and other reward designs?
- Has the organisation reviewed the connection between reward across the organisation, and the risk levers built into the business strategy and operational systems?
- Do your remuneration structures provide for balance between financial and non-financial risks?
- Do your remuneration structures adequately deal with risk and conduct? How are executives rewarded for good behaviour?
- Are the Board's pay governance policies applied in the spirit of Hayne's six principles? Are there feedback loops to help protect stakeholder interests?
- Are there clear and unambiguous policies in relation to matters?
- Are claw-back provisions enforced?

7. Operationalising Human Resource governance

The Report identified broader challenges that impact on human resource governance. Organisations should take an employee centric view when addressing the challenges.

Increased focus on HR risks

The Royal Commission illustrated that people, their decisions and their actions, are one of the greatest sources of risk for any organisation. As a result, HR governance and the appropriate management of HR risks will be a key focus in the aftermath of the Royal Commission.

Speaking up mechanisms

To the extent they do not exist or are not effective, mechanisms for people to 'speak up' without fear of reprisal will need to be put in place and actively encouraged. If the mechanisms in an organisation are not utilised sufficiently, the mechanisms will either need to be changed or fostered more effectively.

Consequence management

A consequence management framework will need to be implemented so that instances of misconduct are treated appropriately and consistently.

Expectations communicated

Organisations will need to set clear expectation so that no person within the organisation can be in doubt about what behaviour is, and is not, acceptable. This goes beyond merely issuing your Code of Conduct during induction and compliance training.

Utilising data

Organisations that are able to use their existing data to proactively identify people related 'hot spots', eg. through the use of predictive analytics, will manage their non-financial risks more effectively.

Fit for purpose HR governance

Organisations will be required to test their existing HR governance model to ensure it is 'fit for purpose' with the aim of ensuring they support their employees to act 'right'.

Independent assessments

Independent assessments will need to be updated or completed to provide assurance that the HR governance model has been implemented and embedded across the organisation. The assessments will be conducted periodically to further enhance the 'review and challenge' approach of the HR function.

Key questions to consider

- Are we satisfied that our current HR structures, systems and processes are fit for purpose?
- Are all instances of misconduct identified and escalated (promptly) and are there appropriate and consistent consequences for misconduct?
- Do people in our organisation know how to make the 'right' decision – and where to seek guidance in those situations where there is some grey?
- In our organisation have we created an environment where it is safe to speak up without recrimination?
- Does our HR related data allow us to manage the human dimension of our organisation satisfactorily?
- Are investigations into alleged employee misconduct undertaken appropriately? Are independent third party investigations undertaken for conduct involving senior management / serious issue?

8. Regulation post Hayne

Regulators, regulatory structures and enforcement approaches are likely to change as a result of the Report's recommendations. Organisations need to prepare for the new regulatory environment.

Simplification

Recommendations need to be implemented carefully, observing the principles of simplicity and connection to the underlying tenets of the Hayne Report.

A more aggressive approach

The Commissioner recommended that ASIC in its enforcement practices take a more aggressive approach which should be viewed alongside the tougher civil penalty framework proposed by the Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) 2018 Bill. This Bill resulted from the work of the ASIC Enforcement Review Taskforce.

Clear objectives

Central to this recommendation is that ASIC must have a clear understanding of what it seeks to achieve, as adequate deterrence of future misconduct depends on public denunciation and punishment. Ever-present issues of time, cost and uncertainty should deter ASIC less from litigation of this kind: it is likely to be better funded and resourced, and is under greater pressure to exercise public power for a public purpose – the overall health of the economy.

Enforceable undertakings

The Commissioner emphasises the importance of ASIC evaluating specific and general deterrence before accepting an enforceable undertaking, and the utility of obtaining an admission by the entity for its breach of specific legislative provisions. These recommendations reinforce ASIC's essential foundation for accepting an EU.

