Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

Commonwealth Bank of Australia

INTERIM REPORT SUBMISSIONS

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1. INTRODUCTION

1. Commonwealth Bank of Australia (**CBA**)[1] and its associated Australian entities (the **Group**) provides the following submission in relation to the policy questions identified in Chapter 10 of the Interim Report (**IR**) of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (**Royal Commission**). Chapter 10 of the IR identifies the issues that have emerged in each round of the Royal Commission hearings (sections 1 to 5), including separate sections dealing with regulation and the regulators (section 6), causes of misconduct attributable to financial services entities (section 7) and concludes by restating the issues (section 8). This submission responds to the questions raised in each of sections 1 to 8 in the structure set out in the IR.

2. The Royal Commission has brought to light circumstances where the Group's conduct has led to poor customer outcomes. It has identified examples of misconduct and conduct which fell below the standards expected of the Group by the community. The Group recognises that this behaviour is unacceptable and acknowledges the impact of it. The Group also recognises that the community expects more than contrition out of the Royal Commission process. The community wants to understand the causes of the misconduct and what is being done to address the identified failings to ensure that the misconduct does not continue to occur. In this submission we have endeavoured to provide the Group's answer to those important questions.

3. For the Group, the assessment of why things went wrong and the plan to fix them started before the Royal Commission process. On 28 August 2017, the Australian Prudential Regulation Authority (**APRA**) announced it would establish a Prudential Inquiry into the Group (**APRA Inquiry**) following a number of incidents in recent years that damaged the Group's reputation and public standing. The purpose of the APRA Inquiry was to examine the frameworks and practices in relation to governance, culture and accountability within the Group that contributed to those incidents. Similar to the approach taken by the Royal Commission, the APRA Inquiry examined those issues through the framework of identified case studies. The APRA Panel issued its report on 30 April 2018 (**APRA Report**) and identified a number of significant shortcomings. The Group recognises and accepts the conclusions reached in the APRA Report.

4. In the Group's view, the causes of the conduct identified by the Royal Commission are consistent with the observations made in the APRA Report, which concluded that *'a complex interplay of organisational and cultural factors has been at work'* spanning accountability, governance, systems, remuneration and leadership.

5. However, the Royal Commission has examined further case studies and has identified further matters for careful consideration.

6. The Group considers that most of the misconduct which has been identified (including the conduct examined by the Royal Commission) raises questions about competency and complacency. When people or processes failed, there were neither the systems nor processes in place to identify and fix the problems, nor a sufficient sense of urgency to identify the root cause and take steps to prevent similar issues arising again. However the Group also considers that while there are some exceptions, there have not been active choices to disadvantage customers, but a focus on profit and profitability has driven prioritisation and decisions that have had that effect. The Group had for a number of years concentrated on improving overall customer satisfaction, which obscured and distracted it from focussing on customer dissatisfaction, which would have alerted it to many of these issues sooner.

7. The Group has started to make significant changes to address the issues identified by the Royal Commission and the APRA Inquiry, particularly around systems, processes and culture, as outlined throughout these submissions. The magnitude of the issues which require rectification means that this is a multi-year process. The Group understands how important it is to make sure those changes comprehensively fix what went wrong and prevent it from re-occurring so that the Group can, through its actions over time, re-build the trust of customers, regulators and the Australian community.

[1] In this submission, a reference to CBA includes Bankwest, unless otherwise specified.

2. CONSUMER LENDING

What duties does an intermediary owe to a borrower? (IR Vol 1, pg 328)

8. A mortgage broker must either be an Australian Credit Licence (**ACL**) holder in its own right or a credit representative of an ACL holder. Accordingly, mortgage brokers have the following specific obligations that amount to duties to the consumers with whom they deal:

   (a) **Duty to act efficiently, honestly and fairly -** A mortgage broker has a duty to do all things necessary to ensure that the credit activities authorised by the licence are engaged in efficiently, honestly and fairly (section 47(1)(a) of the *National Consumer Credit Protection Act* 2009 (Cth) (**NCCP Act**));

   (b) **Unsuitability assessment -** Before a mortgage broker can suggest a consumer apply for a particular credit contract or assist a consumer to do so, they must make reasonable inquiries about the consumer's requirements and objectives in relation to the credit contract and make reasonable inquiries about, and take reasonable steps to verify, the consumer's financial situation. They are also required to make a preliminary assessment as to whether the credit contract will be unsuitable for the consumer, namely whether it is likely that the consumer will be unable to comply with the financial obligations under the contract, or could only comply with substantial hardship, or the contract will not meet the consumer's requirements or objectives. Mortgage brokers must not suggest a contract that would be unsuitable (sections 115 to 118 of the NCCP Act);

   (c) **Not disadvantaged by conflict -** A mortgage broker must have in place adequate arrangements to ensure that clients of the licensee are not disadvantaged by any conflict of interest that may arise wholly or partly in relation to the credit activities engaged in by the ACL holder and its representatives (section 47(1)(b) of the NCCP Act);

   (d) **Due care and skill and fitness for purpose -** where the mortgage broker has a contract with the consumer there is an implied warranty that their services will be provided with due care and skill.[2] It is also likely in certain circumstances there is an implied warranty that the mortgage broker's services will be reasonably fit for the particular purpose for which they were required and are of such a nature and quality that they might reasonably be expected to achieve the result the consumer desires.[3] If the mortgage broker has undertaken the unsuitability assessment this may amount to a warranty to the effect that the mortgage broker's services are of such a nature and quality that they might reasonably be expected to result in a contract that is not unsuitable.

9. Introducers operating within the narrow confines of the referrer exemptions do not owe any legislative duty to prospective borrowers. Where the introducer does not rely upon any of the referrer exemptions, the introducer should either be an ACL holder or a credit representative of an ACL holder and specific obligations under the NCCP Act will be imposed upon the introducer.

What duties should an intermediary owe to a borrower? (IR Vol 1, pg 328)

10. The Group continues to support steps to improve standards and client outcomes in the mortgage broking industry. The Retail Banking Services business unit of CBA (**RBS**) has taken action to introduce new, and improve existing, accreditation standards and heighten monitoring and oversight of Head Groups, as well as through its participation in the Combined Industry Forum (**CIF**). Bankwest is in the process of considering similar changes. However, competition and other constraints limit the extent of changes that can be effected through the CIF.

11. Consistent with the position put by its then CEO to the Sedgwick Review, the Group supports the extension of elements of the Future of Financial Advice reforms of 2013 (**FOFA**) to mortgages (letter dated 10 February 2017[4]) and is of the view that standards and client outcomes in the

[2] Section 12ED(1)(a) of the Australian Securities and Investments Commission Act 2001 (**ASIC Act**)
[3] Section 12ED(2) of the ASIC Act
[4] CBA.0001.0038.0929, Exh bit 1.37

mortgage broking industry may be improved with the introduction of an appropriately considered duty. The Group makes the following additional observations:

(a) The Group accepts there is scope to introduce an obligation on mortgage brokers to give priority to the client's interests in similar terms to section 961J of the *Corporations Act 2001 (Cth)* (**Corporations Act**);

(b) The Group also accepts that, because mortgage brokers position themselves as having knowledge of a broad suite of products from multiple lenders and are able to recommend and negotiate the appropriate product for the client,[5] it is also appropriate to introduce a best interests obligation on mortgage brokers that goes beyond the current obligation to undertake an "unsuitability" assessment. The Group submits that this obligation should require mortgage brokers to make recommendations that are appropriate for the client having regard to the best interests of the client, in light of the product set brokers have available to them;

(c) In developing additional obligations, consideration will need to be given to the product set that mortgage brokers have available to them and the range of features and outcomes that are available to a client. These will not be limited to price, but include, for example, service and product features, to ensure that any duty appropriately defined is fit for its purpose.

12. It may also be appropriate for there to be disclosure obligations imposed in relation to existing and further duties that are introduced (see submissions below at paragraph [32]). The introduction of additional duties will require legislation to be effective.

13. While mortgage brokers are regarded by borrowers as their agents and provide choice of product across multiple lenders, this is to be contrasted with lenders who are limited to supplying their own products. Lenders are not customers' agents nor regarded by customers as their agents and it would not be appropriate to extend the same duties to them.

14. There are also differences between credit assistance that is provided by mortgage brokers in respect of credit contracts regulated by the NCCP Act and personal advice given by financial advisers in respect of financial products regulated by the Corporations Act. These differences include:

(a) at a basic level, a financial adviser provides advice about how to invest a client's own funds and future funds (which exposes the client's funds to risk), whereas a mortgage broker provides a service which may result in a bank lending its funds (which exposes the bank's funds to risk);

(b) the level of skill required by a financial adviser is likely to involve a judgment of the ways in which a client's needs and objectives can be met having regard to a range of advice strategies. In contrast, a mortgage broker's services involve assessments that are more objective in nature with a more limited range of credit products that are able to meet the consumer's requirements and objectives. Accordingly, financial advisers require a significantly broader level of expertise and skill than mortgage brokers; and

(c) lenders have a broad commercial interest in ensuring their borrowers are able to meet their financial commitments under their credit contracts. In that sense it is consistent with a borrower's interest in being able to meet their loan repayments. This is reflected in the fact that after the mortgage broker has made their recommendation, the lender undertakes its own credit assessment and, as required by the NCCP Act, its own unsuitability assessment.

15. The differences between the role of a mortgage broker and a financial adviser mean that caution should be exercised in considering whether the same formulation of obligations imposed on financial advisers under the Corporations Act should be imposed on mortgage brokers under the NCCP Act.

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[5] See examples at paragraphs 153 and 154 of CBA's Submissions on Round 1 dated 3 April 2018.

16. Finally, the Group considers that the limited scope of the activities that fall within the referrer exemptions do not warrant any specific duties being imposed upon introducers.

For whom do mortgage brokers and introducers act? For whom should a mortgage broker and introducer act? *(This question is raised in the IR at "Section 8.1.2 Intermediaries" (Vol 1 pg 343). However, for convenience, the Group has answered this question for mortgage brokers and introducers in the context of Consumer Lending).*

17. The Group agrees with the Commissioner's conclusion that dealing with the issue of for whom mortgage brokers act by reference to agency alone is too narrow a question and submits that the relevant issues are what duties and liabilities mortgage brokers and introducers have and should have. The Group has at paragraphs [8] to [16], outlined the duties that mortgage brokers and introducers have and should have.

Who is responsible for a mortgage broker's default? Who should be responsible? *(This question is raised in the IR at "Section 8.1.2 Intermediaries" (Vol 1, pg 343). However, for convenience, the Group has answered this question for mortgage brokers and Introducers in the context of Consumer Lending).*

18. Currently mortgage brokers and lenders have separate responsible lending obligations. Mortgage brokers are responsible for their own defaults and lenders are responsible for their own defaults. Accordingly, it is possible that both a mortgage broker and a lender may have liability in relation to the same loan.[6] The Group submits this position is appropriate.

How should mortgage brokers be remunerated? *(This question is raised in the IR at "Section 8.1.2 Intermediaries" (Vol 1, pg 343). However, for convenience, the Group has answered this question for mortgage brokers and introducers in the context of Consumer Lending).*

19. When considering appropriate remuneration structures for intermediaries (including mortgage brokers), remuneration should be structured in a way that avoids clients being sold the wrong product, or being sold a product that is not needed (including too much of a particular product).

20. The Group therefore acknowledges that, as concluded by ASIC in its Report 516 in March 2017 and as submitted by the Group's then CEO to the Sedgwick Review, the use of upfront and trailing commissions linked to loan size for third parties can potentially lead to poor customer outcomes. Being a participant in the CIF, the Group is committed to implementing reforms to improve customer outcomes. One such reform is that broker commissions should relate to funds drawn down and utilised (net of offset account balances) rather than the size of the loan. Bankwest changed its practice in relation to utilised funds in July 2018[7] and RBS is working to implement similar changes by 31 December 2018 (in line with the CIF recommended timeline).

21. The Group considers that legislation would be required to change the current market commission structures beyond those that have been proposed through the CIF and that any such change should occur after industry consultation. This would ensure that any outcome achieves the proper balance of eliminating conflicts of interest that lead to potentially poor client outcomes and ensuring that existing and future participants can still be financially viable. The first mover issue identified in the Group's evidence is a genuine commercial impediment to changing the structure of mortgage broker remuneration in the market. The likely impact of unilateral action would be for mortgage brokers to favour current commission structures and redirect clients to lenders who maintain current commissions. This may result in clients being redirected to less suitable loans that retain the current commission structures.

22. The Group recognises that Aussie Home Loans, as a standalone mortgage broker business, has a different view about the appropriate way to remunerate mortgage brokers. In this regard we refer to paragraphs 1 to 22 of its submissions in relation to the policy questions arising out of the Round 1 hearings. They also do not support the extension of FOFA obligations to mortgage brokers.

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[6] This has in fact already happened. See the ANZ car finance responsible lending matter where licence conditions and bans were imposed on the relevant brokers and a penalty was awarded against the lender. https://asic.gov.au/about-asic/news-centre/find-a-media-release/2018-releases/18-057mr-court-finds-anz-breached-responsible-lending-laws-in-its-former-esanda-car-finance-business/

[7] Witness statement of Sinead Taylor in response to Rubric 1-6 dated 13 August 2018 [CBA.9000.0105.1000].

How can entities' systems be improved to detect and prevent breaches of responsible lending obligations by intermediaries? (IR Vol 1, pg 328)

23. As technology improves and the range of information available to lenders improves through legislative reforms such as mandatory comprehensive credit reporting and open banking, lenders' ability to detect and prevent breaches of the responsible lending obligations by intermediaries will improve. For example, the combination of enhanced technology and open banking will result in lenders having access to more accurate information about a customer's income, thereby giving lenders an improved capacity to detect and prevent pay slip fraud. In addition, in 2018, review processes for aggregators were also improved to include compliance certificates which cover compliance obligations, legislation and internal policies, responsible lending obligations and broader NCCP Act requirements.[8]

Are "introducer" programs compatible with responsible lending obligations? (IR Vol 1, pg 328)

24. Yes. The referrer exemption specifically limits the activities which introducers who rely upon the exemption are able to undertake[9] and lenders who receive an introduction must, in any event, prior to entering into all credit contracts, conduct their own unsuitability assessment as part of their responsible lending obligations under the NCCP Act. The introducer has no involvement in the credit application or assessment processes. Where the introducer is an ACL holder or a credit representative of an ACL holder, in addition, specific obligations under the NCCP Act will be imposed upon the introducer.

Do broker contracts, as they stood at the time of the hearings, meet the statutory requirement imposed by Section 912A of the *Corporations Act* 2001 (Cth) to have arrangements in place to manage conflicts of interests? Do broker contracts, as now made, meet those requirements? (IR Vol 1, pg 328)

25. The Group answers this question, as it did in its round 1 submissions, by reference to section 47(1)(b) of the NCCP Act.[10] The Group maintains its previous submissions that section 47(1)(b), in so far as it applies to the Group, does not apply to mortgage broker activities, as there is no relevant conflict of interest that arises in relation to credit activities engaged in by the Group or its representatives.

26. However, on the basis put in the IR that any conflict a mortgage broker has arises "in relation to" the Group's activities of providing credit because the Group sets the terms on which a mortgage broker may submit a borrower's home loan application to the Group, the Group submits that its broker contracts at the time of the hearing met the statutory requirements imposed by section 47(1)(b). Any obligation that the Group had in its contracts to reflect "adequate arrangements" must be viewed in light of the fact that it is the mortgage broker's conflict and the mortgage broker itself was required to have in place such arrangements. The Group's contracts with Head Groups as they stood at the time of the hearing required the Head Group to comply with the law. This means that each Head Group had an additional contractual obligation to the Group to meet its own obligations under section 47(1)(b) of the NCCP Act. The Group submits that this meets the Group's own obligation under section 47(1)(b) if such obligation, in fact, existed.

27. Since the round 1 hearing, RBS has updated and improved the mortgage broker code of conduct which applies to mortgage brokers recommending CBA branded home loans, effective since around 16 April 2018, to:

    (a) enhance the obligation on mortgage brokers to ensure that clients are informed of and understand the nature of any conflict of interest, and that clients are not disadvantaged by any conflict of interest (clause 20);

[8] Third witness statement of Daniel Huggins in response to Rubric 1-2 dated 26 July 2018 [CBA.9001.0002.0001] at paragraph [74].
[9] See National Consumer Credit Protection Regulations 25(2), (2A) and (5)
[10] See paragraphs 13-18 of the Group's submissions on Round 1. See also the IR Vol 2 pp 27-30 which are based on the premise that the relevant obligation is section 47(1)(b) of the NCCP Act.

