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Banking Royal Commission – where are we at?

SHAUN MCGUSHIN, ASH ST.[1]

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After much public debate and political pressure, the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (**Royal Commission**) was established on 14 December 2017 with its first public hearing taking place on 13 March 2018. The Royal Commission was triggered by the myriad of issues that surfaced around Australia's financial sector and in particular the banks and their conduct over the past decade.

The Royal Commission has been asked to investigate whether any of Australia's financial services entities have engaged in misconduct, and if criminal or other legal proceedings should be referred to the Commonwealth. It has also been asked to consider whether sufficient mechanisms are in place to compensate the victims.

The events thus far

Six rounds of hearings have taken place to date, exposing severe misconduct by some of Australia's major banks and other financial services entities.

In this paper we look at where the Royal Commission is at and what the implications or consequences, intended or unintended, may be for the banks and in particular the smaller customer owned or mutual banks. A common complaint amongst the smaller banks is that they are at risk of being subjected to further regulatory burdens by the actions of the major banks, some of whose sins have been laid bare by the Royal Commission.

Whilst the Royal Commission continues in its endeavours, it may be useful to provide some fast facts and a timeline of events to date and our current insights into future regulation changes in the banking industry.

Hearing One - Consumer Lending Practices

The first round of hearings took place between 13 March and 23 March 2018 and focused on the consumer lending practices of Australia's banks. In particular, the Royal Commission looked at case studies in residential mortgages, car financing, credit cards and general account administration, with a breach of responsible lending obligations becoming a major recurring theme.

Residential Mortgages

It was noted in the Royal Commission's opening statement that residential mortgages were the largest assets of authorised deposit-taking institutions (**ADIs**), with approximately $1.6 trillion worth of residential mortgages provided in 2017. Some notable case studies included:

(a) a group of NAB staff members accepting $2,800 in alleged bribes for home loans in 2015, which was discovered in October 2015 but not reported to ASIC until February 2016;

(b) ANZ's failure to run checks on a customer's expenses when approving residential mortgages, citing high costs and difficulties in doing so, as well as administrative errors such as applying the wrong home loan rate.

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In addition, the Commission also explored more systemic problems including commission structures, which rewarded mortgage brokers for high value and long-term loans, and encouraged brokers to recommend loans against the customer's best interests.

Vehicle Financing and Add-on Products

A number of inappropriate dealings relating to car dealerships were also exposed by the Royal Commission, including:

(a) Westpac's use of "flex commissions" to allow dealerships to set the rate of interest for a vehicle loan regardless of credit history, and incentivised them to set the highest interest rate possible; and

(b) Esanda's alleged falsification of customer financial information to approve loans and increase interest rates for better commissions.

Add-on insurance products were also promoted to customers regardless of whether it was in a customer's best interests, or in some cases, even where a customer would not be able to make a claim. This behaviour extended beyond vehicle financing to personal loans, affecting more than 20,000 customers.

Some immediate results of the Royal Commission include ANZ's suspension of its vehicle financing arm in March 2018, pending the Royal Commission's final report and its own internal review, as well as CBA's refund to add-on insurance customers for $16,000,000.

Credit Cards

Procedures undertaken by banks to increase a customer's credit card limit also came under fire and made media headlines with CBA's alleged incessant solicitation of a known gambling addict to increase his credit card limit from $10,000 to $27,100 (with further offers to increase the limit) despite the customer's requests for the bank to stop the limit increase. Westpac were also criticised by ASIC as "not even doing the bare minimum" when it ignored requirements to review a customer's employment status when approving increased credit card limits.

Outcomes

We would expect that the Royal Commission will be recommending changes to consumer lending practices for banks. Whilst there is always a risk that the Royal Commission is cherry picking the worst examples of bank behaviour and the situation is not as bad as the Royal Commission and the media would suggest, some of the issues raised do appear to be systemic and in need of rectification. As such we would expect that further regulation will be recommended to improve bank behaviour, the provision and management of consumer lending and bank responsibilities.

Hearing Two - Financial Advice

The second round of hearings took place between 16 April and 27 April 2018, and related to the provision of financial advice to consumers. It was noted that the big four banks and AMP Limited together accounted for almost half of the financial advice market.

