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## Banking Royal Commission – The Interim Report & What It Means

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With 6 rounds of the Hayne Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry now complete, the Commissioner (Kenneth Hayne AC QC) has released an Interim Report in relation to the first 4 rounds (**Interim Report**), with media outlets highlighting this damning phrase in the executive summary: *"Why did it happen? Too often, the answer seems to be greed – the pursuit of short term profit at the expense of basic standards of honesty*."

This is not surprising given its dramatic impact. However whilst the Interim Report has uncovered some systemic problems in the larger financial institutions it would be wrong to conclude that the system is broke or that the problems are typical for the industry and in particular the smaller banks and the mutuals.

In this paper, we focus on consumer lending (including responsible lending), dealings with small to medium enterprises (**SMEs**) and the outlook of the regulator and the Interim Report's implications for the customer owned banking (**COB**) sector.

To see Ash St.'s overview of the first six rounds of the Royal Commission, please click here.

### Banks and the pursuit for profit

While Commissioner Hayne recognised that commercial enterprises have a duty to pursue profit in the interests of shareholders, it was noted that such profit should be a long-term advantage including "*preserving and enhancing the reputation of the enterprise*" and engaging in its activities "*efficiently, honestly and fairly*". Importantly, these duties were stated to include both obeying the law, and seeking "*to do the right thing*". The latter phrase is clearly something that has meant different things to different people.

The Interim Report concludes that the major financial institutions only did "*as little as they thought they have needed to do to meet their obligations, offering no (or at best, next to no) encouragement to reward staff or third parties to pursue the interests of the consumer. Compliance appeared to have been relegated to a cost of business.*" This conclusion is not surprising given the conduct of the major financial institutions revealed in the hearings to date.

A number of factors were identified as contributing to this widespread misconduct, including the privileged position of banks (as Commonwealth licensed entities), weak competition, the nature of the service provided (all Australians need a bank account), asymmetry of power between the customer and the bank (allowing major banks to fix their risk appetite) and as such there was no real effective deterrent. In other words, *"they have gone beyond the limit because they can, and because they profit from the misconduct*".

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**Responsible lending and suitability**

Under the *National Consumer Credit Protection Act* (**NCCPA**), credit licensees are obliged to assess whether a credit contract is 'suitable' for a consumer after making certain enquiries and verifications in relation to the consumer's financial affairs. The Interim Report found that in practice, credit licensees were primarily focused on the serviceability of the consumer contract (i.e. whether the consumer would likely default).

The major banks and their representatives were criticised for trying to dictate the needs of the consumer by treating all conversations with them as an "*opportunity to sell*", and this was further exacerbated by the consumer's reliance on the bank's expertise. This was illustrated by the case studies into credit card limit increases, which were offered as long as the consumer was not likely to default, and without any enquiry as to the customer's objectives.

Moreover, it found that the major banks only conducted due diligence on a customer's income, but "*much more often than not, none of [the major banks] took any step to verify the applicant's outgoings*" and often used a benchmark for household expenditure stated to be wholly insufficient. In fact, Commissioner Hayne concluded that this practice "*does not constitute any verification of a borrower's expenditure. On the contrary, much more often than not it will mask the fact that on sufficient inquiry has been made.*" The fact that the bank respond was that such verification procedures were "too hard" demonstrate the banks' view of compliance as a cost of business.

★ **Ash St.'s Thoughts**
**Key Points for Compliance/Risk Functions to Consider**

- Confusion concerning the roles and responsibilities of intermediaries.

- Products must be designed to meet a customer need not so they can be convinced they need the product.

- Assessment of a customer's financial position should not be limited to whether or not they are likely to default under a loan.

- Products are not being delivered in accordance with the features offered as they are sold.

**Administrative errors**

Whereas some viewed the problem of administrative and processing errors as having little importance, the Interim Report specifically noted that such errors could amount to misconduct. In particular, Commissioner Hayne stated in no uncertain terms that "*entities should not offer to sell what they cannot deliver*" and that relevant systems should be in place prior to the sale of the product. There was a further warning that banks should resolve such errors as soon as reasonably practicable, highlighting the ANZ case study (where remediation has still not been conducted as at March 2018, despite errors being identified in 2003) as a brown standard.

**Remuneration**

Systemic issues with remuneration policies of major banks leading to poor consumer outcomes was brought to focus repeatedly in the hearings and has captured the public the media's attention. The Interim Report firmly recognised that remuneration policies, whether in relation to bank staff or third party intermediaries, are the "*critical element in forming the culture of the entity*".

*Staff and Management*

The Commissioner concluded that all banks sought to manage their staff by providing remuneration measured to *"sales and profit"*. Earlier attempts at reform were also found to be inadequate – despite the 2012 Future of Financial Advice reforms (which only applies to financial services licensees) as well as the changes brought about by the 2017 Sedgwick Review (which noted that *"sales oriented culture is deeply ingrained"*), banks were still found to emphasize profit in its remuneration structures for staff.