The impact this approach is likely to have on organisations includes:

Compliance

There will be reduced tolerance for inaccurate or incomplete information, or missed deadlines. Compliance functions should therefore not be treated merely as a cost of doing business. Having the right people, with sufficient stature within the organisation, and backed by fit for purpose technology and data will be increasingly important in a post Hayne world.

Technology

Systems will be required to produce data accurately, completely and on time to ensure that organisations have the right information to comply with the law, regulations and regulatory guidance (increasingly real time).

Prioritisation

The increased demands of the regulators will force organisations to take a strategic view on prioritisation. With limited resourcing, organisations will need to 'prioritise the priorities' in order to ensure that backlog activity does not include issues of high importance from the regulators' viewpoint.

Engagement model

Organisations will need to revisit their existing regulator engagement model to cope with increased demands from regulators, both in relation to the number of requests and the type of information (largely non-financial) required to be produced.

Change management

Compliance will need to ensure information is disseminated in a timely manner across organisations in a way that ensures consistent interpretation and application of the regulatory changes.

Relationship management

Avoiding excessively 'legalistic' approaches while defending existing positions requires organisations to foster a transparent, open communication style with regulators. Having a clear understanding of regulators' objectives and making sure they are communicated consistently within the organisation will be essential.

Key questions to consider

- Do we have an appropriate regulator engagement model that will serve us for this new environment?
- Are we in a position to cope with increased requests and demands from the regulators?
- Do we have a prioritisation process in place to manage increased demands?
- Do we have the capability and supporting processes in place to enhance the organisations understanding of regulatory change?
- Is our compliance function appropriately skilled and does it have appropriate stature in the organisation?
- Do our technology systems deliver reliable information for management and regulatory purposes?

9. Social licence to operate

Organisations must address broader, community and environmental challenges to deliver on expectations underlying their 'social licence to operate'.

Norms of conduct

The Commissioner has restated six norms of conduct which he highlights in key places throughout the Report. These norms are fundamental precepts of behaviour that are reflected in the existing law, but the reflection is piecemeal. They further support and entail some general rules.

- obey the law
- do not mislead or deceive
- act fairly
- provide services that are fit for purpose
- deliver services with reasonable care and skill
- when acting for another, act in the best interests of the other.

The general rules outlined in the Final Report are:

- the law must be applied and enforced
- industry codes to be approved under statute and breach of promises to customers to be a breach of the statute
- no hawking of financial product to retail customers
- intermediaries to act only on behalf of the party who pays them
- eliminate exceptions to the ban on conflicted remuneration; and
- culture and governance practices to focus on both financial and non-financial risk.

Social licence to operate

Attached to an entity's 'social licence to operate' are rights, privileges, duties and responsibilities. The social licence carries expectations of appropriate relationships with a range of stakeholders and the wider community. It recognises that the entity is a social organisation dependent on these shared understandings, not merely a legal and economic unit seeking to behave rationally and perfunctorily under its contracts. Optimally, a potent cooperative momentum would arise between the entity and its stakeholders, one that, while dynamic, is directed towards a common goal. This concept is often called 'shared value' – that business is essentially an enterprise that creates with society something more than the sum of their parts.

Take a long term perspective

Boards must demonstrate they are acting in the long term best interests of the organisation. Underlying this will be the need to juggle appropriately between the demands of the different stakeholder groups, and between long and short term priorities.

Multiple stakeholder considerations

In the corporate world post Hayne, we have more evidence than ever that consideration of multiple stakeholder interests is critical to board decisions.

Ecosystem

The effectiveness with which organisations respond to community expectations on 'social licence to operate' will unleash employee productivity and positively impact their strategic partnerships.

Competitive advantage

Studies demonstrate that 'high-sustainability' organisations that take a longer term strategic view generally outperform the competition on a variety of financial and non-financial measures.

Key questions to consider

- Will the Board mandate that their decisions reflect a long-term view and one that explicitly takes into account multiple stakeholder interests?
- Will the Commissioner's six norms of conduct become a proxy for community expectations?
- Are these norms of conduct being promulgated throughout the organisation and are they taking root?