(b) enhance the obligation on mortgage brokers to ensure that clients are fully informed and aware of the commissions and benefits that the mortgage broker may receive, including the amount or rate of any commission or benefit (clause 21); and

(c) impose a new obligation on mortgage brokers to maintain an adequate level of skills and knowledge to ensure that the mortgage broker achieves good client outcomes (clause 32).

What should be disclosed to borrowers about an intermediary's obligations to the lender and to the borrower? What should be disclosed to borrowers about an intermediary's remuneration? (IR Vol 1, pg 328 - 329)

28. There are two relevant disclosure obligations in relation to the mortgage broker-lender relationship, both of which relate to remuneration. The first is the lender's disclosure obligation to the borrower. The second is the mortgage broker's disclosure obligation to the borrower.

29. Section 17(14) of the National Credit Code (**NCC**) provides that if a commission is to be paid by or to the credit provider for the introduction of credit business, the contract between the credit provider and the borrower must contain certain information, but it has never required disclosure of how the commission is calculated unless the amount is ascertainable.

30. In addition, mortgage brokers are required to make detailed disclosures as to the nature and amount of commission they are likely to earn from a lender, based upon assumptions so that the amount of commission is ascertainable, prior to a borrower making a decision as to whether to enter into a credit contract suggested by the mortgage broker.[11] Prospective borrowers are given prior comprehensive disclosures of the nature of remuneration arrangements in place between the mortgage broker and the lender.

31. Notwithstanding that the Group's legislative disclosure obligations are limited as set out in paragraph [29], the Group has made, or is in the process of making, changes to its disclosures in relation to mortgage brokers. These changes are:

(a) In September 2018, it amended the consumer credit loan schedule for CBA branded loans (that formed part of the loan documentation given to the client) to include the maximum rate, or range, of any commission paid or payment made to a mortgage broker Head Group. Similar changes are expected to be made for Bankwest branded loans;[12]

(b) RBS also updated its credit assessment summary[13] to state that:[14]

(i) mortgage brokers receive a commission payment including an upfront component and a trailing commission and how details of specific payments can be obtained; and

(ii) the payment of a commission which is linked to the size and repayment profile of the loan introduces a conflict of interest for the mortgage broker.

32. The disclosure issues relating to the mortgage broker / lender relationship are therefore:

(a) *Should there be a specific legislative requirement for lenders and mortgage brokers to disclose remuneration arrangements that exist between mortgage brokers and lenders?* The Group submits that the NCC should be amended to require lenders to specify the maximum rate or range of any commissions potentially payable to a mortgage broker Head Group but that specific details of the commissions continue to be a disclosure obligation of the mortgage broker. The Group is not privy to contractual arrangements between mortgage brokers and mortgage broker Head Groups that would be required to be known in order to make disclosures about the commissions mortgage brokers receive from Head Groups. The

[11] NCCP Act, ss 113 and 121; and National Consumer Credit Protection Regulation 2010 26A (3), 27(2) and 28G(2).
[12] This was foreshadowed at paragraph [69(a)] of the third witness statement of Daniel Huggins in response to Rubric 1-2 dated 26 July 2018 [CBA.9001.0002.0001].
[13] Bankwest's application form discloses that a commission or other benefit may be payable to a broker or other intermediary who provides services to the customer and that it is possible that a conflict of interest will arise.
[14] See paragraphs [69(b)] and [71] of the third witness statement of Daniel Huggins in response to Rubric 1-2 dated 26 July 2018 [CBA.9001.0002.0001].

Group does not believe that this would be of any additional benefit to customers as the disclosures would already have been provided by mortgage brokers to borrowers prior to lenders approving the loan or advancing funds;

(b) *Should there be any other disclosures concerning the relationship between a mortgage broker and a lender?* It may be appropriate for mortgage brokers to disclose to borrowers the nature of any specific further duties that are introduced but that will depend upon the nature of any such duties.

What steps, consistent with responsible lending obligations, should a lender take to verify a borrower's expenses? Do the processes used by lenders, at the time of the hearings, to verify borrowers' expenses meet the requirements of the NCCP Act? Do the processes now used meet those requirements? Should the HEM continue to be used as a benchmark for borrowers' living expenses? (IR Vol 1, pg 329)

33. When it is recognised that the Household Expenditure Measure (**HEM**) can be used with a level of granularity that reflects a particular consumer's circumstances and represents a reasonable reflection of the variable expenses on which a person is able to live without substantial hardship, the Group submits that the use of HEM in the verification and assessment process is permitted under the legislation and is appropriate to effect the policy objectives that underlie the legislation.

34. The obligation to take reasonable steps to verify a consumer's financial situation is part of a process culminating in the lender making an informed assessment as to whether the consumer will be able to comply with the consumer's financial obligations under the contract without substantial hardship based on their circumstances at the time the loan is made.[15] The underlying policy objective is to ensure that borrowers do not enter into loan contracts whose obligations cannot be met without substantial hardship.

35. The common indication of a loan which is unsuitable on this basis is one which has fallen into significant arrears or hardship.[16] A credit contract may fall into arrears for unrelated reasons such as the borrower becoming ill or a family breakdown, and not because they were not able to meet the financial obligations at the time the contract was made. Accordingly, only a subset of contracts that fall into substantial arrears will have been an unsuitable credit contract. Notwithstanding the low interest rates over the past 3 years, if the Group had entered into a significant number of credit contracts which were unsuitable because the borrower was unable to meet the obligations without substantial hardship, it would be expected that there would be a high level of defaulting loans. However, over the past 3 years the arrears on the Group's regulated loan portfolio have been at a low level.[17] This suggests that there is no significant issue of the Group entering into credit loan contracts which were unsuitable because the borrower was unable to meet the obligations without substantial hardship.

36. The financial obligations assessment mandated by the legislation is that the contract will be unsuitable if it is likely that the consumer will be "*unable to comply with the consumer's obligations under the contract, or could only comply with* *__substantial hardship__*" (emphasis added). The approach of assessing actual income, comparing it with actual expenses and determining whether there is a surplus after deducting proposed loan repayments will demonstrate that, provided circumstances do not change, a consumer is likely to be able to afford the loan repayments without reducing current expenditure. In other words, the consumer must be able to meet the loan

[15] "*Similarly, 'reasonable' inquiries about, and 'reasonable' steps to verify, the consumer's financial situation must be such inquiries and steps as will be sufficient to enable the credit assistance provider to make an informed assessment as to whether the consumer will be able to comply with the consumer's financial obligations under the contract without substantial hardship* " *Australian Securities and Investments Commission v Cash Store Pty Ltd (in liquidation)* [2014] FCA 926 at [28].

[16] Regulatory findings in relation to breaches of the financial obligations aspect of the responsible lending provisions have focussed on loans that have fallen into arrears or hardship. For examples, see Enforceable Undertaking 029533337 offered by Nimble Australia Pty Ltd (18 March 2016), Enforceable Undertaking 029804328 offered by BMW Australia Finance Limited (2 December 2016), Enforceable Undertaking 029490310 offered by Affordable Car Loan Pty Ltd and others (23 May 2017), Enforceable Undertaking 030133417 offered by Thorn Australia Pty Ltd (23 January 2018) and Enforceable Undertaking 030219306 offered by Future Holiday Finance Pty Ltd (FHF) (30 August 2018) and; FOS guidelines on respons ble lending disputes http://www.fos.org.au/custom/files/docs/fos-approach-to-responsible-lending-assessing-consumer-loss.pdf .

[17] The 90 Day + arrears for home loans ranged from 0.52% to 0.70%, for credit cards from 1.03% to 1.05% and for personal loans from 1.34% to 1.44%.

repayments without substantial hardship because it is unlikely the consumer will have to reduce expenses at all.

37. However, it does not follow that simply because the consumer will be unable to meet the loan obligations if actual current expenditure is to be maintained, the consumer can only comply with substantial hardship. This will depend on the extent to which reducing current expenditure gives rise to "substantial hardship". This, in the Group's submission, turns not upon the total amount of a consumer's expenses but the nature of the expenses. If the stated expenses involve significant fixed expenses (such as liabilities to financial institutions) there is a real possibility that they cannot be reduced without substantial hardship. Conversely, if the expenses involve discretionary "lifestyle" expenses, such as overseas holidays, it seems clear that they can be reduced without substantial hardship.

38. Accordingly, the primary issue is the nature of a consumer's existing expenses, rather than their quantum. An approach that involves specific inquiries and, where reasonable to do so, verification of fixed non-discretionary expenses (such as on-going liabilities to financial institutions) and a generic approach to variable living expenses (such as food and clothing) is appropriate.

39. HEM is an index that utilises expenditure data taken from the Bureau of Statistics' Household Expenditure Survey (**HES**). HEM is updated following each new HES and on a regular basis so it is kept in line with general changes to the costs of living.

40. Expenditure is characterised for the purposes of HEM as follows:

    (a) Absolute Basic. This includes food, children's and infant's clothing, health, transportation and telecommunication;

    (b) Basic Discretionary. This includes restaurant meals, alcohol and tobacco, insurance services and adult clothing and recreation, including domestic holidays;

    (c) Non-Basic. This includes household services (such as domestic cleaning and gardening services, overseas holiday travel and accommodation and luxury items (for example, jewellery));

    (d) Not Included. This category includes rent and loan facilities.

41. As the IR indicates HEM uses the median (or the 50th percentile figure) for the total of Absolute Basic expenses and the 25th percentile for the total of Basic Discretionary. These components are calculated separately for each family type (for example separate calculations are made for a single person and a couple). In addition, there are the following different dimensions of HEM which, when selected by the lenders, will impact the benchmark figure to be used:

    (a) Income level. Currently this involves 17 different income brackets ranging from less than $24,009 to $240,085 or greater;

    (b) Geographical location. This involves different locations within Australia which take into account the different costs bases that apply in each of these locations; and

    (c) Family types, in respect of which lenders can adopt slight variations with regard to treatment of dependents.

42. In this way, the selection of dimensions provides lenders a more nuanced application of HEM and a more precise way of understanding the likely expenses needed to avoid substantial hardship for consumers in different, specific circumstances.

43. As indicated above, if an expense is a "luxury" discretionary expense, it is one a consumer can forego without substantial hardship. Accordingly, it should not be taken into account for the purposes of the unsuitability assessment. It follows that the exclusion of Non-Basic expenses from HEM is not relevant to the issue of whether HEM is an appropriate measure in relation to the unsuitability assessment.

44. Further, the nature of some expenses shown on account statements, such as cash, can be difficult to determine and consumers' declarations of their expenses can be unreliable. Accordingly, HEM, which is based upon actual data for specific categories of expenses, may in some circumstances, be a more accurate assessment of the level of the variable expenses required by a consumer for living without substantial hardship than either a consumer declaration or an account statement.

45. In light of these matters, the following conclusions can be drawn:

    (a) HEM can be used with a reasonable degree of granularity and tailoring to reflect the circumstances of the particular consumer in respect of which the unsuitability assessment is being made;

    (b) It is appropriate, in the context of the unsuitability assessment, for Non-Basic expenses not to be included in HEM;

    (c) HEM is not, and does not purport to be, an index that covers all relevant expenses. It is, in substance an index of variable living expenses. Fixed expenses particular to an individual are specifically excluded;

    (d) As HEM reflects the HES figures of actual variable living expenses incurred, regularly updated to take into account changes to the general costs of living, it follows that it represents a realistic level of variable living expenses; and

    (e) HEM may, in some circumstances, be a more accurate assessment of the level of the variable expenses required by a consumer for living without substantial hardship than either a consumer declaration or an account statement.

46. In terms of the use of HEM, ASIC Regulatory Guide (**RG**) 209.49 states "*After inquiries have been made and information about the consumer's financial situation has been gathered, a credit licensee may use benchmarks or automated systems and tools for testing the reliability of the information obtained* <u>*as part of the process for taking reasonable steps to verify the consumer's financial situation. For example, these kinds of systems and tools can be useful for confirming whether it is reasonable to rely on the information provided by a consumer for the purposes of the unsuitability assessment, or whether further inquiries may be warranted."*</u> (emphasis added) This therefore reflects ASIC's position that if declared expenses exceed an appropriate benchmark, there is no need to undertake any further verification. In other words, ASIC's position is that checking against an appropriate benchmark can properly be the first step in verification and in some cases will be the only step.

47. The obligation in the legislation is for the lender to take reasonable steps to verify a consumer's financial situation. There is no specific reference to expenditure. Moreover, as the assessment required to be made is whether the consumer can meet the loan obligations without substantial hardship, it is clear that reasonable steps cannot mandate a requirement to verify every single item of expenditure. Accordingly, it does not follow that in all cases there must be specific verification of all expenditure in order to comply with the responsible lending obligations. For example, a process under which fixed expenditure, such as liabilities to financial institutions are separately disclosed and verified and HEM is used to verify variable living expenses can be appropriate and compliant with the legislation.

48. The reasonable steps for a lender to take to verify a consumer's financial situation will depend upon the specific circumstances of the lender's practices. For example, where a lender employs other processes, such as adding a buffer to interest rates, excluding some types of income, reducing verified income for the purposes of the assessment, including applying a discount to more uncertain forms of income, and assuming certain expenses determined at a high level, may mean that the reasonable steps required to verify a consumer's financial situation will not involve the specific verification of particular expenses or categories of expenses. In other words, it cannot be the case that there will always be an obligation to review the debit entries on a consumer's transaction account.

49. Accordingly, the Group submits that it is appropriate to use a benchmark in the verification and assessment process, that it is permitted under the legislation, and that HEM is an appropriate benchmark to be used.

Is the offer of a credit limit increase, where the customer has consented to receive such marketing, consistent with the NCCP Act obligation not to provide credit that is not unsuitable for the customer, having regard to their requirements and objectives? Is the offer of a credit limit increase based only on information held by the bank about a customer a breach of the NCCP Act obligation to take reasonable steps to verify the consumer's financial situation? (IR Vol 1, pg 329)

50. The NCCP Act has been amended in the following important ways in relation to credit limit increases and is now significantly different from that which applied at the time of the credit limit increase case studies that were examined by the Royal Commission:

    (a) As of 1 July 2018, credit card issuers cannot contact customers to offer credit limit increases. This includes all forms of communication and applies equally to customers that have previously provided consent to receive these invitations;[18] and

    (b) For new contracts after 1 January 2019, a credit card contract must be assessed as unsuitable if the consumer would be unable to repay the amount of the credit limit within a 3-year period.[19]

51. In relation to making inquiries about requirements and objectives for credit limit increases, the Explanatory Memorandum to the NCCP Act states that as credit cards do not have any particular purpose, there is a limited requirement to understand the customer's requirements and objectives. ASIC has stated in RG 209.37 that it expects lenders to make inquiries about the limit the customer requires on their credit card. The Group's processes involve the borrower indicating the limit they require before the credit limit increase comes into effect.

52. Previous offers to increase a credit limit were based on information held by the Group about the customer. The Group considered the customer's repayment history on their existing credit card to determine their capacity to service a higher limit. However, the Group, as part of the offer, also sought confirmation by the customer regarding their level of disposable income. RG 209.19 explicitly recognises that the inquiry and verification obligations are “scalable”, meaning the extent of inquiries and verification may vary depending on the circumstances. ASIC has provided guidance in RG 209 on the factors relevant to scalability, which include the potential impact on consumers of entering into an unsuitable credit contract, the complexity of that contract, the capacity of a consumer to understand the contract and whether a consumer is an existing customer or a new customer. In light of this, the Group submits that the offer of a credit limit increase based on information held about a customer together with confirmation by the customer as to disposal income did not breach the NCCP Act.

When an employee or intermediary is terminated for fraud or other misconduct, should a licensee inform their clients of the reason for termination? When an employee or intermediary is terminated for fraud or other misconduct, should a licensee review all the files or clients of that employee or intermediary for incidence of misconduct? (IR Vol 1, pg 329)

53. Where an employee or intermediary is terminated or resigns during an investigation for fraud or other misconduct, the Group will:

    (a) review the records for every customer of that employee or intermediary where there is a reasonable basis to assume that the conduct has or may have caused them loss or disadvantage;

    (b) inform those customers of the circumstances that led to the review and whether the review determined the employee or intermediary's misconduct or fraud resulted in loss or disadvantage to them; and

[18] Section 133BE of the NCCP Act
[19] Section 160F of the NCCP Act; ASIC Credit (Unsuitability—Credit Cards) Instrument 2018/753

(c) restore customers impacted by the misconduct to at least the position they would have been in had the misconduct not occurred.

