

Royal Commission Series | Banking

AUTHORS | Samantha Carroll, Director, Governance, Compliance and Regulation
Shaun McGushin, Director, Projects and Finance
David Ward, Director, Advisory

RESEARCH | Daniel Gallagher, Para-legal

February 2019

This section of the Report relates to ‘traditional’ banking services, such as lending, deposit taking and the provision of transaction services which came in for a significant amount of attention by the Commission and the media. Consistent with the Interim Report, no wholesale changes to responsible lending practice or lending to small business is considered necessary though there are some specific reforms proposed. Particular attention has been paid to:

- the issues of conflicts and remuneration in respect of mortgage brokers, and this is where the biggest impact of the Recommendations in this category are expected to be felt;
- the access to banking services and the practices of lending to small businesses, particularly in the agricultural sector;
- the expansion of the BEAR and increased clout for the Banking Code.

Summary of Recommendations for Banking

Category	Recommendation	Impact
Consumer lending: Direct lending	Recommendation 1.1 – The NCCP Act The NCCP Act should not be amended to alter the obligation to assess unsuitability.	<ul style="list-style-type: none"> • The status quo remains unchanged. • There was little or no debate regarding the current obligations and their impact on consumers during the Royal Commission. Any issues would be resolved by adherence to the existing law, a common theme for Commissioner Hayne.
Consumer lending: Intermediated home lending	Recommendation 1.2 – Best interests duty The law should be amended to provide that, when acting in connection with home lending, mortgage brokers must act in the best interests of the intending borrower. The obligation should be a civil penalty provision.	<ul style="list-style-type: none"> • This Recommendation is significant and will give effect to what consumers expect from those that are meant to be working on their behalf. • Enshrining this obligation in statute will bring brokers in line with the manner in which other professions such as the financial advisers are treated. • The change will require review of mortgage broking documents, processes and disclosure documents to ensure the ‘best interests’ duty is met and there is adequate evidence held by brokers to establish compliance with the duty.

		<ul style="list-style-type: none"> • Further training will be required to uplift broker’s knowledge and understanding of this duty.
	<p>Recommendation 1.3 – Mortgage broker remuneration</p> <p>The borrower, not the lender, should pay the mortgage broker a fee for acting in connection with home lending.</p> <p>Changes in brokers’ remuneration should be made over a period of two or three years, by first prohibiting lenders from paying trail commission to mortgage brokers in respect of new loans, then prohibiting lenders from paying other commissions to mortgage brokers.</p> <p>Recommendation 1.4 – Establishment of working group</p> <p>A Treasury-led working group should be established to monitor and, if necessary, adjust the remuneration model referred to in Recommendation 1.3, and any fee that lenders should be required to charge to achieve a level playing field, in response to market changes.</p>	<ul style="list-style-type: none"> • This Recommendation, if implemented, will clearly have significant ramifications for brokers and the industry. • Commissioner Hayne noted that as the borrower is looking to the broker for advice, it is a clear conflict for the lender to then pay for their commission, and as a result would clearly influence the outcome of the advice and result in negative outcomes for borrowers. An issue here will be whether the borrower will now want to pay the fee. • In another significant but well-telegraphed move that will significantly impact mortgage brokers, Commissioner Hayne called for the abolition of ‘trail commissions’. The Report notes that this creates a continuing relationship between the lender and broker that would affect the independence of advice among other things.
	<p>Recommendation 1.5 – Mortgage brokers as financial advisers</p> <p>After a sufficient period of transition, mortgage brokers should be subject to and regulated by the law that applies to entities providing financial product advice to retail clients.</p> <p>Recommendation 1.6 – Misconduct by mortgage brokers</p> <p>ACL holders should:</p> <ul style="list-style-type: none"> • be bound by information-sharing and reporting obligations in respect of mortgage brokers similar to those referred to in Recommendations 2.7 and 2.8 for financial advisers; and • take the same steps in response to detecting misconduct of a mortgage broker as those referred to in Recommendation 2.9 for financial advisers 	<ul style="list-style-type: none"> • Consistent with Recommendation 1.2, it is recommended that the legal obligations of brokers properly reflects the position of trust that brokers hold, and treat them in the same manner as financial advisors. • The brokers will need to prepare for such changes and this should clearly impact upon how brokers carry on business in the future.
<p>Consumer lending: Intermediated lending for vehicles and other consumer goods</p>	<p>Recommendation 1.7 – Removal of point-of-sale exemption</p> <p>The exemption of retail dealers from the operation of the NCCP Act should be abolished.</p>	<ul style="list-style-type: none"> • Retail dealers will have to hold an ACL or be appointed a credit representative to broker deals, which would make them subject to the same responsible lending obligations as other brokers. In this case, retail dealers will need to prepare for such changes.