10. Data and technology

There are no recommendations in the Report mandating increased investment in, or use of technology. However, it is evident that this will need to occur in organisations to successfully operationalise key recommendations.

Legacy systems

Typically, in many organisations, data sources are varied, resulting in financial, risk management, regulatory and customer information not always being consistent. An imperative going forward will be on ensuring that there exists "one source of the truth" and that data on non-financial risks, eg customer related data, is accurate and timely, to enable organisations to fulfil increasing customer and community expectations.

Capability to deliver enhanced transparency

Use of technology that interrogates interconnected and unstructured data (eg. social media, customer complaints) using data analytics and artificial intelligence will greatly enhance the ability of organisations to not only comply with the breach reporting process, but to proactively monitor risks.

Enabling organisations to act in accordance with the law

The absence of the appropriate systems makes it difficult for organisations to always act in accordance with the law or community expectations. We expect that the strategic use of systems and technology will play a pivotal role in enabling organisations to operationalise many of the Report recommendations.

Empower customers

Customer education and informed choice is another necessary step towards regulatory compliance. Customers need to genuinely understand products they are purchasing. Clever use of systems that inform and empower customers, and give them rights of redress, will go a long way to addressing the underlying principles set out in the Report, particularly to: provide services that are fit for purpose; not mislead or deceive; and to act fairly.

Enable a customer centric approach

Financial services organisations are pivoting to a focus on how customers want to buy, not how organisations want to sell. Organisations will need to prioritise their customer focus and safeguarding customer data. More particularly, organisations will need to ensure that such data is properly collected, structured, accurate, permissioned, robust and secure and is used both lawfully and in accordance with customer expectations.

Making it easy to 'do the right thing'

Increased transparency and simplification of processes, 'built in compliance', will provide guard rails to prevent errors and shortcuts. .

Facilitate cooperation and data sharing

Consolidation of data sets and interoperability of systems will facilitate access to data and ease of information sharing both internally and with regulators.

Board reporting

The Report makes clear that boards are expected to ensure that they are equipped with the 'right' information to enable them to effectively challenge management.

Ready to engage with regulators

Regulators are now expected to take a far more active supervisory approach, and organisations are already having to provide information online. Technology is essential to ensuring quality and consistency in decision making, real time data analysis, monitoring of behaviour, and encouraging better customer outcomes.

The rise of Fintechs

New and agile digital technologies, strong customer orientation and being unencumbered by legacy systems will see Fintechs playing a greater role in the financial services sector.

Competitive advantage

Investment in new systems will improve the customer experience, reduce the regulatory burden and provide competitive advantage.

Key questions to consider

- Do our current technology solutions assist in the proactive identification of risk? In particular non-financial risk?
- Do our systems adequately allow us to report on risk management processes, reporting and monitoring processes of non-financial risk?
- Are we able to provide customers and regulators with information safely, securely, accurately and in a timely manner?
- How fit for purpose are our technology systems and how capable are they in delivering reliable and timely data, to enable management and the Board to monitor and manage financial and non-financial risks?

SECTION TWO

SECTOR IMPACT

11. Impact on Banking

Recommendations regarding lending focus on the continued improvement of current practices. There is greater impact on the mortgage broking sector with proposed industry reviews and potential changes to remuneration structures. The key impacts are considered below.

Implications for lending

Apply the existing law (as it was intended)

The Commissioner recommends against amending existing responsible lending provisions under the NCCP Act and makes no recommendation to change the way in which responsible lending requirements are framed under the ABA Code of Banking Practice. However banks would be ill-advised to read this as an endorsement of current practice.

Expectation of continued improvement

Though existing responsible lending obligations are technically unchanged, the Commissioner makes clear that he expects recent improvements in lending practices (eg the shift away from use of the HEM or other benchmarks) to continue as necessary steps towards legal compliance.