54. The Group has previously taken an inconsistent approach to this issue, but recognises the importance of open and transparent dealings with its customers. It has commenced a review of policies and processes across the Group to ensure it implements a consistent approach. This review and a plan to develop a Group-wide approach will be completed by the end of 2018 and fully implemented by June 2019.

Are certain types of add-on insurance, by their nature, poor value propositions for customers? (IR Vol 1, pg 329)

55. Whilst there are a large range of products that constitute add-on insurance, Round 1 of the Royal Commission focussed on the subsets of Consumer Credit Insurance (**CCI**) and add-on insurance sold through car dealers. This response considers CCI distributed through bank channels as the Group does not distribute add-on insurance through car dealers. The submission focusses on home loan protection (**HLP**) in circumstances where currently the Group distributes only that form of CCI (and Bankwest will be in the same position from 1 July 2019).

56. CCI is not, by its nature, a poor value proposition for customers. The core purpose of CCI is to:

(a) help meet scheduled loan repayments for a specified time period, where there is an insured event including temporary disability or involuntary unemployment; or

(b) repay the loan amount or outstanding balance where there is an insured event, which may include permanent disability, death or terminal illness. In some cases, the CCI includes a medical trauma benefit that will pay all or a proportion of the loan amount for an insured event.

57. HLP is distributed on a guaranteed acceptance basis up to a maximum loan balance of $750,000. The application process is simple and no medical underwriting is required. By contrast, non-guaranteed acceptance products are usually underwritten. That process can be complicated, time consuming and may result in an adverse underwriting outcome - for example, a premium loading, exclusion on certain conditions or activities or a declination of cover. Further, as a CCI policy, claims benefits paid on involuntary or temporary disability may not be taxable whereas income protection benefits payable under other forms of insurance policies would usually be taxed. This increases the effective benefit level that may be obtained by the insured. CCI also does not offset any other insurance that the customer may hold as the benefit is typically paid directly to the facility.

3. FINANCIAL ADVICE

How does a financial adviser's employer encourage provision of sound advice (including, where appropriate, telling the client to do nothing)? How do advice licensees encourage advisers aligned with the licensee to provide sound advice (including, where appropriate, telling the client to do nothing)? (IR Vol 1, pg 330)

58. The Group considers that financial advisers can be encouraged to provide sound financial advice through appropriate remuneration arrangements and performance objectives, effective conflicts management, education and training, and a client-centric culture, supported by a supervision and monitoring framework that includes preventative and detective measures. All these arrangements and measures need to operate so as to ensure quality advice and apply appropriate consequences to those who provide poor quality advice. The Group's Wealth Management Advice businesses have taken steps to improve these measures, including:

(a) improving educational standards required of financial advisers: since 2014, a requirement for new financial advisers to have a degree in finance, business, commerce or a related field; since 2015, to hold a current membership with an approved financial services industry association; since 2017, to undertake a minimum of 40 CPD hours per annum including five hours of ethics training;

(b) periodic review and updating of Licensee Standards. This involves a set of principles and standards that all Group financial advisers are required to follow, describing the required approach to each component of the financial advice process to support advice which is appropriate and compliant with all statutory and regulatory obligations. The Licensee standards include guidance on when an adviser should not recommend a replacement product, not recommend a product and when an adviser should decline to provide advice;

(c) the pre-vetting of certain categories of advice (e.g. by new financial advisers or advisers returning from a long break) to support appropriateness and compliance with Licensee Standards prior to presentation to the client and, since March 2017, changes to adviser reference checks to be in accordance with the ABA's Reference Checking & Information Sharing Protocol;

(d) changes to remuneration structures to better manage conflicts of interest and to comply with relevant provisions under FOFA. For example, since 1 July 2013, grandfathered investment commissions have not been paid to employed Commonwealth Financial Planning Limited (**CFPL**) advisers. The Group addresses further questions about the remuneration of financial advisers in paragraphs [70] and [214] to [218] below;

(e) the development and implementation of the Representative Supervision and Monitoring Framework (as an agreed step in an Enforceable Undertaking with ASIC in 2011) in around July 2012 to establish higher minimum standards for the supervision and monitoring of financial advisers;

(f) improved Quality Advice Assurance process, including emphasising a focus on the substance of the advice rather than overemphasising compliance with business processes and improving the level of post-advice interaction;

(g) improved data collection, including the introduction of technology platform "Connect" to create a centralised source of information across entities in the Group, including an ability to report on the frequency and nature of concerns identified through certain supervision and monitoring activities; and

(h) refinement of the investigations process to ensure detailed inquiries are carried out into issues raised.

59. In relation to the specific question of how to encourage advisers to tell clients to do nothing where this is appropriate for the client, the law requires that advisers recommend a client make no change where that is appropriate and in the client's best interests, and requires that advisers prioritise the client's interests in reaching this view. The law requires that advisers consider the client's existing situation (including existing financial product holdings) and factor in the costs of any change in providing compliant advice. Existing initiatives to ensure compliant advice (or deter poor quality advice) described above will therefore also encourage quality advice to do nothing.

60. Finally, the Group acknowledges the charging of fees for no service is unacceptable. Recognising the significance of the issue, the Group supports the ABA's proposals to improve the approach of more transparently and fairly charging for fees for ongoing advice including by providing alternative models to suit clients' needs and ensuring delivery of service under ongoing arrangements.

Can conflicts of interest and duty be managed? (IR Vol 1, pg 330)

61. Yes, conflicts of interest and duty can be managed. The Group acknowledges that a number of the conduct issues examined by the Royal Commission were caused by inadequate systems and controls to effectively manage the conflict which can exist between the commercial interests of a financial institution and its representatives, and the duties they owe to clients. However, the Group does not consider that all conflicts between interest and duty are incapable of being effectively managed. As discussed in section 9.3 (paragraphs [253] to [258]) of our submission below, the Group considers that the effective management of the conflict involves the calibration of a number of different levers.

62. Actual or potential conflicts exist in many professional and other service industries. Recognising that potential conflicts inevitably arise in many service industries, it will not always be feasible to avoid conflicts. Rather, where a conflict cannot be, or does not have to be, avoided the question will be *how* the conflict can be most effectively managed.

How far can, and how far should, there be separation between providing financial advice and manufacture or sale of financial products? Should financial product manufacturers be permitted to provide financial advice? At all? To retail clients? Should financial product sellers be permitted to provide financial advice? At all? - To retail clients? (IR Vol 1, pg 330 to 331)

63. The Group addresses this question in section 9.3 (from paragraph [268]).

Should an authorised representative be permitted to recommend a financial product manufactured or sold by the advice licensee (or a related entity of the licensee) with which the representative is associated? At all? Only on written demonstration that the product is better for the client than comparable third party products? (IR Vol 1, pg 331)

64. The Group considers that representatives should be permitted to recommend a financial product manufactured by a related entity. Approved product list approval processes (including research and benchmarking), conflict management processes, adherence to the duty of priority, the best interest duty and other advice obligations provide appropriate protection to clients. Before providing product replacement advice, representatives must have completed all research on the client's existing financial products, any client requested financial products and all financial products they are intending to recommend. The product replacement advice must have regard to the client's relevant circumstances, and must also meet ASIC's better position test as outlined in RG175. Product replacement advice will only meet the better position test if the costs, financial and non-financial benefits, and any significant consequences of the recommended strategy are likely to result in a net benefit to the client (as compared to their existing products or a non-product strategy). Those net benefits must provide a measureable (and not trivial) net benefit to the client.

65. The steps outlined above must be recorded in writing.

Should the grandfathered exceptions to the conflicted remuneration provisions now be changed? How far should they be changed? If they should be changed, when should the change or changes take effect? (IR Vol 1, pg 331)

66. The Group supports an industry wide transition away from grandfathered commissions, in a manner which can provide uniformity and certainty to those in the industry.[20] Ahead of any changes to the legislation, the Group has committed to rebating all grandfathered commissions to CFPL clients from January 2019 in respect of investment and superannuation products. This will benefit around 50,000 client accounts by approximately a total of $20 million annually.[21]

67. The Group supports the ABA position that there should be industry consultation in relation to a transition period. The transition period is important to allow advisers to engage with their clients prior to the ban becoming effective as the financial model of many advice practices will need to adjust. As an interim measure, during the transition period the Group is supportive of disclosure by product manufacturers to clients of the trail commissions being paid to the adviser on their account as recommended by the Productivity Commission.

Should the life risk exceptions to the conflicted remuneration provisions now be changed? How far should they be changed? If they should be changed, when should the change or changes take effect? (IR Vol 1, pg 331)

68. The Group supports the recent amendments to life insurance commissions through the Life Insurance Framework. The Group notes there is an existing review and further annual changes built into Life Insurance Framework legislation and suggests that time is needed to bed down the

[20] The Group supports this transition in respect of investment and superannuation products.
[21] ASX announcement of 9 October 2018

changes and to have a complete understanding of their effectiveness before any further changes are made.

69. The Group's view is that the basis for introducing these exceptions remains relevant. It has been well documented that there is a significant under-insurance issue within Australia.[22] When the ban on conflicted commissions was being considered in 2009 as part of the Inquiry into financial products and services in Australia (**Ripoll Inquiry**), it was noted that banning commissions on insurance products would likely lead to widening the protection gap in Australia. Any proposed change would need to grapple with this challenge, and ensure customers are proactively engaged on insurance products and their often 'unstated' financial needs met.

Should any part of the remuneration of financial advisers be dependent on value or volume of sales? (IR Vol 1, pg 331)

70. The Group repeats its observations in paragraph [20] above about remuneration of intermediaries. It follows that no part of the remuneration of a financial adviser should be dependent on the value or volume of sales of a particular financial product as this potentially incentivises the adviser to either provide the wrong product, or a product which is not needed. However, the Group considers that with appropriate structures and systems in place, remuneration policies that reward financial advisers for the volume of financial advice they provide can exist, provided any such remuneration is product manufacturer agnostic and is not dependent solely on the value of funds under advice or sum insured.

71. In considering the appropriate balance of factors which drive conduct, the Group considers that the enhanced regulation of financial advisers, and heightened duties imposed by the FOFA reforms, means that it is acceptable for financial advisers to be remunerated based (in part) on volume of advice provided.

72. Set out below are some key features of the variable remuneration and performance arrangements for financial advisers employed by CFPL (which form a majority of the Group's employed financial advisers):

    (a) Before any short term variable remuneration payment can be made to a salaried financial adviser, a number of gate openers must be met, including Risk, Values and Key Performance Indicator (**KPI**) requirements.

    (b) Risk and compliance expectations must be satisfied to be eligible for a quarterly variable remuneration payment. Poor risk behaviours have a negative impact on remuneration and outcomes may be reduced, including down to zero. Satisfactory risk behaviours are also a condition for the vesting of deferred variable remuneration, and deferred variable remuneration may be forfeited where risk and compliance expectations are not met.

    (c) The performance assessment includes metrics that are weighted to customer outcomes, advice quality, people and engagement, in addition to other measures, which prioritise customer outcomes. The FY19 KPIs are weighted 60% to client related KPIs, such as Customer Experience and Outcomes and Customer Advice Standards.

    (d) For authorised representatives of Group affiliated AFS licensees, whilst the Group does not have an employment relationship with these advisers, there are legal obligations on the licensees to manage conflicts of interest and take reasonable steps to ensure that the adviser remuneration arrangements that these practices have in place are FOFA compliant and do not lead to advisers breaching their best interests duty and duty of priority obligations.

[22] For example, Rice Warner, "*Underinsurance in Australia*", 2015

Should all financial advisers (including those who now act as authorised representatives of an advice licensee) be licensed by ASIC? (IR Vol 1, pg 331)

73. The Group sees merit in individual authorised representatives being licensed, but notes that ASIC has previously considered the issue in connection with the Ripoll Inquiry and concluded that while there were some potential benefits, the costs of such a reform would outweigh those benefits and the administration of the licensing and supervision of a more dispersed model in this way would be significantly higher.

74. However, such a model would create more direct accountability of financial advisers to ASIC or a separate legislative body (e.g. in terms of a code of conduct, annual training and certification and disciplinary proceedings). The current licensee model is flawed because it incentivises advisers concerned about compliance to move to licensees which are less stringent on monitoring compliance.

Are current product and interests disclosure requirements sufficient to allow customers to make fully informed choices? (IR Vol 1, pg 332)

75. The Group considers that further simplification of disclosure documents by a wholesale review of advice documentation and standard disclosures would promote greater understanding by clients whilst reducing the cost of advice. This could include standard disclosures applied across the industry. The Group believes disclosure requirements should be driven by the nature of the underlying product and the information a customer needs to understand the product - more information for complex products and less information for simple products.

Should the period after which a client must positively review an ongoing fee arrangement be reduced from two years to one? (IR Vol 1, pg 332)

76. The Group considers that the current two-year opt-in regime coupled with the annual fee disclosure statements (**FDS**) requirements strikes the right balance to ensure a client has front of mind attention to their ongoing service arrangements. On 9 October 2018 the Group announced they will provide all CFPL clients with an option to renew their ongoing service arrangements every two years (including clients who entered into arrangements before the FOFA reforms).

Should platform operators be permitted to deduct fees on behalf of licensees without the express authority of the client of the platform operator? (IR Vol 1, pg 332)

77. The Group submits that all ongoing advice fees paid from platform providers to AFS licensees should be authorised by the member and consented to in a transparent way. The deduction of fees from a client's product is both flexible and convenient for clients, including from a cash flow perspective. This allows more consumers to afford advice that may be otherwise out of reach. The Group supports the introduction of standard industry wording to make it clearer to the client at the outset of the arrangement, that they will be providing authority to the platform operator to deduct fees from their account and remit those fees to the AFS licensee.

When an employee or authorised representative is terminated for fraud or other misconduct, should a licensee inform their clients of the reason for termination? When an employee or authorised representative is terminated for fraud or other misconduct, should a licensee review all the files or clients of that employee or intermediary for incidents of misconduct? (IR Vol 1, pg 332)

78. The Group repeats its submission in paragraphs [53] to [54] above.

Should negotiation and settlement be the main approach for a regulator? Should there be greater focus on general deterrence in regulatory strategy? (IR Vol 1, pg 332)

79. The Group refers to its submission in paragraph [243] below.

Should a component of enforceable undertakings be the acknowledgment of specific wrongs? (IR Vol 1, pg 332)

80. The Group does not consider that enforceable undertakings should as a matter of course involve the acknowledgement of specific wrongs. Enforceable undertakings are a useful regulatory enforcement and supervisory tool to resolve issues and avoid potentially protracted legal proceedings. To the extent that admission of specific wrongs in an enforceable undertaking creates a secondary liability (for example, through class action litigation), the inevitable consequence is that entities would be more reluctant to enter an enforceable undertaking. The net effect would be to create a more legalistic process which may lengthen timeframes for achieving a regulatory outcome and timely customer remediation, where required.

Should self-reported breaches of the Corporations Act generally attract legal sanctions unless some special circumstances exist? (IR Vol 1, pg 332)

81. The Group considers that rather than being a trigger for automatic legal sanction, whether something has been self-reported should be a factor in determining the appropriate regulatory response, along with other factors such as:

    (a) the nature and extent of a possible breach and the circumstances in which it arose; and

    (b) how timely the AFS licensee has been in rectifying the issue, including the cooperation shown by the AFS licensee.

82. The breach reporting regime for AFS licensees has been the subject of recent consultation by Treasury following the publication of the ASIC Enforcement Review Taskforce Report (**Taskforce Report**). The Taskforce Report recommended, amongst other things, amendments to the breach reporting provisions of the Corporations Act to:

    (a) prescribe that significant breaches (and suspected breach investigations that are ongoing) must be reported within 30 days; and

    (b) encourage a cooperative approach where AFS licensees report breaches, suspected or potential breaches or employee or representative misconduct at the earliest opportunity.

83. The Taskforce Report noted that while sanctions are a necessary and important feature of the self-reporting regime, it considered that there should be statutory provisions encouraging a collaborative approach between ASIC and AFS licensees. This includes encouraging the reporting of events and information to the regulator at the earliest opportunity, including by creating a formal provision expressly reinforcing ASIC's prerogative to choose whether to take action in respect of AFS licensees when they self-report and certain additional requirements are satisfied. The Group agrees with this approach.

Should banning orders continue to be preferred to civil penalty proceedings in case of licensee/adviser misconduct? (IR Vol 1, pg 332)

84. Where an AFS licensee or adviser has committed misconduct, ASIC relies on a range of enforcement options in its regulatory approach including education, surveillance, negotiated resolution and civil and criminal penalties. Where misconduct is established, the best outcome for both customers and the industry is that the AFS licensee or adviser is prohibited from acting in the industry for an appropriate period of time, which could be a lifetime ban, depending on the nature and extent of the misconduct.