Fees Charged

The Royal Commission revealed a great number of instances where fees were charged to customers for financial advice, despite the customer not receiving such advice or where the customer did not have an allocated financial advisor at all (i.e. orphan customers). Evidence revealed that in general, AMP Limited charged client advisor fees for 90 days even after services had ceased, and in one instance, CBA charged monthly fees to a customer for a decade after his death. A common theme throughout the hearings was that institutions lacked the appropriate systems and procedures to review the fees applicable to customers, resulting in a failure to reduce fees where necessary. An alleged result of this was that the profitability of the bank was being protected at the expense of the customer.

Fees charged to customers in relation to investment platforms were also reviewed, with concerns raised in relation to platforms which restricted the movement of assets (which prevented customers from changing platforms, as it would trigger a capital gains tax event) as well as fees which were indexed to funds under management (despite this bearing no relationship to the costs incurred by the platform operator). Further, conflict of interest issues were also raised where a financial service entity provided both financial advice and operated investment platforms.

Inappropriate Financial Advice and Conduct

Staggering statements by an ASIC Commissioner indicated that 75% of financial advice provided by financial advisors from the four major banks and AMP Limited did not demonstrate compliance with their duties as financial advisors. The Credit and Investment Ombudsman also revealed that “inappropriate advice” was the most prevalent concern amongst consumers, constituting 39% of complaints lodged to it, followed closely by “inappropriate fees” constituting 28% of complaints.

The Royal Commission addressed systemic issues contributing to the rate of inappropriate advice, including the:

(a) inadequate vetting and due diligence at the recruitment stage;

(b) policies and procedures being too high-level with little practical guidance;

(c) indifference of staff to policies and controls;

(d) lack of systems of preventative oversight; and

(e) untimely auditing, review and remediation.

There were further instances of alleged dishonest or improper conduct by specific financial advisors in a number of banks, with NAB employees incorrectly witnessing forms and ANZ representatives falsifying documents and misappropriating funds, generally to increase customer lending and investment. This round of hearings infamously resulted in the premature resignation of Craig Meller from AMP (CEO), as well as the resignation of Catherine Brenner (Chairman) and three other directors, after it was discovered that AMP Limited charged customers for financial advice which was never received, and for allegedly misleading ASIC in relation to its misconduct.

Outcomes

This area is clearly an area where further regulation will be expected. The picture painted by the Royal Commission is not a pretty one. One immediate result (or is it a coincidence?) is that some of the major banks have already indicated that they will be exiting certain sectors of the financial advice market. An interesting question is whether the Banking Executive Accountability Regime would have made a significant difference if it were in place earlier. At this stage, we could only hope so as something has to change. We anticipate that increased regulation here would not significantly impact a number of the smaller banks as this is not a sector which accounts for a significant part of their business. However, the unintended consequences of increased regulation is an area that will need to be watched.

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Hearing Three – Loans to SMEs

The third round of hearings took place between 21 May and 1 June 2018, delving into the surrounding framework, as well as the specific conduct of banks, in relation to the provision of financial advice to small and medium enterprises (**SMEs**).

Responsible Lending and Code of Banking Practice	A takeaway from the Royal Commission is that it is not likely to recommend increasing the responsible lending obligations of bankers in relation to SMEs. There was a concern voiced by representatives of SMEs that such additional obligations would further restrict loans to SMEs. This is good news for the small banks and overall seems to be a sensible decision. Currently there is no credit specific legislative protection for SMEs, with the only regulation being the general protections afforded under the Australian Securities and Investments Commission Act 2001 (Cth), and the voluntary application of the Code of Banking Practice (**Code**) published by the Australian Banking Association (**ABA**). Under the Code, the banker is only required to "exercise the care and skill of a diligent and prudent banker" to assess the SME's ability to repay the loan. It is not required to make any assessment of the SME's likelihood of success, which is concerning considering the bearing it would have on the SME's ability to repay. In the three case studies examined by the Royal Commission (ANZ, Westpac and Bank of Queensland), it was found that the primary problem was the failure of the SME in meeting its projections, rather than any misconduct by the banker.
Application of Code of Banking Practice	Another issue explored was how the Code should be applied. Currently, the Code only applies to loans to "small business", which is not comprehensively defined. While ASIC recommended defining a small business as those with total debt of $5,000,000 or less, this has yet to be adopted. The ABA is not in favour of increasing the threshold as it argues that businesses with total debt of $3,000,000 generally have a sophisticated understanding of banking and investment and also have access to commercial and legal advice. Further, a high threshold might create risks for banks (in particular disadvantaging smaller banks), and increasing costs for borrowers. The Code was been updated by the ABA and will commence from 1 July 2019 after it received ASIC approval on 31 July 2018. Significantly, all ABA members will be required to sign up to the new Code, applying to small businesses who borrow up to $3 million, covering most of the small business sector. The new Code improves existing protections from consumers.
Unfair Contract Terms	On 12 November 2016 the unfair contract term provisions contained in the *Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Act 2015* (Cth) were extended to cover standard form small business contracts, including small business loans of up to $1 million. The big four banks have been slow to comply with the unfair contract terms provisions and evidence at the Royal Commission showed that Suncorp was still non-compliant despite the protracted adjustment period. The Royal Commission also criticised ASIC's lack of enforcement action in this regard.