<p>Access to banking services</p>	<p>Recommendation 1.8 – Amending the Banking Code</p> <p>The ABA should amend the Banking Code to provide that:</p> <ul style="list-style-type: none"> • banks will work with customers: <ul style="list-style-type: none"> – who live in remote areas; or – who are not adept in using English, • to identify a suitable way for those customers to access and undertake their banking; • if a customer is having difficulty proving his or her identity, and tells the bank that he or she identifies as an Aboriginal or Torres Strait Islander person, the bank will follow AUSTRAC’s guidance about the identification and verification of persons of Aboriginal or Torres Strait Islander heritage; • without prior express agreement with the customer, banks will not allow informal overdrafts on basic accounts; and • banks will not charge dishonour fees on basic accounts 	<ul style="list-style-type: none"> • Commissioner Hayne noted that although modern society increasingly requires reliance on banking services, there are many who cannot meet the requirements of the banks’ policies, or are unable to even access the services due to language or geographic barriers. • By including such provisions in the Banking Code, the ability to access such services should be greatly increased. The banks will have to adjust their services here to comply, which will come at a cost to them.
<p>Lending to small and medium enterprises</p>	<p>Recommendation 1.9 – No extension of the NCCP Act</p> <p>The NCCP Act should not be amended to extend its operation to lending to small businesses.</p>	<ul style="list-style-type: none"> • There is no significant change to lending to small businesses, and any extension of the NCCP protections would likely inhibit the capability of small businesses to access to reasonably affordable and available credit. • It is considered such an extension is unnecessary due to a number of protecting provisions in the current law, such as misleading or deceptive and unconscionable conduct in relation to financial services, as well as the unfair contract regime.
	<p>Recommendation 1.10 – Definition of ‘small business’</p> <p>The ABA should amend the definition of ‘small business’ in the Banking Code so that the Code applies to any business or group employing fewer than 100 full-time equivalent employees, where the loan applied for is less than \$5 million.</p>	<ul style="list-style-type: none"> • The current three-part test for consideration as a ‘small business’ is considered as overly complicated and restrictive. Commissioner Hayne is of the view that simplifying the definition will clarify the test whilst having minimal change.
	<p>Recommendation 1.11 – Farm debt mediation</p> <p>A national scheme of farm debt mediation should be enacted.</p>	<ul style="list-style-type: none"> • The Commission has paid special attention to lending to the agricultural sector. • There are currently compulsory FDM schemes in the three states on the eastern sea board as well as South Australia. There are inconsistencies between these schemes and clearly the introduction of a national scheme, which would encourage lenders to formulate national

		<p>policies that would enable better operation and coordination of policy across Australia, is a sensible step.</p>
	<p>Recommendation 1.12 – Valuations of land</p> <p>APRA should amend Prudential Standard APS 220 to:</p> <ul style="list-style-type: none"> • require that internal appraisals of the value of land taken or to be taken as security should be independent of loan origination, loan processing and loan decision processes; and • provide for valuation of agricultural land in a manner that will recognise, to the extent possible: <ul style="list-style-type: none"> – the likelihood of external events affecting its realisable value; and – the time that may be taken to realise the land at a reasonable price affecting its realisable value. 	<ul style="list-style-type: none"> • Farmers will no doubt welcome the move to make valuations independent of the lending process. This move will also likely increase the transparency of valuations, although it is another Recommendation banks will need to take steps to implement including review and amendment of valuation processes and related credit policies.
	<p>Recommendation 1.13 – Charging default interest</p> <p>The ABA should amend the Banking Code to provide that, while a declaration remains in force, banks will not charge default interest on loans secured by agricultural land in an area declared to be affected by drought or other natural disaster.</p> <p>Recommendation 1.14 – Distressed agricultural loans</p> <p>When dealing with distressed agricultural loans, banks should:</p> <ul style="list-style-type: none"> • ensure that those loans are managed by experienced agricultural bankers; • offer farm debt mediation as soon as a loan is classified as distressed; • manage every distressed loan on the footing that working out will be the best outcome for bank and borrower, and enforcement the worst; • recognise that appointment of receivers or any other form of external administrator is a remedy of last resort; and • cease charging default interest when there is no realistic prospect of recovering the amount charged. 	<ul style="list-style-type: none"> • In the event that farm loans become distressed there are a number of complex issues to work through. This is exacerbated by the fact that agricultural enterprises face unique circumstances. This move will go a ways toward aiding the sector. • This move is given teeth by the proposal to make the Code enforceable. • The early referral of a challenged farm loan should increase the opportunity for a fair and equitable outcome for both the lender and the borrower. • There is little doubt that borrowers in the agricultural sector will support the abolition of this practice, as well as the Recommendation generally. • Banks will need to take steps to implement the Recommendation including reviewing available resources to ensure agricultural loans are managed by appropriately experienced bankers and review and amendment of collection/enforcement processes for agricultural loans to align with the Recommendation.
<p>Enforceability of industry codes</p>	<p>Recommendation 1.15 – Enforceable code provisions</p> <p>The law should be amended to provide:</p> <ul style="list-style-type: none"> • that ASIC’s power to approve codes of conduct extends to codes relating to all APRA-regulated institutions and ACL holders; 	<ul style="list-style-type: none"> • Keeping in line with the theme of increased accountability in the Report and the need to make Codes enforceable, Commissioner Hayne notes the limitations of industry codes, including their

- that industry codes of conduct approved by ASIC may include ‘enforceable code provisions’, which are provisions in respect of which a contravention will constitute a breach of the law;
- that ASIC may take into consideration whether particular provisions of an industry code of conduct have been designated as ‘enforceable code provisions’ in determining whether to approve a code;
- for remedies, modelled on those now set out in Part VI of the Competition and Consumer Act, for breach of an ‘enforceable code provision’; and
- for the establishment and imposition of mandatory financial services industry codes.