85. In its submission following Round 2, ASIC noted that legal reforms could enhance the educative and denunciatory impact of banning orders including by allowing:

    (a) an entry to be made in the Financial Advisers Register on the sending out by ASIC of notice to an adviser of a hearing to consider whether a banning order will be made; and

    (b) the publication by ASIC of the ASIC delegate's reason for decision.

86. The Group supports and agrees with these suggested reforms. Where an ASIC delegate makes a banning determination, the Group agrees with the recommendation in (b) above. If the entry is made at the time ASIC sends a notice of a hearing, a mechanism should exist to note that no decision has been made at the time of the notice regarding whether the adviser should be banned and for the entry to be removed if the hearing does not result in a banning order.

Should ASIC make more use of its Section 916G power to give a licensee information about a person who is or will be a representative of the licensee? Does Section 916G need to be amended so as to be more effective? (IR Vol 1, pg 332)

87. The Group agrees that information sharing is a key component to ensuring that only quality advisers remain in the financial services industry and supports any improvements which would facilitate the sharing of information between ASIC and AFS licensees, including greater use of section 916G.

88. The Group considers that barriers to sharing information between AFS licensees exist. There are concerns in the industry that the sharing of information, in particular adverse information about a candidate, may expose the AFS licensee to potential liability or claims (for example in relation to defamation and privacy). Those concerns are to a certain extent ameliorated under section 916G, which provides a limited statutory protection of qualified privilege to the sharing of information. Any enhancement to protections for AFS licensees, when engaging in reference checking processes, to facilitate a greater sharing of information between AFS licensees will assist in ensuring that only quality advisers remain in the industry. To the extent that any amendments are made in relation to the uses which can be made of information provided under section 916G, the qualified privilege provision should be extended to cover such uses for both ASIC and the AFS licensee.

89. The Group considers further guidance around the use which can be made of information provided under section 916G would be of assistance (for example, how the information informs any remediation program and subsequent communication with customers).

90. The Group is a subscriber to the Australian Banking Association's Reference Checking Protocol. As noted in the IR, the reference checking protocol is limited to signatories and not consistently applied. The Group would welcome any proposal that takes the principles of the reference checking protocol and extends them industry wide.

Should there be more focus on criminal proceedings against licensees rather than individual advisers? (IR Vol 1, pg 332)

91. No. The Group considers that individual accountability is a strong driver of behaviour. This recognition seems implicit in the introduction of the Banking Executive Accountability Regime (**BEAR**), with its focus on individual accountability. The appropriate enforcement option adopted by ASIC will always depend on the facts and circumstances of each case. The selection of the appropriate option will be determined by ASIC based on what is best suited to the case and what it seeks to achieve having regard to its resources and strategic priorities. Licensees already have the significant deterrence of ASIC's existing powers including the power to ban firms from continued involvement in the sector, the removal of licences or the imposition of conditions on the licence.

4. SMALL AND MEDIUM ENTERPRISES

Should there be any change to the legal framework governing small and medium enterprise (SME) lending? In particular, should any lending to SMEs come within the reach of the National Consumer Credit Protection Act 2009 (Cth) (the NCCP Act)? (IR Vol 1, pg 333)

92. The Group considers there should not be any change to the legal framework governing SMEs and, more specifically, SMEs should not come within the reach of the NCCP Act.[23] The current legal framework for SME lending is a blend of the common law, supplemented by legislation that addresses particular issues that are pertinent to business (e.g. unfair contract terms (**UCT**) for

[23] See also reasons given in paragraphs 17-19 of the Group's Part B submissions on Round 3

small business) and other forms of regulation[24] (for example, the new Code of Banking Practice (**2019 Code**)). Overall this framework works well with respect to SME lending and strikes an appropriate balance between facilitating access to credit for business and providing a degree of protection for SME borrowers.

93. The Group acknowledges that from time to time cases of concern will arise, some of which featured as case studies in Round 3, but to regard such cases as emblematic of the operation of the legal framework, and therefore requiring changes to this framework which would impact all borrowers, would be the wrong conclusion. This is particularly so, given the case studies occurred prior to implementation of a number of changes, for example those changes outlined in section 9.3.

94. Complicating the legal framework for SME lending with more regulation is likely to limit or constrain the circumstances in which lenders may make credit available and/or increase the cost of lending. This has implications for economic activity and the viability of certain businesses.

95. The Khoury Report noted that small business representatives were concerned that applying NCCP Act responsible lending-type requirements to SME lending may lead to undesirable consequences that could restrict access to small business credit.[25]

96. Further, in its submission to the Royal Commission, the Council of Small Business Organisations Australia stated that the application of the NCCP Act should not apply to business activities[26] and one of its member associations, Commercial and Asset Finance Brokers Association of Australia, made a submission to the Royal Commission opposing the extension of the responsible lending regime to SME lending.[27]

4.1 Code of Banking practice

What inquiries should a diligent and prudent banker make when deciding whether to lend to an SME? (IR Vol 1, pg 334)

97. The relevant inquiries necessarily differ depending on the borrower, the proposed loan value, purpose and circumstances of the borrower and the nature of security. It is for this reason that a general requirement to exercise the care and skill of a diligent and prudent banker is appropriate rather than a prescriptive outline of required inquiries.

98. A diligent and prudent banker would make the inquiries reasonably necessary to complete a credit application that would demonstrate that the borrower has the capacity to service and repay the loan in order that the application be supported by the credit function of the bank. At the present time, these inquiries may include (amongst other things) cash flow and current financial position of the business, the type of industry the borrower is in, the prior track record of the borrower both as a business entity and as a borrower. Management and expertise of principals of a SME borrower may also be considered.

99. At this point, it is important to note that a fundamental activity of banking is the definition of a credit risk appetite and management of credit risk within that appetite precisely because there is an expectation that not all loans made by the bank will be repaid in full. If an effective guarantee of full repayment was required, it would imply an ex ante test on the viability of businesses that many borrowers would not pass and it would significantly reduce the availability of credit and, ultimately, undermine economic growth.

100. With improvements in data analytics and the likely advent of "open banking" in Australia[28] there are circumstances (and these are likely to evolve over time) in which some inquiries can be made using data already available to the lender, and/or without the manual intervention of a banker (e.g.

[24] Royal Commission Background Paper 10: Credit for Small Business an Overview of Australian Law Regulating Small Business Loans, 7 May 2018 at pp11–12
[25] P Khoury, Independent Review of the Code of Banking Practice 2017 at p 49
[26] Council of Small Business Organisations Australia Submission to the Royal Commission dated 17 April 2018.
[27] Commercial & Asset Finance Brokers Association of Australia Comment on Royal Commission Background Papers 10, 11, and 12, dated 17 May 2018: https://docs.wixstatic.com/ugd/c7ffff_a695ebeff8a644faa0f05e47a8dddc39.pdf
[28] Australian Government, *Open Banking: customers, choice, convenience, confidence,* December 2017 found at: https://static.treasury.gov.au/uploads/sites/1/2018/02/Review-into-Open-Banking-_For-web-1.pdf

an algorithm based decision model to evaluate limit increases or new to bank lending applications based on transaction flows visible to the bank). The lack of manual or human intervention in every application does not imply of itself a lack of diligence or prudence.

Does "forming an opinion about the customer's ability to repay the loan facility" as required by Clause 51 of the 2019 Code involve bringing critical analysis to the cash flow forecasts and other business plan documents presented by customers? If so, what level of analysis is acceptable? (IR Vol 1, pg 334)

101. Clause 51 of the 2019 Code provides that when assessing whether a small business borrower can repay a loan, a bank considers the appropriate circumstances reasonably known to the bank about the borrower's financial position and account conduct. Although the Group considers that cash flow forecasts and other business plan documents can be useful to assess a borrower's ability to repay a loan, they comprise only one source of information that needs to be adequately interrogated in order for a lender to exercise the care and skill of a diligent and prudent banker. When assessing an application, the Group employee will analyse all information provided by the borrower and consider a range of other sources of available information to make a judgment informed by his or her expertise in the area. It is not possible to be prescriptive about the level of analysis required.

Is it enough that the lender satisfy itself the borrower can repay the loan and that the business plan is not obviously flawed? (IR Vol 1, pg 334)

102. In order to exercise the care and skill of a diligent and prudent banker in forming a view as to whether the loan is suitable, a lender must satisfy itself that the borrower can repay the loan which may, but does not necessarily include, the lender forming a view on a borrower's business plan. Ultimately, the decision to approve a business loan is a judgment call made by the bank, having regard to a number of factors, including the bank's level of risk appetite. The relevant relationship is one of lender and borrower, not business adviser and client.

Is the standard set out in Clause 51 of the 2019 Code, which requires a bank to determine whether a customer can repay a loan based on their financial position and account conduct, a sufficient standard? (IR Vol 1, pg 334)

103. The 2019 Code does not limit the lender's consideration to these two factors, however they are appropriately called out as two mandatory points of consideration as to whether a borrower can repay a loan. There are likely to be other factors considered in determining whether to offer the loan, such as the character of the borrower and the conditions of the loan, which a bank would consider as part of its obligations to exercise care and skill of a diligent and prudent banker. Increasingly, account conduct data will also provide a source of up to date financial information as to the performance of a borrower rather than the traditional approach of relying solely on historical financial accounts.

4.2 Guarantees

If established principles of judge-made law and statutory provisions about unconscionability would not relieve a guarantor of responsibility under a guarantee, and if, further, a bank’s voluntary undertaking to a potential guarantor to exercise the care and skill of a diligent and prudent banker has not been breached, are there circumstances in which the law should nevertheless hold that the guarantee may not be enforced? What would those circumstances be? Would they be defined by reference to what the lender did or did not do, by reference to what the guarantor was or was not told or by reference to some combination of factors of those kinds? (IR Vol 1, pg 334 to 335)

104. The Group does not consider there to be a need to extend the law relating to protection of guarantors beyond that which currently exists. Further, the Group notes that statutory protections go beyond unconscionability to extend, at least in New South Wales, to the provision of relief

against "unjust" contracts or provisions.[29] Such protections have been successfully invoked by guarantors.[30]

Is there a reason to shift the boundaries of established principles, existing law and the industry code of conduct? (IR Vol 1, pg 335)

105. The Group does not consider there to be a need to extend the law relating to protection of guarantors beyond the current regime. The established law (both common and statutory) provides sufficient protection to guarantors. Amendments to the regime, in circumstances where sufficient protections already exist, are not only unnecessary but apt to lead to confusion and uncertainty around the efficacy of a guarantee. A reduction in the clarity and efficacy of a guarantee as a form of security will reduce its value to borrowers and lenders alike. If the law undermines the ability of lenders to rely on guarantees it will have the likely effect of constraining lenders' willingness to extend credit.

If the guarantor is a volunteer, and if further, the guarantor is aware of the nature and extent of the obligations undertaken by executing the guarantee, is there some additional requirement that must be shown to have been met before the guarantee was given if it is to be an enforceable undertaking? (IR Vol 1, pg 335)

106. If a guarantor is a volunteer and understands the nature and extent of their obligations, there is no justification to impose an additional requirement to be met before the guarantee is enforceable.

Should lenders give potential guarantors more information about the borrower or the proposed loan? What information could be given with respect to a new business? (IR Vol 1, pg 335)

107. It is appropriate that banks should be required to provide prospective guarantors with relevant information that is covered by Part 7 of the 2019 Code. Further, the Group considers that it is sufficient protection to require banks to recommend that prospective guarantors seek advice from a legal advisor independent of the borrower. Regulation 11 of the *Legal Profession Uniform Legal Practice (Solicitors) Rules* 2015 prescribes obligations on solicitors who have been engaged by signatories to particular types of instruments, including prospective guarantors, to provide advice and who are asked to provide evidence of the provision of such advice.

4.3 External Dispute Resolution

Should AFCA adopt FOS's approach of putting the borrower back in the position they would be in if the loan had not been made, but not awarding compensation for losses or harm caused? Are there circumstances in which AFCA should waive a customer's debt? (IR Vol 1, pg 335)

108. The AFCA Operational Guidelines notes that AFCA *"will have regard to established legal principles as to the recoverability of loss…. When deciding the remedy, we often seek to achieve, as nearly as possible, either to place the Complainant in the position they would have been in if the conduct of the Financial Firm had not caused the loss; or to compensate the Complainant for their loss to the extent AFCA holds the Financial Firm responsible for the loss.*" AFCA also has the power to order compensation for non-financial loss up to $5,000 and payment of the Complainant’s costs (generally up to $5,000): [D.3.3], table in [D4], [D.5].

109. The Group notes that ASIC approved AFCA's Complaint Resolution Scheme Rules and the Terms of Reference of the AFCA Independent Assessor on 12 September 2018. Pursuant to the Scheme Rules, AFCA can order compensation for *direct financial loss*, calculated by reference to “*monetary compensation and any remedy where the value can readily be calculated, such as the waiving of a debt*”, up to the cap amount ($0.5M for consumers; $1M for small businesses; $2M for Primary Producers): [D.3.1].

110. The Group supports AFCA's approach to compensation and its powers.

[29] *Contracts Review Act 1980* (NSW)
[30] *Fast Fix Loans Pty Limited v Samardzic* [2011] NSWCA 260

5. AGRICULTURAL LENDING

How are borrowers and lenders in the agricultural sector to deal with the consequences of uncontrollable and unforeseen external events? (IR Vol 1, pg 335)

111. The Group agrees with the Commissioner's view expressed in the IR that there is no universal answer as to how borrowers and lenders should approach the consequences of uncontrollable external forces. The Group advocates for engagement between the borrower and the lender to determine an appropriate approach in the circumstances. The Group considers that the nature, unpredictability and extent of the event may significantly impact the scope of an appropriate response and therefore additional prescription of factors relevant to the provision of relief is unlikely to be of assistance.

112. The Group provides a number of support measures when its agribusiness customers are facing difficult circumstances as a result of unforeseen natural events. For example, in response to the current drought, CBA is providing a range of options to customers depending on their circumstances, including access to a confidential telephone counselling service, a loan repayment pause, extending the loan term agreement, waiving fees and charges related to business loan restructures, allowing the withdrawal of Farm Management Deposits before maturity without penalty and applying a credit adjustment for eligible customers with Farm Management Deposits for financial year 2018.

Does the 2019 Banking Code of Practice provide adequate protection for agricultural businesses? If not, what changes should be made? (IR Vol 1, pg 336)

113. While there are no express provisions covering agricultural businesses in the 2019 Code, most agricultural businesses would be encompassed by the definition of a "small business" and are therefore entitled to the benefits under the Code. The matter should be kept under review and when the 2019 Code is to be reviewed any gaps in providing adequate protection to agricultural businesses should be addressed at that time.

How, and by whom should property offered as security by agricultural businesses be valued? - Is market value the appropriate basis? Should the possibility, or probability of external shocks be taken to account in fixing lending value? How? Should the time for realisation of security be taken to account in fixing value? How? Is the possibility, or probability of external shock sufficiently met by fixing the loan-to-value ratio? If prudential standard APS 220 is amended to require internal appraisals to be independent of loan origination, loan processing and loan decision processes, when should that amendment take effect? (IR Vol 1, pg 336)

114. The Group considers that market value is the appropriate basis for valuing real property, including agricultural land. In determining the market value of a property, it is essential that a valuer takes into consideration the general market conditions, which must include factoring in the possibility of an external shock. This is true not only for rural properties, but also other assets that can be impacted by shifting markets. The Group notes that there are a number of examples outside of agricultural lending where the valuation will be affected by the prevailing market conditions or commodity prices. These include more volatile commodity markets such as resources, and industries where reliance on discretionary spending is higher, such as retail property.

115. The estimated time for the realisation of security should also be taken into account in determining value. A valuation should take into account whether there is a willing buyer and seller, as well as an available market. Market values in an agricultural setting anticipate a longer sales process than in ordinary commercial lending, often based on seasonal factors.

116. The Group believes the possibility, or probability, of external shock is sufficiently met by determining the loan-to-value ratio. Loan-to-value ratio can be varied to manage overall property risk, be it market, asset, cash flow, development, management and value risks. It is important to note however that loan-to-value ratios are only one aspect the Group takes into consideration when making both lending and enforcement decisions, with other factors such as serviceability, the

nature of the industry, the experience of the borrower within that industry and their business relationship with the Group, all being taken into consideration.

117. The Group notes that APRA intends to amend the credit risk framework to adopt the Basel Committee on Banking Commission's requirement that real property valuations are appraised independently from an ADI's mortgage acquisition, loan processing and loan decision process and that the Commissioner supports this move. The Group recommends a 12 month implementation period once any revisions to APS 220 are finalised to minimise any negative customer impact.