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Quality Assurance

Evidence from ASIC revealed some surprising statistics about the time it takes for misconduct to identified and reported. These included:

(a) 1,552 days to identify action which requires investigation;

(b) 123 days for an investigation to conclude, and a breach report lodged.

This is despite the current requirement in the Corporations Act that misconduct by AFS licensees be reported as soon as possible, but in any event within 10 days of becoming aware of a breach or likely breach. Certain banking institutions have taken steps to ensure that reports are lodged within 18 days of the conclusion of an investigation, whereas ASIC proposes to require a report within 30 days of discovery of the breach, regardless of whether the investigation is complete.

Consistent with the criticism of ASIC mentioned above, the Royal Commission also contrasted ASIC's "consultative approach" to regulation by working with industry participants, to the ACCC's "enforcement mode" of taking action (including court action) to ensure compliance. It remains to be seen whether a recommendation will be made for a more aggressive approach by ASIC.

Outcomes

Overall the third round of hearings had the biggest potential to result in the greatest changes for the smaller banks and be the harbinger for increased regulation. However those fears appear to have subsided and apart from changes to the Code, further regulations appear unlikely. However, it is possible that regulators, particularly ASIC, will adopt a more proactive approach to compliance in the future.

Hearing Four – Remote and Regional Communities

The fourth round of hearings took place between 25 June and 29 June and explored the issues affecting how banking services are provided to Australians in remote and regional communities, and Aboriginal and Torres Strait Islander people.

Farming Finance

Five case studies were heard in relation to the provision of farming finance by ANZ, Rabobank, Bankwest, NAB and Rural Bank. A recurring theme emerged that local financiers were either unable to, or intentionally did not, take into account the nature of agribusiness in their lending practices. For example, local financiers failed to inform customers of hardship relief policies, failed to provide any seasonal funding, applied interest payments at a time incompatible with a farm's working capital cycle, or otherwise failed to take into account factors (such as prolonged weather events, pests, commodity price fluctuations). Moreover, financiers prioritised new sales without adequate loan management, overvalued properties to extend borrowing capacity and commissions, failed to communicate transparently with customers and applied default interest as a way to pressure borrowers to settle with the financier on terms which may not have been favourable to the borrower.

This conduct forced owners of agribusiness being into technical default and they were forced to sell their land in some cases. The lack of flexibility and communication further meant that in some cases, the land was sold at a disadvantageous price. It was left open as to whether ASIC should take a more direct approach in farming finance.

Aboriginal and Torres Strait Islanders

An ANZ case study illustrated the inherent difficulties in the provision of financial services to Aboriginal and Torres Straight Islanders, particularly where they reside in remote areas. One such customer lived 100km away from the nearest branch, and with English being a second language, it took over 4 months with the help of a financial counsellor and a formal complaint, to set up a no-fee bank account (despite the customer being eligible for it). On a related note, issues were raised as to the difficulty of Aboriginal and Torres Strait Islanders in accessing superannuation entitlements, whether due to lack of understanding or administrative issues.

More specific issues arose, particularly in relation to funeral insurance for Aboriginal and Torres Strait Islanders, with a 2014 ASIC survey revealing the incredible profit margin by nine funeral insurers, which collected $315,000,000 in premiums but only paid out $103,000,000 in claims.

Specific examples included Aboriginal Community Funeral Plan (**ACBF**), which marketed itself as a seller of funeral insurance dedicated to the Aboriginal community despite its lack of affiliation to any such Aboriginal related organisation (nor were any of its directors or managers, Aboriginal or of Aboriginal descent). Other questionable conduct included having policies which could result in a plan holder paying more in premiums than they could possibly recover (against ASIC's recommendations) and selling funeral insurance to younger family members with little need of the product, simply to make sales. Statistics show that approximately 50% of ACBF's policy holders were under 20.