Areas where more improvement is needed

The Commissioner recommends a number of measures focused on shoring up customer protection and increasing banks' focus on customer needs (eg improvements to agricultural lending services; the extension of the definition of small business in the ABA Code of Banking Practice to cover more businesses and accessibility measures).

Opportunity to take steps to rebuild trust

A number of the recommendations, particularly those concerning accessibility of services, represent an opportunity for banks to take immediate steps to rebuild lost community trust, and demonstrate their increased focus on customer needs.

Review current lending practices

Lenders would be well advised to review their current lending practices, products, systems and processes against heightened compliance obligations foreshadowed in the report, and in view of strengthened enforcement mechanisms.

Implications for mortgage broking

Areas where more improvement is needed

The Commissioner makes clear that he regards the recent moves by industry as inadequate, to address the issues identified. He recommends a raft of significant amendments to force a change in approach.

Political landscape

The Government's decision not to follow all of the recommendations in the Final Report exposes the industry to uncertainty. But it also gives the industry the opportunity to persuade the Government that mortgage brokers can act in their clients' best interests, and address the conflicts and other deficiencies identified in the Final Report, without being subject to the full financial advice regime, and without a prohibition on lender fees.

Proposed industry review

The proposed review in three years gives mortgage brokers time to implement changes that will convince the Government that the industry improves customer outcomes and increases competition. The industry has the opportunity to monitor whether the remuneration changes have a negative impact on customers, including, for example, whether the move to upfront commissions encourages customer churn.

Regulation

The Commissioner recommends that borrowers, not lenders, should pay mortgage brokers, and that brokers should be regulated as financial advisers. It also raises the prospect of following changes introduced in the Netherlands that 'level the playing field' by requiring banks to charge for mortgage broking services at cost. The Government has not gone this far, but proposes to make changes that significantly restrict mortgage brokers' income, while significantly increasing their costs.

Restrictions on remuneration

From 1 July 2020 the Government has agreed to introduce various restrictions to remuneration that will be reviewed in three years. The changes will have significant implications for consumer outcomes and competition of moving to a borrower pays system.

Best interests test

The best interests test is likely to be expressed as a requirement to 'act in the best interests of the loan applicant in the selection and arranging of loans'. This is a much broader obligation than a duty to give preference to the client's interests where the client's interests and the broker's interests do not coincide.

Key questions to consider

- How do we begin to operationalise the customer best interests duty?
- How do we define a good consumer outcome?
- Have we established a code of conduct? Do we have supporting processes to monitor Brokers behaviour and outcomes?
- As a Board, do our existing systems, processes, and incentive schemes incentivise the right behaviour? If not, how do they need to change? What metrics will we use to monitor the effectiveness of the changes we implement?
- How does our current approach to delivering services to our customers, especially those in regional and rural areas need to change? Do we have the right skills within the organisation to be able to operationalise the changes?

12. Impact on Financial Advice

Recommendations regarding Financial Advice seek to tighten fee structures, increase disclosures and accountability with the intent of providing consumers with products and advice suited to their financial needs. The key impacts are considered below.

The end of ongoing fee arrangements (OFAs)

The recommendation for annual renewal of all OFAs (meaning an end to grandfathering for OFAs as well) and payment authorities puts significant regulatory pressure on annual advice fees and is likely to lead to increased use of fee-for-service models where clients are charged a fixed rate or hourly rate fee for each service they receive. The requirement for product issuers to ensure they receive a fee authorisation from each client each year will increase costs. They may be unwilling to allow advisers to deduct fees from client accounts unless technological solutions can be developed to mitigate costs.

The end of grandfathering

This will apply to not only commissions but also to OFAs. The Government's proposed time frame for commissions provides both a transition period for managing the consequences of the end of grandfathering and pressure to end grandfathering early and pass on the benefit to clients which is subject to ASIC monitoring. The Commissioner has also suggested that the cap on life risk commissions should be further reduced, ultimately to zero. Presumably the end of grandfathering will also apply to volume-based shelf space fees for platforms but this has not been stated explicitly.