Should distressed agricultural loans be managed only by experienced agricultural bankers? (IR Vol 1, pg 336)

118. Clause 9 of the 2019 Code requires that staff be trained to competently do their work. The Group has a specialist team within Group Credit Structuring who manage most rural and agribusiness clients (not just those who are small and medium enterprises) that are classified as troubled and impaired. This team has many years of experience in dealing with rural and agribusiness clients.

Do asset management managers need more information (such as the cost to the lender of holding the loan) to make informed commercial decisions about management of distressed agricultural loans? (IR Vol 1, pg 336)

119. No. The Group considers the costs of holding loans versus the likely asset values at various time periods and the impact on the client before deciding whether to enforce or not.

Are there circumstances in which default interest should not be charged? In particular, should default interest be charged to borrowers in drought-declared areas? If it should not, how, and where, is that policy to be expressed? Should the policy apply to other natural disasters? (IR Vol 1, pg 336)

120. Decisions around when to apply a default interest rate, and the amount of the rate, are made on a case by case basis. These decisions are informed by factors such as the type, severity, and duration of default as well as the conduct and history of the customer with the Group and ultimate risk of loss to the bank.

121. In recent times, the Group has also instituted a moratorium on charging default interest for business term loans for farmers facing financial difficulty caused by the current drought. The Group believes such a practice should be a matter for each individual lender, rather than being mandated, in order that they can deliver flexible relief to customers that takes into account the nature of the external event, longevity and form of support needed by customers.

In what circumstances may a lender appoint an external administrator (such as a receiver, receiver and manager or agent of the mortgagee in possession)? Is appointment of an external administrator to be the enforcement measure of last resort? (IR Vol 1, pg 336)

122. When there is no reasonable prospect of a customer being rehabilitated, it may be in the customer's and bank's interests to appoint an external administrator, if the customer is unwilling or unable to arrange for an orderly wind up of the business and the sale of all relevant assets.

123. It is the Group's preferred position not to appoint external administrators if at all possible but if a customer refuses to proceed with asset sales or is dissipating the assets or cash flows of the enterprise, the Group may have no option but to do so, both in the interests of the Group's depositors and other creditors.

Having regard to the answers given to the preceding questions: Is any regulatory change necessary or desirable? Is any change to the 2019 Code necessary or desirable? (IR Vol 1, pg 336)

124. Consistent with its position for SME lending, the Group does not consider any regulatory change is necessary or desirable in relation to agricultural lending other than as specifically mentioned below (for example, the introduction of a national Farm Debt Mediation scheme).

Should there be a national system for farm debt mediation? If so, what model should be adopted? (IR Vol 1, pg 337)

125. Under the NSW Farm Debt Mediation Act, which the Group supports being the basis for a national scheme, there are no restrictions preventing any party from requesting a mediation at any point in the negotiation process or entering into discussions about actual or probable financial distress. However, the Group does not consider that an offer of mediation should be required as soon as an agricultural loan is impaired.

Should lenders be required to offer farm debt mediation as soon as an agricultural loan is impaired (in the sense of being more than 90 days past due)? (IR Vol 1, pg 337)

126. The Group does not consider that an offer of mediation should be required as soon as an agricultural loan is impaired. The Group notes that mediation will only be relevant in circumstances where there is a dispute between the lender and the farmer. It does not necessarily follow that a dispute will exist in every instance a loan is in default. Under the NSW Farm Debt Mediation Act, which the Group supports being the basis for a national scheme, there are no restrictions preventing any party from requesting a mediation at any point in the negotiation process or entering into discussions about actual or probable financial distress.

6. REMOTE COMMUNITIES

Do financial services entities have in place appropriate policies and procedures to assist Aboriginal and Torres Strait Islander people: to overcome obstacles associated with the geographical remoteness? To address the cultural barriers to engagement that some face? To address the linguistic barriers to engagement that some face? To address the obstacles posed for some by their level of financial literacy? (IR Vol 1, pg 337 to 338)

127. The Group acknowledges the comments made by the Commissioner that the Group's solution of having a special assistance line (**ICAL**) for persons in remote and very remote communities appears to be the best practice so far devised and applied to address access issues for Aboriginal and Torres Strait Islanders. However, the Group recognises that opportunities exist to further improve accessibility and overcome challenges these communities continue to face. Bankwest does not have an ICAL service so reference to the Group in relation to ICAL is a reference to RBS only.

128. The Group suggests taking the following additional steps to improve access:

(a) identifying key branches where targeted education of branch staff will strengthen awareness and use of tools available to conduct banking with these communities (to complement the existing online cultural awareness program available to all Group employees);

(b) simplifying ICAL on-boarding processes for new-to-bank customers, in particular with respect to documentation required;

(c) overcoming challenges when remote customers access banking services outside the dedicated ICAL service; and

(d) working towards conformity of processes between Group and other critical service organisations with respect to witness and eligibility requirements.

129. When formulating solutions for access issues faced by Aboriginal and Torres Strait Islanders, the Group believes it is imperative that the industry consider any potential increased workload on community representatives/organisations as they are unlikely to have the necessary resources to be in the position to provide the same high level of on the ground support for multiple institutions.

Are banks' identification requirements appropriate for Aboriginal and Torres Strait Islander customers? If they are, are those policies sufficiently understood and applied by staff? (IR Vol 1, pg 338)

130. Yes. The Group has adopted modified identification processes for Indigenous customers who access its ICAL service. These identification processes are well understood by ICAL's dedicated team and are used on a daily basis. The Indigenous Affairs team at the Group are looking to establish a cross-industry group to review identification processes with community organisations and seek to innovate and simplify the mechanics of the identification process.

Should more banks have a telephone service staffed by employees with specific training in assisting Indigenous consumers? (IR Vol 1, pg 338)

131. Yes. The Group considers that telephone service staff with specific training in assisting Indigenous consumers may assist with improving access to banking services for Indigenous consumers.

Do banks take sufficient steps to promote the availability of fee-free accounts to eligible customers? (IR Vol 1, pg 338)

132. CBA considers that it takes sufficient steps to promote the availability of its basic bank account to eligible customers.[31] It is committed to meeting its obligations, particularly Chapters 15 and 16 of the 2019 Code and is currently working through options that will raise awareness of affordable banking products and services. For example, if a customer applies for a new Transaction account and they answer "yes" when asked whether they have either a Commonwealth Seniors Health Card, Commonwealth Health Care Card or Commonwealth Pensioner Concession card then the process will require that customers are provided information about banking services available that have low or no standard fees/charges.

If a customer seeking to open a basic bank account has no substantial income other than Centrelink benefits, should a bank ever try to sell the customer another form of account? (IR Vol 1, pg 338)

133. If a customer is eligible and requests a basic bank account (e.g. in CBA's case Streamline Basic Account), a bank should not try to sell the customer another form of account that would incur a fee. However, if the customer, at the same time or later, expresses a banking need which would not be fulfilled by a basic bank account (for example, saving money or an interest bearing account), CBA staff are trained to provide the customer with information about other accounts which may satisfy that need, so that the customer can make an informed choice as to which is the best product for them.

134. CBA is currently working through options to increase awareness and promotion of low or no fee accounts in accordance with the Group's obligations under the 2019 Code and has committed to meeting these obligations (Chapters 15 and 16 of the 2019 Code). Specifically, CBA is currently working through enabling the capability to ask customers who are seeking to open a new transaction account if they hold a government card that would entitle them to a basic bank account, for example CBA's Streamline Basic Account. If the customer informs CBA that they have one of these cards, CBA will implement a process that requires that customers are given information about banking services that CBA offers that have low or no standard fees, including Streamline Basic Accounts.

Should informal overdrafts be allowed on a bank account if credits to the account are only, or are substantially, by payment of Centrelink benefits? (IR Vol 1, pg 338)

135. CBA considers it is appropriate to provide recipients of government benefits with an informal overdraft in circumstances such as honouring a direct debit or a scheduled BPAY payment, however the feature must be offered responsibly, with sufficient disclosures and the ability to opt-in or opt-out at any time. CBA does not provide an overdrawing feature on its basic bank account, or

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[31] See details of these steps in paragraph [73] of the Group's Part B submissions on Round 4.

to customers who are insolvent or in financial hardship or have a poor credit history with the organisation or who have been declined a formal overdraft in the last 6 months.

Should the application of the 90% arrangements provided by the Code of Operation be at the discretion of the bank, the customer or both? Or should banks apply these arrangements automatically? (IR Vol 1, pg 338)

136. As a member of the ABA, the Group subscribes to the Code of Operation. As a result, for an account that receives income support or Department of Veteran Affairs payments, CBA allows the account holder access to 90% of these payments with only 10% being applied to the repayment of any overdrawing. It is CBA policy to release 90% of such payments at the request of the customer without challenge, (that is, staff release funds where a client makes the request). CBA considers banks should apply the 90% arrangements at the request of the customer.

If direct debits are dishonoured for want of sufficient funds, are there cases in which dishonour fees should not be charged? (IR Vol 1, pg 338)

137. Dishonour fees should not be charged if the customer requests a stop on the direct debit prior to the transaction taking place. In addition, for customers with basic bank accounts, dishonour fees should not be charged for unpaid cheque or debit fees.

Are funeral policies, or particular kinds of funeral policy, financial products warranting intervention by ASIC in the exercise of its product intervention powers? Should all forms of funeral insurance be financial products for the purposes of Chapter 7 of the Corporations Act 2001 (Cth)? Should all forms of funeral insurance be covered by Part 2 Division 2 of the Australian Securities and Investments Commission Act 2001 (Cth)? Should it be unlawful to sell funeral insurance for persons under 18 years? (IR Vol 1, pg 338)

138. The Group does not sell funeral insurance to consumers and accordingly does not consider that it is appropriate for it to comment on the questions listed above.

7. REGULATION AND THE REGULATORS

Is the law governing financial services entities and their conduct too complicated? Does it impede effective conduct risk management? Does it impede effective regulatory enforcement? (IR Vol 1, pg 339)

139. The Group agrees that the regulatory and legislative framework is complicated, and in some cases, too complicated, but considers that it has, overall, struck an appropriate balance between the objectives of stability, fairness, competition and efficiency. While the Group does not consider that the current regulatory and legislative framework impedes effective risk management and enforcement, there are obvious areas for improvement.

140. The Group makes further submissions about potential changes to the law in section 9.3 below.

Should there be annual reviews of the regulators' performance against their mandates? (IR Vol 1, pg 339)

141. The Group supports regular reviews of the regulators' performance against their mandates as this will provide a mechanism to consider whether there are areas for enhancement and improvement which will ultimately produce better outcomes for consumers.

Is ASIC's remit too large? If it were to be reduced, who would take over those parts of the remit that are detached? Why would detachment be better? (IR Vol 1, pg 339)

142. The Group refers to its submission in section 9.1.4 below (paragraphs [233] and following).

Is the regulatory regime too complex? Should there be radical simplification of the regulatory regime? (IR Vol 1, pg 339)

143. The Group refers to its submission in section 9.1.4 below (paragraph [233] and following).

Should industry codes relating to the provision of financial services, such as the 2019 Banking Code of Practice, be recognised and applied by legislation like Part IVB of the Competition and Consumer Act 2010 (Cth)? (IR Vol 1, pg 340)

Protections provided by the 2019 Code

144. The 2019 Code gives rise to contractual rights for consumers (above those provided by existing legislation (including specific measures for vulnerable customers)) and is also subject to independent regulatory oversight, with ongoing monitoring by the Banking Code Compliance Committee (**BCCC**) and endorsement from ASIC (which provides a level of assurance that the Code is consumer focussed). The BCCC has the power to apply sanctions to a 2019 Code subscriber for a breach of the Code, including requiring the bank to take corrective action for a breach through to reporting to ASIC serious or systemic non-compliance with the Code. The Group is supportive of increased monitoring and transparency of banks' compliance with the 2019 Code.

145. The high-level of engagement by industry participants in the development of the 2019 Code means there is a significant degree of ownership of the outcomes delivered by the 2019 Code and an industry wide understanding of the work required to adapt and align bank practices with Code requirements.

Overlap with existing legislative provisions

146. The 2019 Code provides a plain English articulation of banks' obligations to their customers and was drafted in light of the recommendations of the Khoury Report[32] to "*use plain, accessible language and warmer tone as part of making the document more customer-focused and accessible*" and "*be as straightforward as possible with the minimum of qualification and 'fine print*".[33] As a consequence the 2019 Code is purposefully drafted as principles based rather than as prescriptive and rules based.

147. There is a significant overlap between the provisions of the 2019 Code that give rise to contractual remedies to customers and existing legislative provisions that give rise to regulatory enforcement. For example, the 2019 Code requires that banks engage with customers in a *"fair, reasonable and ethical manner"* (Chapter 4, [10]) and section 912A(1)(a) of the Corporations Act requires a financial services licensee "*do all things necessary to ensure that the financial services… are provided efficiently, honestly and fairly"*. If the 2019 Code was recognised and applied by legislation, there would be a substantial increase in the complexity of the regulatory framework given the high degree of interaction between the 2019 Code and existing legislation.

148. If given legislative effect, the 2019 Code would require considerable revision to better clarify the nature and extent of a bank's obligations. This would likely mean that the 2019 Code would revert to more legalistic language at the expense of accessibility to both regular users and first time readers of the 2019 Code.[34] By way of example, the Franchising Code of Conduct imposes an obligation on each party to act towards the other 'with good faith'. It has almost a page of provisions that seek to give that principle context and meaning.

149. Finally, the Group notes that the ASIC Enforcement Review rejected the option of giving codes legislative effect, preferring instead a co-regulatory model, *'under which industry participants would be required to subscribe to an ASIC approved code that would be binding and enforceable through contractual arrangements with an independent code monitoring body'.*[35] The co-regulatory model

[32] P Khoury, Independent Review of the Code of Banking Practice, 31 January 2017
[33] Khoury Report, Recommendation 1 at p 36
[34] Khoury Report, at p 21
[35] ASIC Enforcement Review, Position and Consultation Paper 4 Industry Codes in the Financial Sector 28 June 2017, p 11.

process allows a more flexible response to adapting and updating the 2019 Code than would be the case if the 2019 Code was a legislative instrument. It also noted that the enforceable codes seek to address issues which are internal to the industry, rather than regulating activities between the industry and consumers.

Are ASIC's enforcement practices satisfactory? If not, how should they be changed? If the recommendations of the Enforcement Review are implemented, will ASIC have enough and appropriate regulatory tools? Should ASIC's enforcement priorities change? In particular, if there is a reasonable prospect of proving contravention, should ASIC institute proceedings unless it determines that it is in the public interest not to do so? Are APRA's regulatory practices satisfactory? If not, how should they be changed? Are APRA's enforcement practices satisfactory? If not, how should they be changed? Does the conduct identified and criticised in this report call for reconsideration of APRA's prudential standards on governance? (IR Vol 1, pg 340)

150. The Group refers to its submission in section 9.1.4 below (paragraph [233] and following).

Having examined the governance, culture and accountability within the CBA group, what steps (if any) can APRA take in relation to those issues in other financial services entities? (IR Vol 1, pg 340)

151. The Group has found the APRA Inquiry a confronting but valuable process. As detailed in section 8.1 below, the Group is taking steps to rectify the shortcomings identified by the APRA Inquiry. The Group will be a better more customer-centric organisation because of that process. The Group understands APRA has asked other regulated financial institutions to conduct a self-assessment to consider whether similar issues exist in their institutions.

8. ENTITIES: CAUSES OF MISCONDUCT

152. As noted in the Introduction to these submissions, the Group's view is that there are several causes of the misconduct examined by the Royal Commission, many of which, insofar as the Group is concerned, were accurately identified in the APRA Report. As noted in the Introduction, the APRA Inquiry concluded that *'a complex interplay of organisational and cultural factors has been at work'* that spanned accountability, governance, systems, remuneration and leadership. The Group's culture became complacent, it did not take its obligations seriously enough and it underinvested in key areas, particularly operational risk and compliance. The balance between short-term outcomes and long-term shareholder and customer interests was not right.

153. We expand on each of those matters, and respond to the specific questions raised in the IR, below.

8.1 Conduct Risk

What are banks doing to meet the danger of conduct risk? What are regulators doing to meet it? What can banks do? What can regulators do? What should either or both be doing? (IR Vol 1, pg 341)

154. The APRA Inquiry reached a number of conclusions about what the Group was doing to meet the dangers of conduct risk, and what it should be doing.