Select AFSL's aggressive sales tactics were also explored, with customers pressured to purchase two funeral insurance policies, even in cases where prospective purchaser did not speak English as a first language. This behaviour was found to be systemic, with representatives being trained in such aggressive behaviour, KPIs and incentives being set to prioritise as many sales as possible, and an ineffective quality assurance and disciplinary framework which allowed representatives to make unethical sales without reprimand.

Outcomes

We would expect that there will be further regulations in relation to providing financial and other services (such as funeral insurance) to Aboriginal and Torres Strait Islanders to ensure better outcomes are achieved. We would expect that further regulation for farming finance would be an inappropriate solution and as such, is unlikely. Lenders in the farming finance sector generally appear to need to be more attentive to the specific issues which affect farming finance and the risks involved. The solution here does not, to us, appear to be a regulatory one, but one that is focused on the terms that apply to any farming finance and their flexibility to address external factors such as drought.

We would not generally expect to see any significant changes in relation to smaller banks in this area.

Hearing Five – Superannuation Industry

Round 5 of the Hayne Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry is now complete (6 to 17 August 2018), with the Commission asking a number of serious questions in relation to the cultural, structural and regulatory systems in the superannuation industry.

Trustees and Financial Advisors: Managing Conflict

The Royal Commission explored a number of case studies where the misconduct related to conduct that "benefits financial advisers to the detriment of the members of a superannuation fund", usually in the form of commissions. This included grandfathered commissions, ongoing adviser fees for no service, contribution or plan service fees or otherwise encouraging members to make investment decisions contrary to their interest (e.g delaying the transition from ADAs to MySuper products). This is unsurprising given the conduct exposed by the first and second round of hearings, which revealed similar systemic problems with commission and fee structures for mortgage brokers and providers of financial advice.

This led to questions on whether it would be appropriate to prohibit all commissions and end grandfathering, as well as ongoing service fees. This is also consistent with the recent Productivity Commission Report on Competition in the Australian Financial System, which recommended that trailing commissions be banned by the end of 2018.

A suggestion was also made to investigate whether it is appropriate to extend the obligation to act in the best interest of members (of a superannuation fund) under the Superannuation Industry (Supervision) Act 1993 (Cth) (**SIS Act**) to extend to the shareholders of a superannuation trustee (including in relation to its appointment and removal of directors) and any related bodies corporate of a superannuation trustee. It was also mentioned that a contravention of this obligation could be made into a civil penalty provision to act as a stronger general deterrent.

Advertising and Inducements

The Royal Commission also explored a number of marketing practices of superannuation products in the course of the hearings, including:

- The donation by AustralianSuper to an advertising campaign by Industry Super Australia against certain anticipated changes to the default fund system. While the Commissioner was not invited to find any misconduct or conduct falling short of community standards and expectations, questions were left open as to whether such political advertising could possibly comply with the sole purpose test in section 62 of the **SIS Act** and whether such conduct should be regulated;
- The purchase of approximately $300,000 worth of tickets to sports events by Hostplus, primarily for employers, with the aim of building relationships and inducing those employers to select Hostplus as their default fund. The Counsel assisting noted that such conduct is not currently prohibited by section 68A of the SIS Act, which only prohibits inducements from being given as a *condition* to membership (rather than an inducement). However, the Royal Commission has invited submissions as to whether this prohibition should be widened;
- A case study of ANZ found that it sold its superannuation products through its bank branches, in circumstances where customers might be led to believe that the branch staff were recommending the product (Smart Choice Super) based on their personal circumstances (i.e. personal advice). The Counsel assisting left it open for the Commissioner to find that such conduct fell below community standards and expectations, which is consistent with the Productivity Commission Report, which found that consumers often unduly rely on general advice (including sales and

marketing material) to their detriment. More generally, the Royal Commission asked the question of whether it is *ever* appropriate for superannuation products to be sold through bank branches.