In a (not-so) subtle condemnation of such practices, Commissioner Hayne challenged the assumption that "*staff and intermediaries will not do their job properly and to the best of their ability without incentive payments*" and offered examples of other remuneration structures which could lessen the focus on sales and profit. In addition Commissioner Hayne mentioned the mutuals as an exception to the prevailing remuneration practices so some remuneration policies have worked in the COB sector.

In recognising that culture is largely driven top-down, Commissioner Hayne noted the possible need to scrutinise remuneration structures not just for junior employees but also for managers and senior executives to avoid too heavy an emphasis on sales and profit. In this respect, it was noted that the BEAR regime (under the *Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Act 2018*) could have a role to play and it can be expected to have such a role to lead to better outcomes. In the case of the COB sector this should not be such an issue for a number of the ADIs here given their remuneration structure.

(For Ash St.'s summary on the technical requirements of BEAR, click here.).

*Brokers*

Damningly (although unsurprisingly), brokers were roundly criticised as leading to poor consumer outcomes. Broker loans were "*reliably associated with higher leverage… interest-only repayments… higher debt to income levels, higher loan to value ratios and higher interests costs"*. Much of this was attributed to the value and volume based remuneration practices set by the major banks.

The Interim Report gave a strong indication towards tighter controls on remuneration for intermediaries, including the possibility of abolishing value-based remuneration altogether.

## The role of the intermediary

The Royal Commission also discussed the confusing nature of intermediaries, stating that there is "*no legal answer as to who the intermediary acts for"*. This was particularly important for the home loans industry, where the mortgage broking industry settles 55.7% of Australian home loans.

Consumers may see a broker as a person acting in his or her interest, by submitting a loan proposal application on their behalf. On the other hand, lenders may view brokers as being tasked to sell their products. It was noted that in practice, brokers have every incentive to prioritise their relationships with a lender over the interests of a consumer – as indicated by the remuneration issues above, they are paid by the banks and deal with them on a regular basis, whereas a consumer is, by in large, a one-time customer.

While the law currently does not prescribe a general duty of care from a broker to a borrower (except for the general protections under the Corporations Act and NCCPA), there was a warning this relationship could be further complicated by brokers expressly assuming specific obligations by making certain assertions to the consumer beyond the legislation.

The Interim Report indicated little intention to recommend introducing a 'customer first' duty to intermediaries, given the existing requirements under the Corporations Act (for financial advisers) and the NCCA (for credit licensees). However, it was left open as to whether intermediaries should have, and the extent of such, a duty to manage the inherent conflicts of interest of personal profit or gain, and their duty towards the consumer.

## SMEs

The provision of loans to SMEs may not be a primary focus for all of the COB sector but it still is a matter of interest. Commissioner Hayne noted the lack of appetite for a change to the legal framework to SMEs, due to the fear that extra layers of compliance would lead to an increase in cost and availability of SME lending. In particular, there was no desire to expand the NCCPA to include SMEs. Instead, the chief protection would lie with the Banking Code of Conduct (discussed in more detail below) or Customer Owned Banking Code of Practice (in addition to the general protections under the unconscionable conduct and unfair contract term provisions in the *Australian Securities and Investments Commission Act 2001* (Cth)). This is an area where a framework is already in place and you would have expected to be sufficient. It just needs to be properly complied with and enforced.

Nevertheless, the Interim Report raised some issues for consideration, including whether additional rules should be put in place in relation to the enforcement of an SME loan, whether voluntary guarantors should be given some protection, and the role of authorities in providing guidance to SMEs who have suffered as a result of a breach by a lender under the Banking Code of Conduct.

## Banking Code of Conduct

The Banking Code of Conduct (**Code**) was originally a voluntary code of conduct established by the Australian Banking Association, which a number of member banks (including the major banks) publicly stated they would comply with. The Code is incorporated as part of the contract between the bank and customer and is one of the only protections for loans to SMEs. The Interim Report described the Code as a document written by the industry, for the industry as informing customers the standards of behaviour they can expect from the bank, beyond the minimum requirements of law. It is hard to find any fault with that description of the Code.

One of the principal obligations is the need for the bank to *"exercise the care and skill of a diligent and prudent banker"* when offering credit. This raises the further question of what the hypothetical banker standard, in fact, requires and the level of independent enquiry required. In particular in relation to loans to SMEs, is the bank required to verify the business case of the SME and stress test any assumptions? For consumers, to what extent will the bank be required to ensure that the product is what the consumer actually needs rather than just something to be sold?

The Code has undergone a number of amendments, and the latest Code (which will commence operation on 1 July 2019) was the first Code to receive ASIC approval. Despite acknowledging the value of regulator input, the Interim Report stated that the Code remained a largely industry driven document.