155. The APRA Inquiry made 35 recommendations which focus on 5 key levers to implement and promote change in the Group:

(a) Governance: more rigorous Board and Executive Committee level governance of non-financial risks (**NFR**);

(b) Accountability: exacting accountability standards reinforced by remuneration practices;

(c) Capability: a substantial upgrading of the authority and capability of the operational risk management and compliance functions;

(d) Customer: prioritisation of the "should we" question in all dealings with and decisions on customers; and

(e) Culture: cultural change that moves the dial from reactive and complacent to empowered, challenging and striving for best practice in risk identification and remediation.

*Remedial Action Plan (**the Plan**) and Better Risk Outcomes Program (**BROP**)*

156. The Group is committed to addressing the findings of the APRA Report and has developed the Plan. The Plan has been endorsed by APRA and is subject to a comprehensive assurance framework. The Plan contains clear and measurable responses to each of the APRA Report's recommendations, supported by a timeline and executive accountabilities. Promontory Australasia (Sydney) has been appointed by APRA as the independent reviewer and has and will continue to provide quarterly progress updates against the Plan to APRA.

157. Work to ensure delivery of the Plan is now underway, and is being managed by a dedicated team called the BROP team. The centralised BROP team, reporting directly to the CEO, will govern the implementation of the Plan and delivery of a comprehensive transformational program, with realistic timeframes, to uplift customer and risk outcomes.

158. Business unit and support unit leaders are accountable for execution of the Plan, with appropriate accountability. Accountability for completing items under the Plan has been given significant weight (20–30%) in the performance scorecards of all General Managers, Executive General Managers and Group Executives.

159. The BROP will lift the effectiveness and efficiency of the Group's management of operational risk and compliance risk, including to drive consistent practices across the Group. Ultimately, BROP will form an important part of the Group's effort to rebuild and maintain the trust of our customers and community of key stakeholders.

Non-financial risk framework (including compliance framework)

160. A dedicated Executive Leadership Team NFR Committee has been set up. It meets monthly. This committee will increase the scrutiny of the NFR facing the Group and will strengthen the governance and oversight of these risks including the frameworks to manage these risks such as the compliance framework. Each of the Group's lines of business are also setting up NFR Committees.

Data improvements

161. As noted above, some of the problems identified by Royal Commission case studies involved inadequate data governance.

162. To drive accountability and oversight:

(a) BEAR Accountability Statements of all Group Executives reporting to the Chief Executive Officer include responsibilities associated with information and data management;

(b) A new Group-wide data management operating model is being embedded to uplift data quality and data management practices;

(c) A Group Data Office with accountability to set Group-wide standards, tools and approaches to data management has been established, with separate Data Offices in each business and support unit;

(d) The Group Data Management Council was established in August 2018 as the primary Group-level data governance body. The GDMC provides quarterly data and privacy progress updates to the NFR Committee and can escalate issues to the NFR Committee as appropriate.

Culture and Code of Conduct

163. As part of the measures to address conduct risk, on 24 September 2018, the Group commenced introduction of a new Code of Conduct which applies to all employees, contractors and Board members. The Code of Conduct sets the standards of behaviour, actions and decisions expected of CBA employees and contractors to deliver the right outcomes for all stakeholders. This is a key step towards changing the culture of the Group and improving outcomes for customers. Central to the Code is embedding the "Should We" test. "Should We?" can be considered by answering these four important questions:

    (a) Would I be comfortable if I had to tell my family or a friend?

    (b) Is this consistent with the Group's Values Expectations and Policies?

    (c) Am I being clear and transparent?

    (d) Is this fair to customers and the community?

164. If the answer to all of the questions above is 'Yes', then it is likely that conduct will be in line with the Group's Code. The Code sets out expected outcomes, including:

    (a) Products and services are fair, transparent, and meet customer needs, and the Group's distribution approach is appropriate for customers. The Group is compassionate to the circumstances of customers, including those most vulnerable.

    (b) The Group protects its community and the integrity of the financial system, including through meeting its obligations in respect of anti-bribery and corruption and anti-money laundering and counter-terrorism financing, and managing fraud.

    (c) The standards in the Group's policies and practices ensure fair customer and community outcomes and that the spirit, as well as the letter, of regulations are adhered to.

    (d) People are only hired, promoted and rewarded when they demonstrate the highest standards and strong values.

165. Failure to comply with the Code will result in consequences that may include dismissal or ending a contractor's business engagement.

166. The Group has also strengthened its whistle-blower policy to extend it to former employees.

Remuneration

167. Recent changes made to the remuneration framework, including for the CEO and senior executives, outlined in paragraph [182] below, will also aid in addressing conduct risk.

    (a) We are building better oversight of the remuneration framework through:

        (i) enhanced input from our Chief Risk Officer;

        (ii) better data analytics for the Remuneration Committee and Board; and

        (iii) better integration between the Board Remuneration Committee and the Risk and Audit Committees.

    (b) We are working on more effective application of the remuneration framework, through:

(i) the provision of Board guidance on risk expectations and consequences for remuneration outcomes, setting the tone from the top;

(ii) increased challenge from the risk function; and

(iii) greater transparency for employees of remuneration consequences of both good and poor risk outcomes.

(c) We are reviewing and updating our remuneration frameworks to specifically consider:

(i) reward for positive risk behaviours and outcomes, and collective risk adjustments (e.g. via pool funding) to promote collective accountability; and

(ii) guidance on the application of malus to both short and long-term variable remuneration.

Remediation

168. The Group has developed a Group Customer Remediation Policy effective as of September 2018. The policy assists businesses to identify and remediate customer loss or disadvantage arising from an incident or systemic issue. It documents a consistent and compulsory approach to determining whether a remediation project is required, and what conditions must be met before a remediation is considered closed. Compliance with the Policy will ensure that:

(a) impacted customers receive fair and consistent outcomes;

(b) remediation activities are undertaken in a procedurally consistent, timely and transparent way, using best endeavours to restore customers to at least the position they would have been in had the remediation related issue not occurred;

(c) customer communication is timely and easily understood; and

(d) there is appropriate accountability from senior CBA leadership and procedural consistency.

8.2 Remuneration

What more should be done to implement the recommendations of the Sedgwick Review? (IR Vol 1, pg 341)

169. There are three preliminary observations to make. First, when considering an appropriate remuneration structure, there is an inescapable reality that financial services entities are engaged in a commercial enterprise, and the aim of that enterprise is to generate a profit. There are two related comments:

(a) While shareholders have an expectation that the organisation will deliver a return on capital, the Group recognises that this does not mean that shareholder return and customer outcomes are mutually exclusive pursuits. A focus on short term financial performance at the expense of customers will result in a long term reduction in shareholder return. In this way, over the long term, the interests of shareholders and customers align.

(b) The commercial enterprise should never be advanced in a way which infringes basic norms of conduct, such as those identified at page 290 of the IR, namely: obey the law; do not mislead or deceive; be fair; provide services which are fit for purpose; deliver services with reasonable care and skill; when acting for another, act in the best interest of that other.

170. As noted in paragraph [185] below, the Group believes variable remuneration can positively contribute to a performance culture and reinforce expected standards of conduct through consequences. Like many of the factors which reinforce conduct, the question is a matter of balance and emphasis, which in the past has not always been appropriately calibrated by the Group and the industry more broadly. However, the recent enhancements which the Group has

made (and its support for further enhancements foreshadowed in the discussion below) has sought to place greater emphasis on not only the balance of outcomes to be achieved, but also the manner in which they are achieved.

171. The APRA Report concluded that the remuneration outcomes of the past are symptomatic of significant weaknesses in the implementation and broader oversight of the remuneration process in the Group, which have undermined the promotion of greater accountability. The Group agrees with those conclusions and as discussed below, is taking steps to enhance its remuneration framework, not only in the way in which it recognises performance and positive behaviours, including for risk, but also the consequences for people who do not meet expected standards of conduct.

The Group's remuneration framework

172. The remuneration and performance framework for the Group has changed in recent years and continues to evolve.

173. The Board Remuneration Committee commissioned a comprehensive review of the executive remuneration framework with changes effective from 1 July 2017. The key changes included:

(a) 50% of Short Term Variable Remuneration (**STVR**) deferred into equity (previously cash);

(b) a longer STVR deferral period over two years (previously STVR deferral was one year);

(c) introduction of new LTVR performance measures;

(d) allocating LTVR reward rights on a face value basis (previously this was on a fair value basis);

(e) enhanced risk and remuneration governance and frameworks.

174. In response to the Sedgwick recommendations, the Group has made substantive changes as outlined in paragraphs [176] to [182] below.

175. The present remuneration structure for the Group is governed by the Group Remuneration Policy.[36] Broadly speaking, the Group's remuneration framework has a total remuneration amount with the following components:[37]

(a) Fixed remuneration: which includes Base Remuneration (reviewed annually) and superannuation;

(b) STVR: which includes discretionary STVR and formula-guided schemes.[38] The discretionary STVR scheme is a variable performance-based remuneration scheme that is allocated on a balanced scorecard approach. The majority of Group employees participate in discretionary STVR. The performance framework evaluates performance against KPIs, the Group's Values and adherence to risk management standards (risk assessment). Where expectations of risk conduct are not fully met, this may result in a 'Partial Met' or 'Not Met' risk rating which can result in the variable remuneration being reduced to zero;

(c) Formula guided STVR schemes:[39] outcomes for these schemes are calculated and informed by a variety of measures, which may include customer, risk, values and business outcomes, incorporating a discretionary assessment or overlay;[40] and

[36] See for example Statement of Christopher Williams in response to Rubric 3-9, dated 30 April 2018 at paragraph [61]
[37] Ibid (paragraph [104] details CBA's Group Remuneration framework); Statement of Gareth Russell dated 22 March 2018 [CBA.0517.0022.0001] at paragraph [21]; Witness Statement of Peter Chun in response to Rubric 5-37 dated 31 July 2018 [CBA.9000.0108.0001] at paragraph [47]
[38] Statement of Gareth Russell dated 22 March 2018 [CBA.0517.0022.0001] at paragraph [25]; See also Statement of Christopher Williams in response to Rubric 3-9, dated 30 April 2018 at paragraph [107]; and Statement of Peter Chun in response to Rubric 5-37 dated 31 July 2018 [CBA.9000.0108.0001] at paragraphs [49]-[50]
[39] Ibid at paragraph [21]
[40] The introduction of the Net Promotor Score means that there is a more rigorous assessment of customer satisfaction.

(d) Long-term variable remuneration (**LTVR**): available for the Executive Committee and is based on performance against key financial and non-financial measures.[41]

Implementation of the Sedgwick Review

176. The Group supports all of the recommendations and is committed to implementing all of them ahead of the 2020 deadline.

Frontline staff

177. The Group has fully implemented the Sedgwick recommendations for RBS and Bankwest frontline teams and leaders in relation to variable remuneration recommendations, with transitional arrangements in place for some lenders.

178. Effective from 1 July 2018 the Group has made substantive changes to the way retail customer-facing roles and their leaders are recognised and rewarded. In summary:

(a) The weighting of any financial measures is now limited to 30% of a balanced scorecard and customer KPI weighting has increased from 40% to 75% for some frontline roles with the majority having a weighting of 40%, including for Branch and Area Managers;

(b) Teller's performance is assessed based on customer outcomes, including customer feedback, and leader observations of quality customer interactions (and contribution to team culture in Bankwest);

(c) We have changed the way customer outcomes are measured from customer experience (satisfaction), which focused on positive customer feedback. We have introduced net promoter scores (**NPS**) (advocacy) as well as considering the opinion of customers who are detractors as well as advocates;

(d) The majority of branch frontline roles are on the Group discretionary STVR plan;

(e) We have removed accelerators or accelerator like features from all variable remuneration plans including those remaining on formula-guided variable remuneration plans;

(f) We have broadened the risk assessment for Branch Managers and Lenders beyond lending compliance to the more holistic assessment of risk conduct;

(g) Reductions have been made to variable remuneration to ensure it represents a relatively small proportion of fixed remuneration by introducing STVR maximums and reducing the STVR potentials for retail frontline roles which had relatively high potentials.

179. Further, for the employees where risk management requirements and values expectations are not met then STVR payments may be reduced to zero.

180. Implementation of the Sedgwick recommendations on governance, culture and performance management is currently in progress. Current and future initiatives include:

(a) An increased focus on customer insights and how frontline staff impact NPS results by identifying and addressing poor customer experiences by reviewing complaints data;

(b) A continued focus on leadership programs to further build leadership capabilities to holistically assess performance. This includes programs that focus on emotional intelligence and uplifting coaching skills;

(c) A continued review and monitoring of the primary recognition programs, enhancing guidelines and reporting to ensure appropriate use, including the cessation of sales and product related campaigns;

[41] Statement of Linda Maree Elkins in response to Rubric 5-17 [CBA.9000.0091.0001] dated 26 July 2018 at paragraph [107]

(d) Enhanced governance processes around the application of KPI guidance and policies to ensure appropriate and effective KPI setting; and

(e) Continuing examination of responses provided through feedback channels from frontline employees where they provide their perspectives on the effectiveness of efforts to reform culture, performance management and remuneration arrangements, as well as assess workplace culture and understand the impact of various cultural and motivational levers on employee perceptions and behaviours.

Mortgage brokers

181. The changes made by the Group in relation to mortgage broker remuneration are discussed in section 2 of this submission (paragraph [20]).

Senior Leaders and Executives

182. The Group has made the following recent material changes to the remuneration system for senior leaders and executives:

(a) Reduction in weighting of financial performance measures: For FY19 the CEO and Group Executives performance scorecards' Shareholder KRA (which contains all financial measures) was adjusted to a maximum 30% weighting. The adjustment to 30% is directionally aligned with both the Sedgwick Review and APRA Inquiry. For FY18 the weighting for financial measures had been 60% for both the CEO and Group Executives in the revenue-generating Business Units and 40% for support functions;

(b) Range of measures considered for STVR pool: A new model for the STVR pool has been developed. The FY19 STVR pool (the pool for funding all participating employees' STVR including the Group Executives) incorporates a formal assessment of both financial and non-financial measures to determine the target pool and pool size above/below target at Group and Business Unit levels. The formal assessment applies the outcome of the CEO (Group) scorecard, with financial measures carrying a 30% weighting and non-financial measures making up the 70% balance. The design of this funding model is consistent with the Sedgwick Review recommendation to consider a number of measures in performance assessment, including customer and other non-financial measures.

Should any bank employee dealing with a customer be rewarded (whether by commission or as part of an incentive remuneration scheme) for selling the client a product of the employer? That is, should any 'customer facing employee' be paid variable remuneration? If the answer is either 'no' or 'some should not' what follows about incentive remuneration for managers or more senior executives? If more junior employees should not be remunerated in this way, why should their managers and senior executives? (IR Vol 1, pg 341)

183. The Group Remuneration Policy outlines the variable remuneration principles for the Group, including the need to ensure that customer front-line staff are not rewarded solely on the sale of product.

184. The Group acknowledges that there can be inherent risks in variable remuneration, including poor conduct, and in recent years has implemented significant changes to mitigate these risks. In addition to changes outlined earlier, recent changes include limiting the weighting of financial KPIs in scorecards to a maximum of 30% for the CEO and Group Executives and retail customer facing teams and leaders, and 0% in the case of tellers within retail bank. Customer facing variable remuneration schemes have been simplified, with many transitioning to the Group-wide discretionary STVR model to facilitate alignment and consistent governance.

185. While the Group believes that remuneration, including variable remuneration for customer facing employees, can play a balanced and important role in delivering a positive performance culture, we are committed to further exploring the role of variable remuneration within the broader employee value proposition and assessing the effectiveness and efficacy of remuneration systems in delivering on stated principles, including striking the right balance across all stakeholders.

186. With the rapidly evolving organisational, cultural and external context, it is important to review and challenge the role of variable remuneration more broadly in driving employee and organisational performance and supporting consequence management. Any future changes to the design or breadth of the application of variable remuneration across the Group will be considered alongside the role and relative prominence of non-financial motivational levers and other reinforcers of performance and conduct (e.g. performance management, leadership, progression and promotion practices).

187. The Group recognises that overall organisational culture, including risk culture, is fundamental to supporting high collective and individual operating standards and conduct, and ultimately delivering positive customer outcomes and sound risk management. Cultural levers beyond variable remuneration (e.g. performance management systems, recognition programs, promotion and career progression, tone from the top) can also be strong reinforcers of positive or negative culture.

188. The Group considers that recent changes to its performance and remuneration approach, are a positive step to supporting variable remuneration in reinforcing and appropriately recognising the achievement of balanced outcomes and expected employee conduct, while discouraging behaviours and outcomes misaligned with delivering better customer and risk outcomes. Recent consequences applied to employees through variable remuneration outcomes, including by remuneration deferral mechanisms, aim to discourage poor conduct and risk outcomes.