Aboriginal and Torres Strait Islander People

In relation to the provision of superannuation services to Aboriginals and Torres Straight Islanders, the Royal Commission looked at practices by QSuper Board. Many issues which were brought up here were also discussed in the round 4 hearings (Experiences with financial services entities in regional and remote communities), however important questions raised include:

- Whether existing identification procedures used by superannuation funds are appropriate for Aboriginal and Torres Strait Islander members, and whether it should be mandatory to record whether a member is an Aboriginal and Torres Strait Islander member;
- Whether superannuation funds should permit the early release of superannuation on the basis of severe financial hardship;
- Whether the release of superannuation should take into account the lower life expectancy of Aboriginal and Torres Strait Islander people; and
- Whether binding nominations should be broadened to reflect Aboriginal and Torres Strait Islander kinship structures.

Regulatory Framework

The Royal Commission appeared to be quite critical of the lack of enforcement action taken by the industry regulators, the Australian Prudential Regulatory Authority (**APRA**) and the Australian Securities and Investments Commission (**ASIC**). By way of example, it was revealed that APRA has not imposed any enforceable undertaking on a regulated body in the last 10 years, and has never commenced a civil proceeding in relation to section 62 of the SIS Act (sole purpose test). Similarly, an ASIC investigation into the distribution of superannuation products through retail bank branches which began in 2014 took over 4 years to conclude, with enforceable undertakings by CBA and ANZ being entered into in July 2018.

Specifically in relation to APRA, it was noted that the prudential standards were high-level documents, with the purpose of allowing regulated entities to comply with the requirements in their own way, at the cost of making them difficult to enforce. ASIC also came under scrutiny for its preference for using enforceable undertakings, which were criticised as being “likely to encourage conduct that courts contraventions of statute”.

Finally, the closing submissions of counsel assisting made the scathing remark in the closing statement that “it is not clear why so little action has been taken”, noting that the stability preferred by the regulators was “not readily reconciled with being an effective conduct regulator”. In light of this, we would not be surprised if these regulators take on a more aggressive enforcement strategy in the following years akin to that of the Australian Competition and Consumer Commission.

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Hearing Six – Insurance Industry

Round 6 of the Hayne Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry is now complete (10 to 21 September 2018), focusing on life and general insurance products and natural disaster insurance. We set out some fast facts on Round 6 as well as our insights as to its potential impact on regulation in this sector.

In all, the hearings were a disaster for the insurers and painted a picture of systemic problems, and even abuse, in the industry as well as the lack of enforcement by the regulator. Several of the issues uncovered were similar to issues that emerged in earlier hearings.

Remuneration Structures and Conflicts of Interest

Systemic conflicts of interest between sales agents and consumers leading to poor outcomes for consumers have been explored in previous rounds of the Royal Commission, and it was no different for insurance products. Some notable examples include ClearView's attempt to circumvent the 2012 Future of Financial Advice conflicting remuneration reforms by packaging trip incentives to sales staff as a "training/educational trip", as well as the remuneration structure of Freedom Insurance's sales agents, which included uncapped commissions, and high incentives for staff to 'retain' policies and press consumers to remain in unwanted policies.

General Insurance

It was noted that certain monetary benefits are specifically excluded from the conflicted remuneration prohibitions in Part 7.7A of the Corporations Act. There were submissions that this was further exacerbated by 'reverse competition' by general insurance providers, who competed to provide retailers with the best incentives (usually in the form of commissions) to dominate distribution channels.

Insurance Policy Structure and Design

The case studies by the Royal Commission also demonstrated that insurance products were often designed poorly which led to poor consumer outcomes. A look into CommInsure's life insurance policy found that it used outdated medical definitions to deny claims. Similar concerns were raised in relation to general insurance, with outdated or non-standard definitions, highly technical language and narrow interpretation of terms being common reasons for denying claims, as well as poor case management, such as AMP's assumption that policy holders were smokers unless a declaration was signed to the contrary (which is contrary to ASIC's advice) in its life insurance product.

An interesting statistic is that from 2013 to 2015, insurers collected $1.6 billion in premiums for general insurance, and paid out only $144 million in claims. By any definition this should not be an acceptable business practice in this area.

Accidental Death Policies

Concerns were also raised in relation to accidental death insurance policies as a whole, noting high denial rates (primarily where death was not 'solely' due to accident, even if it was partly or predominantly the cause), stating that such a product had "limited benefits for consumers".