An unlimited best interests duty

There will be a comprehensive review of measures to improve quality of advice in 2022, including whether to repeal the best interests duty, safe harbour and conflicted remuneration exemptions. The duty seems to be developing into one that not only shapes the content of the advice, but how it is arrived at. The result will be more emphasis on individual accountability of advisers for the advice they give which is consistent with other recommendations, such as individual registration with a single disciplinary body.

Conflicts disclosure

Despite concerns about the effectiveness of disclosure, yet another disclosure document – the non-'independent' disclosure – will need to be given to clients.

BEAR like regime

Firms will need to restructure to comply with the expanded Executive Accountability Regime currently known as BEAR. Significant work will be required to reshape roles and accountabilities and ensure that reporting lines support executives with ultimate accountability for a function.

Compulsory reference checking, information sharing and reporting serious concerns

This important recommendation builds on the ABA's good work and will help address some of the limitations of the existing protocols. It will be important to expressly override perceived legal impediments to information sharing, such as employment, defamation and privacy laws. Information sharing challenges key assumptions about dealings with competitors and regulators. They reflect expectations that customer centricity is not limited to individual businesses but extends to the broader impact of business decisions.

Focus on remediation

Formal obligations to remediate clients promptly and giving AFCA and ASIC explicit oversight of remediation programs reflect the key role played by remediation. However, remediation can also be an opportunity for brand protection and customer retention.

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Key questions to consider

- Do you have an appropriate corporate and ownership structure for a professional advice business?
- Are fee arrangements suitable for clients? Is adviser remuneration suitable, including soft dollar benefits?
- How will you manage the end of grandfathering and the consequences for advisers? How will you retain client investments?
- Do your business practices and compliance systems support professional advisers acting in individual client best interests?
- How effective is your conflicts disclosure, particularly where you are not 'independent'?
- Have you reviewed recruitment and termination procedures for advisers and support staff?
- What are you doing to prepare for the BEAR like regime?

13. Impact on Insurance

Recommendations regarding Insurance will significantly change the way insurance products are sold to consumers. The key impacts are considered below.

Extending the commission ban?

Recommendations to consider reducing the cap on life insurance commissions to zero and to ban or limit general insurance commissions place increased pressure to drive poor sales practices out of the sector. Underinsurance is a serious issue but cannot be used as an excuse for selling poor value products to consumers who may not require them.

Reviewing remuneration models

Further regulation of commission will impact distribution models, particularly where key functions are outsourced. Sales incentives need to be appropriate for the line of business and distribution channel. If the rate of commission does not reflect costs plus a reasonable profit, the rate may be too high.

BEAR like regime

Businesses will need to restructure to comply with the expanded Executive Accountability Regime currently known as BEAR. Significant work will be required to reshape roles and accountabilities and ensure that reporting lines support executives with ultimate accountability for a function.

No hawking

The ban on cross-selling and outbound telephone sales will mean more advertising and a greater emphasis on internet-based sales. It will also have a significant impact on the value of distribution channels.

Permission to use the term 'insurance'?

Along with removing the exemptions for funeral expenses policies, the Government proposes to restrict the use of terminology such as 'insurance'. This restriction may require licence variations. It is not clear whether this is restricted to funeral products or will apply across the board.

A simplified duty for consumers

The duty of disclosure for retail and life insurance will be abolished and replaced with a duty of care not to make misrepresentations. Life insurers will be particularly affected and will need to review underwriting processes to ensure they ask all relevant questions.

Unfair contract terms

The Commissioner appears to have accepted the view that almost all aspects of consumer insurance contracts should be subject to review. This could have serious implications on the availability and pricing of insurance. Combined with the proposed design and distribution changes, insurers will need to carefully review and redraft their products.