189. Regarding discouraging misaligned behaviours and outcomes, there is recent evidence of the increased delivery of consequences through variable remuneration, including remuneration deferral mechanisms. Specifically, in response to the APRA Report findings, the Board exercised its discretion to reduce 2018 financial year STVR payments of current and former Group Executives by 20%; lapse a portion of the unvested deferred STVR awards for approximately 400 current and former Executive General Managers and General Managers; and forfeit the full amount of unvested LTVR awards of select former Group Executives. The Board applied further negative STVR adjustments to current and former Group Executives relating to individual risk matters, separate to the APRA Report. In August 2017 it reduced Non-Executive Director fees. The cumulative impact of these actions was a reduction exceeding $100 million in remuneration outcomes for employees and Directors.

190. Outcomes from the recent FY18 Annual Reviews for employees demonstrated an increased focus on consequences applied in relation to risk assessments. There was a significant increase in the proportion of employees rated Partially Met in the FY18 Annual Risk Assessment compared to FY17 (8.1% of employees rated Partially Met in FY18 vs 3.9% in FY17). In addition, the number of Not Met Risk Assessment ratings also increased in FY18 compared to FY17 (0.8% of employees rated Not Met in FY18 vs 0.5% in FY17). The vast majority (99.9%) of employees with a Partially Met Risk Assessment outcome had a minimum STVR adjustment of -10%. This is a significant shift in remuneration consequences from FY17 where 65% of employees with a Partially Met Risk Assessment outcome had an STVR adjustment of up to -10%. There remained a consistent 'tone from the top' year on year, where a higher proportion of Executive General Managers and General Managers were held to account for risk matters compared to Executive Manager and below employees. This trend became more prominent in FY18 with 16.7% of Executive General Managers and General Managers rated Partially Met compared to 10.4% in FY17.

Should other changes be made to the remuneration practices of banks? What would they be, and how could change be required? (IR Vol 1, pg 341)

191. In addition to the remuneration changes outlined above and continuing to embed the Sedgwick recommendations, the Group is committed to delivering on the APRA recommendations, updating remuneration frameworks to specifically consider:

    (a) reward upside for positive risk behaviours and outcomes, and collective risk adjustments (e.g. via pool funding) to promote collective accountability;

    (b) guidance on the application of malus to both short and long-term variable remuneration; and

    (c) the potential for clawback in the case of serious misconduct.

192. Given the extent of changes to remuneration in recent years, there is a lead time before the impact and effectiveness of the changes can be fully evaluated, and the required scope of future changes to remuneration practices concluded. Some initial areas for consideration are:

    (a) exploring additional customer measures beyond measuring customer loyalty and satisfaction;

    (b) further simplifying remuneration frameworks, including rationalising variable remuneration plans and transitioning them to Group-wide STVR models; and

    (c) enhancing the quality, assessment and governance of KPIs, including the application of discretion.

193. Future changes to the Group remuneration practices more broadly should reflect evolving stakeholder expectations, learnings from assessments of remuneration effectiveness, and insights from global and local better practice approaches to remuneration and broader approaches to employee motivation, performance and conduct, including from the non-banking sector.

8.3 Banking Executive Accountability Regime

Is the Banking Executive Accountability Regime ('the BEAR') relevant to the intersections between remuneration and culture more generally than in its application to particular senior executives? Should the BEAR be altered? Should the BEAR be extended in application? (IR Vol 1, pg 341)

194. The APRA Report concluded that *"a lack of accountability is a common theme underlying several of the issues observed"* in the APRA Inquiry. In this regard, the Group supports the introduction of the BEAR and APRA's role in enforcing it. We believe the BEAR will strengthen the accountability of senior executives and directors. That being said, the Group accepts that the BEAR can and should influence the intersection of remuneration and culture beyond particular senior executives. The Group is of the view that, in addition to strengthening accountability, BEAR implementation has been valuable in clarifying accountability, and identifying any gaps and overlaps. Consistent with this view, Accountability Statements[42] will soon be applied to a broader population of Group executives beyond its Accountable Persons[43] and the Group will be cascading its accountability principles further throughout the organisation.

195. The Group considers that restricting the application of the BEAR to ADIs and groups with an ADI parent will limit the effectiveness of the regime in driving transparency and clarity of accountability which are important to regain trust in the financial services industry as a whole. This is also likely to result in an uneven playing field across the financial services industry. In order to enhance trust in the entire industry, the BEAR should apply consistently across APRA's regulated population. This has been the approach taken in the United Kingdom, where the Senior Manager and Certification Regime, which started out with banks and insurers, is to be extended to all sectors of the financial services industry to ensure the same high standards apply throughout the industry.

8.4 Intermediaries

Is it desirable to prescribe that some or all of those who are not employees of banks, but deal with bank customers, must act in the interests, or the best interests, of the client? In particular, what duty, if any, should a mortgage broker owe to the prospective borrower? Is value based commission, paid to the broker by the lender, consonant with that duty? Should an aggregator owe any duty to the borrower? Again, are the remuneration arrangements for aggregators consonant with that duty? (IR Vol 1, pg 341 to 342)

196. The Group refers to its submissions on these matters in section 2 above and section 9.1.2 below.

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[42] As defined by section 37FA of the *Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Act 2018*

[43] As defined by section 37BA of the *Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Act 2018*

How is value based commission consistent with acting in the interests, or best interests, of the client? (IR Vol 1, pg 342)

197. The Group refers to the response provided in paragraphs [20] and [70] above of the effects of value-based remuneration for intermediaries, acknowledging that value based commission can create a conflict between the financial interests of intermediaries and their duties to clients.

Should intermediaries be subject to rules generally similar to the conflicted remuneration prohibitions applying to the provision of financial advice? (IR Vol 1, pg 342)

198. As noted in paragraph [70] above, the Group acknowledges that the use of upfront and trailing commissions linked to loan size for third parties can potentially lead to poor customer outcomes and is in the process of implementing its proposal that commissions based on loan size should relate to funds drawn down and utilised. It considers that any further change will require legislative intervention.

199. In addition, as noted in paragraph [11] above, the Group supports extension of elements of the FOFA regime to mortgages (letter dated 10 February 2017[44]) and considers that standards and consumer outcomes in the mortgage broking industry may be improved with the introduction of an appropriately drafted duty.

If some or all intermediaries should owe the customer a duty to act in that customer's interests, or best interests, is it enough to prescribe the duty and direct 'management' of conflicts between interest and duty? (IR Vol 1, pg 342)

200. As noted in section 9.3 of these submissions, the Group considers that the effective management of conflicts involves the correct calibration of a number of levers both internal and external to the entity. It refers to its responses in sections 2 and 3 these submissions.

8.5 Business structures

Do the events that have happened raise any issue about business structures? Do the events that have happened invite consideration of whether structural changes should now be made? Do the events that have happened suggest that manufacturers of financial products should not be permitted to provide, whether by employee or authorised representative, personal financial advice in relation to products of a kind it manufactures? (IR Vol 1, pg 342)

201. The Group provides its response to questions about the structure of financial services entities (including vertical integration) in section 9.3 below (paragraph [268] and following).

More particularly, do they provoke examination of how and to what extent conflicts of interest and duty arising from the structure of the business can be managed? (IR Vol 1, pg 342)

202. The Group provides its response to this question in section 9.3 below.

9. RESTATING THE ISSUES

9.1.1 Access

Do all Australians have adequate and appropriate access to banking services? (IR Vol 1, pg 343)

203. The Group believes that the majority of Australians have adequate and appropriate access to banking services, but it recognises that for some there are further steps that could be taken to ensure adequate and appropriate access.

[44] CBA.0001.0038.0929, Exh bit 1.37

204. Despite Australia's large land mass, most Australians are able to access banking services. The Productivity Commission, in its recent report on competition in the Australian financial system,[45] acknowledged that "*Australians have ready access to funds at all hours of the day*."[46] Among the Organisation for Economic Co-operation and Development nations, Australia has one of the highest ratios of branches per capita. Despite a recognised decline in the physical presence of banks in Australia, the presence is still significant (with the Group providing the largest presence of the major 4 banks with 1119 branches and 3729 ATMs)[47] and the ABA has published a branch closure protocol that seeks to minimise the impact of branch closures on communities and, where possible, offer alternative face to face access. All ABA members are required to observe this protocol as part of compliance with the 2019 Code. Australians are also adopting digital channels at relatively high rates.[48] Internet banking is now the most common way that Australian consumers interact with their bank, and mobile banking usage is growing strongly, while branch usage is declining.

205. The Group has acknowledged that not all Australians access banking services through all of the channels which they are provided. For example, some older Australians may prefer face-to-face interactions and there may also be geographical or cultural barriers to accessing all available channels, for example in Aboriginal and Torres Strait Islander communities where lack of traditional identification documentation can cause challenges in accessing banking services. The Group has established the ICAL to give improved access to banking services for these remote communities.[49] The Group's customers also have had access to free ATM cash withdrawals and balance inquiries from identified ATMs in remote communities since 2012 as part of the ATM Fee Free Agreement.[50]

206. More recently, on 8 October 2018, the Group announced the renewal of its long-standing Bank@Post partnership with Australia Post for another five years. This commitment means CBA customers can access banking services at one of Australia Post's approximately 3,500 Bank@Post post offices in addition to the CommBank app, CBA branch network, the Group ATM network, and CBA's Australian-based customer call centres.

9.1.2 Intermediaries

207. For convenience, the Group has provided its response to the questions raised in IR Section 9.1.2 in relation to mortgage brokers, mortgage aggregators and introducers in Section 2: Consumer Lending above. As the Group does not distribute products through point of sale seller loans, it has not provided a response to the following questions in relation to those intermediaries.

For whom do financial advisers and authorised representatives of licensees act? (IR Vol 1, pg 344)

208. Insofar as the Group is concerned, financial advisers are either:

(a) employed by the Group or its subsidiaries;

(b) self-employed authorised representatives of Group subsidiaries; or

(c) employed by a third party that has an Authorised Representative Agreement with a Group subsidiary.

209. In providing financial advice, financial advisers are acting for their client. The Group considers that this is appropriate.

[45] Productivity Commission, *Competition in the Australian Financial System* Inquiry Report no.89, 29 June 2018
[46] Productivity Commission, *fn 2, Overview & Recommendations,* at p 3
[47] *APRA ADI Points of Presence Statistics* dated June 2017, released March 2018
[48] Bain & Company Report entitled "*Evolving the Customer Experience in Banking*" dated 2017, see Figure 14
[49] Witness statement of Sian Lewis in response to Rubric 4-12 [CBA.9000.0078.0001] dated 28 June 2018 at paragraphs [69]-[70]
[50] Witness statement of Sian Lewis in response to Rubric 4-12 [CBA.9000.0078.0001] dated 28 June 2018 at paragraphs [18] and [21]

If financial advisers and authorised representatives of licensees act for the consumer of a financial service: What duty do they now owe the consumer? What duty should they owe? (IR Vol 1, pg 344)

210. Financial advisers owe a duty of care to their clients to act with due care, diligence and competence. Depending on the context in which advice is given, a financial adviser's obligations may also include fiduciary duties, which require fully informed consent to the adviser acting for the client if there is a conflict. Additionally, financial advisers are required by the FOFA legislation to:

(a) act in the best interests of the client in relation to the advice;[51]

(b) not give the advice unless it would be reasonable for the adviser, (if it had in fact taken the steps required by the best interests duty), to conclude the advice is appropriate;[52]

(c) warn the client if the advice is based on incomplete or inaccurate information;[53] and

(d) give the customer's interests priority where there is a conflict. [54]

211. In addition to these duties, the existing legal framework within which financial planners operate (discussed in detail in Background Paper 7[55]) provides a series of additional safeguards to protect clients of financial advisers.

212. The Group considers that the current legal protections afforded to retail customers are adequate. Nevertheless, the Group considers that improvements can be made to the regulatory environment through the removal of grandfathered trail commissions (discussed at [66] and [215]), strengthening the monitoring and supervision of financial advisers' failure to comply with the law and the ongoing professionalisation of the advice industry. In that regard, the Group supports a number of initiatives:

(a) creating a more robust link between professional associations, ASIC and financial advisers in terms of acting cohesively on adviser conduct where disciplinary measures are required. The concept of establishing an independent, industry-based professional standards board to oversee competency and conduct standards for financial advisers was recommended in the Ripoll Inquiry which considered that the establishment of such an entity would be more effective at identifying and addressing problems early, receiving better intelligence at industry level and not being constrained by meeting high legislative thresholds before taking action (than ASIC oversight);

(b) the introduction of the Financial Adviser Standards and Ethics Authority (**FASEA**) code of ethics and enhanced education and entry requirements for financial advisers. The Group also supports the introduction of a uniform code of ethics developed by the FASEA and ASIC-approved monitoring bodies to operate compliance schemes in relation to the Code to enhance the framework for professional responsibility and discipline structures for financial advisers. However, the Group would support ASIC establishing a single governing body to carry out monitoring, sanctions and appeals activities for all approved schemes. This would provide efficiency and consistency in the application of disciplinary procedures. Finally, the Group supports the introduction of an annual attestation by financial advisers to a professional body or ASIC. These measures would move providing financial advice towards being a profession.

[51] Section 961B(1) Corporations Act
[52] Section 961G Corporations Act
[53] Section 961H Corporations Act
[54] Section 961J Corporations Act
[55] See in particular Royal Commission Background Paper 7: Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households, sections 3.1 - 3.5 and 3.8 - 3.11

Who is responsible for financial adviser and authorised representatives of licensees' defaults? Who should be responsible? (IR Vol 1, pg 344)

213. The consequence of the existing liability regime is that an AFS licensee is, in most cases, jointly and severally responsible alongside the financial adviser for any loss suffered by the client as a result of the conduct of its financial adviser regardless of whether that financial adviser is an employee or an authorised representative[56] and whether the representative's conduct is within authority or not.[57] The Group submits that, under the current regulatory framework, this responsibility for default is appropriate.

How should financial advisers and authorised representatives of licensees be remunerated? (IR Vol 1, pg 344)

214. Generally, financial advisers should be remunerated in a way that encourages them to act prudently, ethically and in the client's best interests, whilst still encouraging them to act efficiently. The Group's remuneration framework for financial advisers is outlined in paragraphs [70] to [72(d)] above.

215. The Group supports the removal of grandfathered trail commission payments, and the Group has already made changes in this direction. On 9 October 2018, the Group announced that CFPL would no longer be accepting grandfathered commissions, and will ensure the reduction in fees is passed on to clients via rebate arrangements. The Group supports the ABA's announcement of 10 October 2018 that it would seek legislative changes to remove grandfathering of conflicted remuneration across all financial advice AFS licensees.

216. Within ongoing fee arrangements under FOFA, fees for service agreed between the adviser and client can be calculated by reference to volume (e.g. calculated as a percentage of assets invested). Through the process of legislating the FOFA reforms this method of calculating adviser remuneration was considered to be an appropriate fee charging arrangement. The Group supports the ongoing existence and application of this provision within the Corporations Act as we believe it permits advisers flexibility to agree fee arrangements with their clients.

217. Under FOFA this method of fee charging is accompanied by significant consumer protection and disclosure measures in the biennial opt-in and annual FDSs. CFPL has announced that it intends to extend opt-in arrangements to all clients from 1 January 2019 (legislation currently only requires renewal notices to be sent to clients who first received advice after 1 July 2013).

218. Finally, if a wholesale review of the remuneration of financial advisers is to occur, the Group considers that it may be appropriate to fundamentally shift the payment structure so the advisers are paid like other professions, for example on a per-hourly basis, in exchange for the services they have provided.

Are external dispute resolution mechanisms satisfactory? Should there be a mechanism for compensation of last resort? (IR Vol 1, pg 344)

219. The Group considers external dispute resolution (**EDR**) mechanisms are appropriate and provide a satisfactory outcome (see above at paragraphs [108] – [110]). With respect to compensation of last resort schemes (**CSLR**), the Group supports the establishment of a limited and carefully targeted CSLR to deal with prospective financial advice claims where those claims have not already been addressed by a determination made by an ASIC approved external dispute resolution scheme and where the advice firm is in insolvency and all other avenues of redress have been exhausted.

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[56] Sections 917A and 917E Corporations Act

[57] Section 917B Corporations Act (subject only to the limited exception in section 917D, in circumstances where the representative disclosed that fact to the client before the client relied on the conduct, and the clarity and the prominence of the disclosure was such as a person would reasonably require for the purpose of deciding whether to acquire the relevant financial service). Further section 911C makes it an offence to hold out that conduct, or proposed conduct, of a person is within authority (within the meaning of Division 6) in relation to a particular financial services licensee if that is not the case.