Recommendation 1.16 – 2019 Banking Code

In respect of the Banking Code that ASIC approved in 2018, the ABA and ASIC should take all necessary steps to have the provisions that govern the terms of the contract made or to be made between the bank and the customer or guarantor designated as ‘enforceable code provisions’.

limited reach, the noncompulsory adherence to them, and the lack of proper recourse where there is a breach.

- By creating mandatory codes that include penalties that are enforceable by law, the Recommendation seeks to provide for a more meaningful and effective system of governance, particularly as it pertains to customers and guarantors.

Processing and administrative errors

Recommendation 1.17 – BEAR product responsibility

After appropriate consultation, APRA should determine for the purposes of section 37BA(2)(b) of the Banking Act, a responsibility, within each ADI subject to the BEAR, for all steps in the design, delivery and maintenance of all products offered to customers by the ADI and any necessary remediation of customers in respect of any of those products.

- BEAR is proposed to be given greater reach.
- Following evidence of pervasive processing and administrative errors that were not systemically addressed by banks, it is recommended that there be a single responsible person to ensure that the institutions take greater care in their systems to ensure they deliver the products promised and charge what they are entitled to.
- Linking this responsibility to the BEAR will improve the manner in which these products work, and ensure a greater level of accountability. Lenders will need to take steps here to implement this effectively.
- The change will trigger a need to review and update Accountability Maps and Statements.

What can you do now to prepare?

Banks and mortgage brokers clearly have work to do to prepare for the implementation of the Recommendations as mentioned above; however, there have been no fundamental changes recommended to the NCCP provisions (save for in the mortgage broking industry, which is likely to be wound back in any case based on the current Government's response and strong lobbying from industry) and a number of the Recommendations should not result in significant additional costs. The clear message is for banks to apply the law as it stands. The extension of the BEAR regime to cover product design, delivery and maintenance, as well as making key provisions of the Banking Code should go a long way to achieving this outcome.

Closing Comments

The Recommendations made by Commissioner Hayne ultimately seek to remedy the power disparity apparent in the current system. For the traditional banking services, there was nothing in the Report that was unexpected following the hearings. The introduction of statutory duties and changes to remuneration structures for mortgage brokers will be undoubtedly irksome for many in the industry, however this is an important move to ensure that it is the borrower's interests that are being served, which will ultimately strengthen the integrity of the mortgage system overall. Further to this, consumers and banks alike will benefit from greater access to services by the ATSI community and those in remote areas. Many would also be happy that small businesses have also been afforded greater protections, particularly in the agricultural sector. However, it is important to note that the Recommendations did not include adherence to a consumer lending law for small business lenders, which would likely unduly inhibit the ability for small businesses to access credit. Instead small business lending has remained unchanged.

Ash St. Legal and Advisory

Ash St. Legal & Advisory provide fully integrated and independent expert advice that delivers robust, high quality business solutions quickly and at high value. Strong legal backgrounds combine with other professions including corporate finance, tax, human resources, strategy and management consulting and organisational design to challenge traditional thinking without the cognitive bias that may exist in any one professional discipline.

We view the Royal Commission recommendations as an opportunity for industries to strengthen their compliance frameworks and apply independent practices to their respective businesses.

Call Ash St. today on + 61 2 8651 8700 to help you interpret the Recommendations and formulate effective solutions for your organisation.

LEGAL SERVICES



PETER SHAW
Corporate, M&A
 Director - MBA BSc LLB
pshaw@ashstreet.com.au
 +61 2 8651 8706



SHAUN MCGUSHIN
Projects & Finance
 Director - MBA BSc LLB
smcgushin@ashstreet.com.au
 +61 2 8651 8717



SAMANTHA CARROLL
Governance, Compliance & Regulation
 Director - LLB
scarroll@ashstreet.com.au
 +61 438 323 584



JANNA PARFENOVA
Corporate, M&A
 Associate Director - LLM LLB
jparfenova@ashstreet.com.au
 +61 2 8651 8708



KATRECIA MARCH
Corporate, M&A & Governance
 Special Counsel - LLM LLB
kmarch@ashstreet.com.au
 +61 2 8651 8709



CHRIS BARTON
Employment Associate
cbarton@ashstreet.com.au
 +61 2 8651 8700



ANDREW CALVIN
IT, IP & Real Property
 Associate Director - LLM LLB
acalvin@ashstreet.com.au
 +61 2 8651 8712



DANNY SANKEY
Associate
dsankey@ashstreet.com.au
 +61 2 8651 8700

ADVISORY SERVICES



DAVID WARD
 Director - MBA BSc
dward@ashstreet.com.au
 +61 2 8651 8704

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.