Removal of the claims handling exemption

The core business of insurers will now be subject to ASIC as well as APRA oversight. Insurers will need to develop and maintain "Best Practice" claim guidelines and review training and competency requirements for claims staff. Prescriptive standards can be expected to develop over time. Businesses requiring a new licence could range from loss adjustors to anyone with claims-related contact with clients, such as repairers and doctors unless exemptions (and therefore more complexity) apply. Prescriptive disclosure requirements, such as financial services guides, and regulation of remuneration may also apply.

Enforceable codes

Industry codes will require review if they are to have the force of law. This is likely to sacrifice user-friendly language for more precision. Enforceability and greater sanctions mean that insurers will need to review code compliance policies and procedures to ensure they are sufficiently robust.

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Key questions to consider

- Do your culture, governance and remuneration frameworks support a customer-centric approach? This affects all areas, including sales, underwriting, claims and complaints.
- Do your sales practices and incentives reflect a culture of zero tolerance for poor consumer outcomes?
- How can you promote products and help customers identify their insurance needs without product-pushing?
- How will you identify and improve your ability to respond to the needs of vulnerable customers and to better target products to identifiable customer needs?
- What changes need to be made to prevent a sales focus overriding customer need and value in the future?
- What are you doing to prepare for the BEAR like regime?

14. Impact on Superannuation Funds

Recommendations regarding Superannuation Funds include calls for increased executive accountability, structural changes, increased supervision and a review into selling practices. The key impacts are considered below.

BEAR like regime

Trustees will need to restructure their businesses to comply with the expanded Executive Accountability Regime also known as BEAR. Significant work will be required to reshape roles and accountabilities and ensure that reporting lines support executives with ultimate accountability for a function.

Impact of additional liabilities

The expansion of civil penalties will broaden directors' liability exposure, as liability for a civil penalty cannot be reimbursed from insurance or from fund assets. It may become harder to find persons willing to be a director, given the additional liabilities of directors.

Implementation costs

The abolition of dual-regulated entities will have cost implications and require significant lead time to implement, particularly if a new AFS or RSE licence needs to be obtained.

Impacts of one default account

As a member will only have one default account, the machinery for selecting that account will shape the future of the industry. Funds will need to engage on this issue and consider how it will affect inflows and their business model. For example, will the reform favour super funds that target, or which are typically joined by, younger new entrants to the workforce?

MySuper

The ability to offer MySuper in products that are only available through advisers (e.g. super platform products) will be adversely impacted.

'Treating' of employers prohibition

It is unclear whether the prohibition on 'treating' of employers will cover fee discounts or rebates to members of an employer plan, particularly where fees are paid by the employer.

Related party insurance arrangements

Related party insurance arrangements will be subject to additional regulatory scrutiny. Independent legal certification confirming that the arrangement is compliant and in members' best interest will need to be obtained and provided to APRA periodically.

Impact on systems, policies and procedures

Systems, policies and procedures will need to be developed to prevent advice fees being charged in MySuper, including switches into MySuper from a product or investment option where advice fees were being charged. Processes will need to be put in place to ensure advisers do not advise members to switch from MySuper to a choice product so that advice fees can continue to be charged.

Distribution and third party advisers

Requiring trustees to monitor the conduct of third party advisers may expose trustees to liability for poor adviser conduct. The monitoring obligations for trustees should be clearly articulated and a 'safe harbour' provided for trustees who take on the responsibility to monitor the conduct of third party advisers.

Hawking provisions

How super products (including training and monitoring of representatives) are distributed will need to be reviewed in order to avoid breaching the new 'hawking' prohibition.

Engaging with ASIC

ASIC might interpret trustee obligations differently to how they have been interpreted by APRA. Arguably, the best interests duty has been significantly expanded by the Royal Commission and it is likely that 'community expectations' will be used as a measure of fairness.

Key questions to consider

- What should you be doing now to prepare for the BEAR like regime?
- Do you have a legal basis to stop paying commissions before 1 January 2021?
- Do you need to review your policies relating to 'treating' (ie. providing entertainment, gifts or benefits to) employers?
- What impact will the reforms have on new or existing distribution/strategic alliances?

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