Sales and Retention Tactics

Aggressive sales tactics of insurance products such as cold calling and pressure selling were already explored in the round 4 hearings, but was expanded here, with Gregory Martin (Chief Actuary and Risk Officer of ClearView) admitting that sales tactics used by staff were, on occasion, unconscionable. When asked whether outbound sales calls could be both financially viable and legally compliant, he responded "In retrospect I find it difficult to understand how you can reconcile those things." Interestingly, Freedom Insurance sold its life insurance products solely through telemarketing.

Other issues included poor training and record management (frustrating any future dispute resolution process), poor quality assurance programmes and compliance staff often not being sufficiently resourced, trained or independent from the sales team. Submissions in relation to life insurance also raised concerns in relation to the poor advice given to consumers (particularly over the phone) leading to consumers being underinsured.

Special considerations for Mental Health

The Royal Commission also explored the difficulties faced by insured persons for mental health-related issues or other pre-existing conditions, including excessive premiums and exclusions or carve-outs, which possibly had the effect of excluding them entirely from the insurance market.

Claims Handling and Management

The difficulty of insured persons in going through the claims process were brought into focus here, with the TAL case study highlighting difficulties faced by claims in relation to mental illness and taking 3 years to accept the claim, even after the FOS ruled in support of the insured.

Other instances of poor claims management were brought to light, including charging premiums to members even after their death, or where the member was no longer entitled to claim under a policy (e.g. unemployment), echoing the issues raised in the second round of hearings in relation to financial advice.

Natural Disaster Insurance

The Royal Commission looked at case studies from Youi and AAI which demonstrated instances of insurers acting with complete disregard to an insured's needs. Separately, concerns were raised that the excessive premiums charged for flood coverage could potentially lead to a lack of coverage, when such an event occurs in the future.

Policies held via Superannuation Funds

The Royal Commission stated that 70% of life insurance policies are held through superannuation funds. However, concerns were raised as to the efficacy of such an arrangement and specific questions were raised in the REST case study in relation to whether the funds represented the insurer rather than the members.

Regulatory Framework and Approach

Poor compliance culture demonstrated in certain case studies, including Allianz, who identified false and misleading advertisements (through its website) in 2015, but did not remove or report them to ASIC until May 2018 despite receiving legal advice advising them of the issue. It was noted that over 2 million travel insurance policies have been sold during the duration of the misleading or deceptive advertisements, and that the persons involved in the contravention had not faced internal disciplinary action.

ASIC itself was also criticised for its lack of enforcement in this regard, echoing statements made in round 3 of the hearings. In particular, ASIC's decision to issue infringement notices in relation to the misleading and deceptive advertisements by CommInsure and AAI were criticised as being too light. In particular for the AAI case study (which sold natural disaster insurance), the infringement notices totalled $43,200, which was a mere 0.001% of the premiums earned by AAI from the relevant products, which can be seen as an incentive for non-compliance.

Outcomes	If you thought things could not get worse then you were wrong, as the Royal Commission completed its sweep across the financial sector. This is an area, like financial advice, for which further regulation can be expected (with some similar issues being raised). An interesting issue here is the spotlight that has continued to be applied to the regulators, ASIC in this case. The issue with the regulator is not the lack of powers (although query if penalties should be increased further in some cases) but the lack of enforcement such as to act as a real deterrent.

The Royal Commission is inviting public submissions in relation to the policy issues surrounding insurance products, which will close on Thursday, **25 October 2018**. The Royal Commission also revealed its Interim Report on 28 September 2018, and Ash St. will provide its insights on this in a separate article. Ash St. will stay tuned for any further updates in this space and communicate accordingly.

DISCLAIMER: This communication is intended to provide commentary and general information only. It is not intended to be a comprehensive review of all aspects of the matter referred to. It should not be relied upon as legal advice as to specific issues or transactions.

ABOUT THE AUTHOR

smcgushin@ashstreet.com.au

+61 2 8651 8717

SHAUN McGUSHIN | Director, Projects & Finance

Shaun leads the Ash St. Projects & Finance team. He is one of Australia's most experienced advisers on infrastructure and finance, including buying and selling infrastructure assets, public private partnerships, project finance, corporate finance, acquisition finance, capital markets and workouts.

Formerly a partner of both Corrs and Freehills, Shaun has over thirty years' experience advising local and international corporates on a wide range of transactions with particular focus on the infrastructure, power, energy and resources industries. He has a reputation for successfully completing major transactions, no matter how complex, and is sought for his strategic and negotiating skills.