Interestingly, Commissioner Hayne seemed to support a push for the Code to be enforceable under legislation (despite the concerns raised by the SME industry as mentioned above) and this could have implications for the COB sector. In particular, given that the Code was created by the industry, it was stated that it should be "*presumed that they now seek to apply them. That being so, it is far from obvious why making their contravention a breach of law should impose any additional cost or burden"*. In other words if you agree to exercise a standard of care, voluntarily or otherwise, there should be a real consequence if you do not do so and this should not be totally dependent upon an aggrieved consumer having the means and determination to take appropriate action.

**Regulators**

During the first 6 rounds of hearings, the regulators were criticised on many occasions for a lack of enforcement action. In some respects the regulators came out of the Royal Commission in as bad a light as the major financial institutions. The Interim Report confirmed the importance of the role of regulators, noting that where the market lacked sufficient competitive pressures, "*only the regulator can mark and enforce"* proper conduct. As the Australian Prudential Regulatory Authority (**APRA**) was chiefly focused on "*governance and risk culture"*, the Interim Report aimed its efforts instead at the Australian Securities Investments Commission (**ASIC**), due to its supposed role on "*conduct regulation*".

One particularly damning statistic showed that over the past 10 years, ASIC issued infringement notices amounting to approximately $1.3 million. By way of comparison, CBA declared a $9.93 billion profit in a single year. Criticising this as entirely insufficient, Commissioner Hayne stated that a "*regulator must do whatever can be done to ensure that breach of the law is not profitable".*

ASIC's enforcement strategy was found as having a starting point of "*How can this be resolved by agreement?*" with a focus on remediation. Whilst this approach can have some merit as it can lead to speedier resolutions of disputes and without the inherent uncertainty of proceedings, Commissioner Hayne decried this approach as being wholly inappropriate, as *"contraventions of law are not to be treated as no more than bargaining chips to procure agreement to remediate consumers"*,. In addition this strategy allowed the banks to dictate the when and how the law should be obeyed. The conduct (or misconduct) of the major banks then shapes the conduct of the rest of the industry. Similarly, statistics showed that ASIC had a 96% success rate in proceedings during 2015 to 2016. The Interim Report concluded that this suggested ASIC's lack of appetite to pursue strategically important litigation or resolve grey areas of law. Instead, it was said that ASIC's strategy should be akin to the Commonwealth Director of Prosecutions i.e. by asking *"whether it can make a case, [and if it can] then ask why it would not be in the public interest to bring proceedings"*. It is difficult to fault such an approach when dealing with law enforcement.

The Interim Report lists a number of advantages having matters resolved by the courts, including higher penalties, public denunciation, a unified interpretation of the law and so forth. While Commissioner Hayne recognised that ASIC had limited powers, he also noted that ASIC had greater powers than had, in fact, been used. A question was also raised as to whether it was appropriate to implement a mechanism to assess ASIC's enforcement action, for example by having ASIC report to a Financial Regulator Assessment Board.

**Changes to law?**

In general, Commissioner Hayne indicated that it was not necessarily prepared to recommend changes to banking and financial services law. Instead, it was stated in the Interim Report that *"adding any new layer of law or regulation will add a new layer of compliance cost and complexity… would serve only to distract attention from the very simple ideas that must inform the conduct of financial services entities"*. These ideas were stated to be:

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

Moreover, Commissioner Hayne stated his view that while good culture and proper governance can be affected by law, "*in the end they depend upon people applying the right standards and doing their jobs properly*". This is clearly not just an issue about the culture of the financial institutions which is an inherently difficult issue to try and legislate for. What appears here is that the major financial institutions have not only not complied with the law in a number of respects and people have not done the right thing, the regulators also have not enforced the laws which are already there.

**Conclusions**

The Interim Report did not provide any recommendations as to any specific changes in any laws or modes of conduct. The final report is currently to be published on 1 February 2019 and we can expect a series of recommendations including some increased regulation and penalties to be increased.

In relation to the COB sector, whilst it was not subject to the spotlight of the Royal Commission we would expect that overall their business will not be materially adversely affected by the outcomes particularly given the markets they focus in. Indeed it may be that the outcomes may present some opportunities for at least the larger institutions in the COB sector to increase their business. One danger that does remain however is whether the COB sector will be caught up in some

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> increased regulation imposed upon all ADIs and the increased costs that this brings. This has been a common complaint of the COB sector and it can only be hoped that this time they will not be so penalised.

**Round 7** of the Royal Commission will take place between **19 to 30 November**, focusing on policy questions arising from the issues explored in the earlier hearings, before a **final report** being published on **1 February 2019.** It should be noted that Commissioner Hayne has the power to extend this timeline, but has not indicated that he would do so. Indeed notwithstanding pressure from some parties, particularly from the political arena, an extension seems unlikely.



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