9.1.3 Responsible Lending

Should the test to be applied by the lender remain 'not unsuitable'? (IR Vol 1, pg 344)

220. The Group does not believe that the responsible lending test needs to change. The entire industry has become familiar with the conceptual bases inherent in the test and have developed systems in relation to its compliance. There is no evidence to suggest that the principles based standard in its current form does not meet the objective of ensuring that lenders do not enter into unsuitable loans. Its enforcement history in fact suggests that the obligations serve their purpose - failure to comply with them has been demonstrated and has led to the imposition of penalties.

221. The responsible lending obligations can be described as a "principles based" standard. This means that for most types of credit contract the legislation does not specify the particular inquiries and verifications that need to be made. This has a number of benefits, which include:

    (a) it is suitable for application across the different range of regulated credit products (ranging from large home loans to residential investment loans to small unsecured loans) and the different circumstances of individual borrowers. Given the scope of regulation of the NCCP Act, this flexible application is essential;

    (b) the way in which it is applied and its interpretation will change appropriately over time. It is important this is the case because:

        (i) legislative changes affect the nature of information to which a lender can have access. The impending implementation of compulsory comprehensive credit reporting for the 4 major banks and open banking will significantly increase the information available to lenders;

        (ii) technology will affect the way in which inquiries and verification can be made. It is therefore important that any regulation is technologically neutral; and

    (c) practices and community standards change over time. This has been evidenced by the changes made to RG 209 since it was first issued in February 2010. ASIC updated it in June 2010, March 2011, February 2013 and September 2013, before the current version of RG 209 was issued in November 2014. ASIC has announced that it is completely reviewing RG 209 and will be consulting with stakeholders in relation to a further revision shortly.

222. The major disadvantage of a principles based standard is that it could give rise to uncertainty of scope and interpretation. This disadvantage would be mitigated somewhat if a regime were created which gave a 'safe harbour' beyond the wording of the provisions in that if certain processes were undertaken, they could be said to have met the reasonable enquiries and reasonable steps to verify obligations. Different processes may constitute a safe harbour for different circumstances. For example, different safe harbour processes may apply to different classes of lending products. However, failure to fall within the "safe harbour" would not, of itself, mean that the obligations had been breached. This could be effected through the declaration of standards by ASIC that are periodically updated, whilst allowing for appropriate implementation periods to facilitate things such as systems changes and staff training.

223. Further, increasing lending obligations may have the unintended consequence that large, highly-regulated institutions retreat from higher-risk segments of the market, which may disproportionately affect low-income earners and vulnerable customer groups (and have implications for equity and access to the asset class that many Australians use as primary vehicle for wealth accumulation).

How should the lender assess suitability? (IR Vol 1, pg 344)

224. A lender should apply the principles based unsuitability test, as is required by the legislation, by making reasonable inquiries into a consumer's requirements and objectives and financial circumstances and taking reasonable steps to verify a consumer's financial situation. These inquiries and verifications should be used in making the unsuitability assessment. As is set out in RG 209, a lender should be able to use appropriate tools and benchmarks as part of its inquiries,

verification and assessment. For the reasons set out above in section 2 at paragraphs [33] to [49], the use of HEM in the verification and assessment process is permitted under the legislation and is appropriate to effect the policy objectives that underlie the legislation.

Should there be some different rule for some home loans? (IR Vol 1, pg 344)

225. As set out above, a principles based standard provides for flexible application across a range of different products and the different circumstances of the range of consumers. Accordingly, the Group does not see any need for the introduction of different rules for home loans. Nonetheless, a "safe harbour" regime, as described above, could specifically and separately cover home loans. This might satisfy the need for certainty in relation to the application of the legislation whilst not adversely constraining flexibility.

Should the NCCP Act apply to any business lending? In particular, should any of its provisions apply to: SMEs? agricultural businesses? some guarantors of some business loans? (IR Vol 1, pg 344)

226. The Group considers that a responsible lending regime similar to that under the NCCP Act should not be implemented with respect to small and medium sized business lending. This includes, agricultural businesses (which often are SMEs), and guarantors of business loans. The Group refers to its submissions at paragraphs [92] to [96] above.

227. The Group considers that matters related to hardship, contract terms, enforcement and responsible lending are appropriately addressed in the 2019 Code, which specifically applies to small businesses.

To what business lending should the Banking Code of Practice apply? Is the definition of 'small business' satisfactory? (IR Vol 1, pg 344)

228. The Group considers that the definitions of business lending and small business as contained in the 2019 Code are appropriate and satisfactory. The definition of a small business has been extensively considered and debated and the definition in the 2019 Code now reflects the agreed position of the members of the ABA and endorsed by ASIC. Nevertheless the Group acknowledges that there are different views expressed by others and when the 2019 Code is reviewed in 18 months' time after it commences operation, the matter could be reconsidered at that time.

Should lenders adopt different practices or procedures with respect to agricultural lending? (IR Vol 1, pg 344)

229. As explained in more detail below under the heading "Agricultural Lending" (section 5), there are different practices and procedures that should be employed with respect to agricultural lending.

Are there classes of persons from whom lenders: should not take guarantees; or should not take guarantees unless the person is given particular information or meets certain conditions? (IR Vol 1, pg 345)

230. The Group does not consider that there are classes of persons who should not give guarantees (except for those persons that the law would protect from giving a guarantee). Rather, the Group considers that a lender must always consider the suitability of a guarantor, having regard specifically for potential vulnerability or disadvantage on the part of the guarantor.

How should lenders manage exit from a loan: at the end of the loan's term; if the borrower is in default? (IR Vol 1, pg 345)

231. The Group considers that where a bank has determined that a relationship with a borrower must end, regardless of whether the term of the loan has expired or the borrower is in default, lenders need to manage exit from a loan in an orderly manner appropriate to the circumstances pertaining at the time.

232. In respect of:

(a) **expiration of a loan -** The Group considers that the 2019 Code sufficiently and appropriately sets out how lenders should manage the exit from a loan where the term of the loan is about to expire and the borrower is not in default. Chapter 23 of the 2019 Code provides that a bank will give a borrower notice of its decision not to extend the loan at least three months before the borrower needs to repay the loan in full. According to the 2019 Code, if a bank decides to extend or refinance a loan that is about to expire, it is not required to do so on the same terms.

(b) **default -** If the loan is in default, the Group considers that it is appropriate for the lender to either seek to rehabilitate the loan or encourage the borrower to refinance. If enforcement action needs to be taken, it should occur as a last resort and comply with all statutory time frames.

9.1.4 Regulation and the regulators

Have entities responded sufficiently to the conduct identified and criticised in this report? (IR Vol 1, pg 345)

233. There are two aspects to this question:

(a) First, did entities respond sufficiently at the time the conduct examined by the Royal Commission was identified?

(b) Secondly, have the entities, at a more general level, identified why the issues examined by the Royal Commission occurred, and taken steps to ensure that they are not repeated?

234. The answer to the first question, from the Group's perspective, is clearly not. The Royal Commission has identified a number of instances where it took the Group too long to identify the problem; too long to report the problem to the regulator; too long to properly remediate customers affected by the issue; and too long to adequately address the root cause of the problem. The causes for these failures are outlined in section 8 above.

235. In terms of the second question, the Group refers to its submissions at paragraphs [154] to [168] above about the steps it is taking to reduce the risk of such matters continuing to arise in the future. As noted in the introduction, that work commenced in response to the failings identified in the APRA Report. This includes the significant work being undertaken in the Plan and the dedicated BROP team.

Has ASIC and APRAs response to misconduct been appropriate? If not, why not? How can recurrence of inappropriate responses be prevented? (IR Vol 1, pg 345)

236. From the outset the Group acknowledges that the responsibility for its misconduct rests solely with the Group. The Group has the responsibility to comply with the law and to behave in a way that the community expects. It is no answer for the Group to say that the regulatory regime permitted its behaviour or failed to enforce the law in a way that generated a sufficient deterrent.

237. The issues identified in the IR about regulatory approach (including those outlined above) have a number of sub-elements:

(a) **Regulatory responsibility** - Should the regulatory architecture change? Are some tasks better detached from ASIC? Are some tasks better detached from APRA? What authority should take up any detached task? Is ASIC’s remit too large? If it were to be reduced, who would take over those parts of the remit that are detached? Why would detachment be better?

(b) **Regulatory powers** - If the recommendations of the Enforcement Review are implemented, will ASIC have enough and appropriate regulatory tools?

(c) **Regulatory approach** - Are ASIC's enforcement practices satisfactory? If not, how should they be changed? In particular, if there is a reasonable prospect of proving contravention, should ASIC institute proceedings unless it determines that it is in the public interest not to do so? Are APRA's regulatory and enforcement practices satisfactory? If not, how should they be changed? Does the conduct identified and criticised in this report call for reconsideration of APRA's prudential standards on governance?

238. By way of general comment, the Group notes that the relative strength of the Australian financial services industry following the GFC should not be overlooked. The strength of the industry is at least in part a function of the regulatory environment in which it operates. For nearly three decades, the Australian economy has avoided recession, aided by the stability of the financial system during periods of severe global volatility.

239. The task confronting regulators is complex, with competing factors at play. During oral testimony, David Cohen, the Group's Chief Risk Officer, provided an explanation of the factors at play in assessing risk:[58]

> *there are some issues that are quite complex, because they involve a number of balancing of different factors. Sometimes competing factors…One is prudential obligations to appropriately provision which is borne out of the fact that it's depositor's money that is being lent. So 61 cent of every dollar that we lend belongs to depositors. So prudential are very focused on protecting depositors. Those in turn drive prudential standards about provisioning, for example. So there is one level of driver for risk management to focus on prudential standards. There's a second element, which is the role the banks play in funding the economy… because Australia is a net importer of capital, banks have a role in recycling capital…The third element that competes with those two is customer interests…– and that can translate into, for example, taking action against a borrower in order to protect a depositor's funds and satisfy prudential obligations. It might also mean that one should recycle capital, but that can have a devastating effect on the individual borrower, particularly if it's a small business. The intersection competing factors, almost like a Venn diagram if you will, lies right at the heart of some of the judgments that have to be made in risk management…and those judgments are not a black and white issue, they are often subjective.*

240. It follows from Mr Cohen's explanation above, that there are also a number of complex and potentially competing factors that the regulators must balance to effectively carry out their roles. As the Financial System Inquiry (**FSI**) identified, through-cycle stability and appropriate prudential regulation is essential to protect depositors and encourage economic growth (partly by attracting offshore capital to fund local domestic growth). Although Australia's regulatory framework may be strengthened and improved it has supported the resilience of the Australian economy and financial system in economically uncertain times.

Regulatory responsibility, powers and approach

241. In terms of regulatory responsibility and powers, the Group notes that the effectiveness of the regulators has been carefully examined in a number of previous reviews including the 2014 FSI, the ASIC Capability Review conducted in 2015 and 2016, and more recently the ASIC Enforcement Review Taskforce which made 50 recommendations regarding ASIC's enforcement capability. As Treasury noted in its Background Paper 24 to the Royal Commission, these reviews have led to a number of recent or proposed reforms. While some of the reforms are still being implemented, taken together they reflect a substantial change to ASIC's capabilities and if utilised effectively, this could have a material impact on how ASIC delivers on its mandate. Treasury also noted that steps have been taken to enhance APRA's effectiveness.

242. The Group considers that the changes which have been made, the proposed enhancements to ASIC's powers, and ASIC's altered approach to enforcement which has become evident throughout

[58] T2814.29-T2815.12

the Royal Commission,[59] should be given some time to embed before any more fundamental change is made to the regulators' remit or powers.

243. The Group also considers that it is important that regulators maintain freedom to deploy the various enforcement procedures available to them, rather than having a particular form of enforcement (such as commencement of legal proceedings) mandated by legislation. While the deterrent effect of litigation cannot be understated, there are many reasons why alternative enforcement procedures may be favoured by regulators (such as flexibility of enforcement outcome, time and resources required to achieve outcome, certainty of outcome) which justifies maintaining enforcement flexibility. It will clearly be a matter for the regulators to assess whether they are deploying the right procedures in the right cases to achieve the best outcomes for consumers.

Response to misconduct

244. As noted above, a number of enhancements to ASIC's powers are underway to address concerns regarding their approach to misconduct.

245. The Group is committed to cooperating with regulators to prevent misconduct and draw matters of potential misconduct to the regulators' attention at the earliest opportunity. It supports a regulatory regime which seeks to foster a cooperative approach between regulators and industry participants, while also acknowledging that sanctions, including criminal sanctions, must be part of any such regime.

246. As part of the Group Plan a regulatory operating model will be implemented with a focus on increasing proactivity, transparency and responsiveness in engagement with regulators. We have a number of initiatives in progress, but have also implemented the following:

    (a) regular, transparent and constructive engagements with the regulators at a senior business unit level, including the CEO and Group Executives. This is supported by a new set of engagement principles; and

    (b) embed enhanced global regulatory protocols to improve consistency of our regulatory relationships and information flows.

247. The Group provides responses to some of the specific questions identified in the IR about regulatory remit, power and approach and enhancement of regulation in section 7 of these submissions.

9.2 Causes

What were the causes of the conduct identified and criticised in this report? Conflict of interest and duty? Remuneration structures? Culture and governance? Regulatory response? (IR Vol 1, pg 345)

248. As noted throughout this submission, the Group considers that the conclusions reached in the APRA Report are an accurate diagnosis of the root causes of the Group's failings, including those examined by the Royal Commission. In addition, the Group recognises that it did not effectively manage the tension between duties to customers and intermediaries' self-interest, and that its legalistic and defensive approach to dealing with regulators also contributed.

Conflict of interest and duty (IR Vol 1, pg 345)

249. The Group refers to its submissions in paragraphs [61] and [62] above, and recognises that the conflict between interest and duty has not always been appropriately managed in the past or should have been better managed.

[59] IR at p 294

Remuneration structures (IR Vol 1, pg 345)

250. Recent proactive changes to remuneration frameworks and practices recognise the potential risks in poorly designed remuneration systems, including employee misconduct. The Group has made material changes to its remuneration framework and continues to do so as it implements all of the recommendations arising from the Sedgwick review and the APRA Report.

Culture and governance (IR Vol 1, pg 345)

251. The Group repeats its submissions in section 8.1 above.

Regulatory response (IR Vol 1, pg 345)

252. Like the other features identified in the IR, the response of the regulators has contributed to the environment in which the conduct examined by the Royal Commission has occurred. The Group repeats its submission in section 7 above.

9.3 Responses

What responses should be made to the conduct identified and criticised in this report? (IR Vol 1, pg 345)

253. In the Group's view, the effective management and control of the causes of misconduct involves a number of different elements:

    (a) First, there are a number of factors which are internal to a financial services entity, namely its culture and governance, and its remuneration structures.

    (b) Secondly, there are a number of factors which are external to a financial services entity, but which have an influence on the internal elements, such as the forces of regulation and the enforcement of that regulation by the regulators.

    (c) Finally, there is an overarching structural element. This is the structure of the financial services industry and in particular, what aspects of financial services commercial enterprise the law permits any one organisation to participate in.

254. These can shift voluntarily by the financial services entities and regulators through changes in policy, behaviour and approach; or they can be calibrated by force of legislation and regulation.

255. The conduct examined by the Royal Commission demonstrates that in the past the balance has not been right. However, it should be noted that some of the instances of misconduct examined by the Royal Commission were historic and financial services entities, including the Group, have already taken steps to address the issues identified above. It is clear that the work of the Royal Commission, and in the case of the Group, APRA, has accelerated the process.

256. The Group considers that the steps it has taken to reform its culture, governance structures and remuneration policies mean that, in future, it will manage the conflict between interests and duties more appropriately, will more consistently expect employees to demonstrate this in their behaviours and hold to account employees who do not meet these standards, and will be observable in better customer outcomes. There is some clarification of regulation which will assist; and some reform to regulatory powers which has already been foreshadowed.

257. In the Group's submission, that work is already underway. It repeats its submissions in sections 8.1 and 8.2 about the changes being implemented in response to the matters raised in the APRA Report. In addition to those matters, given the other reforms which it supports, it does not believe that a fundamental structural change in the industry is warranted. As outlined in section 9.3 below the Group considers that some of the potential structural changes which have been considered would have significant unintended consequences for customers including, for example, by making financial advice less accessible.

258. Finally, in any response to the matters raised by the Royal Commission, care will be required to ensure that unintended consequences are avoided. For example:

(a) too great a shift of responsibility from borrower to lender will make it less likely that credit will be made available by the larger financial institutions or be higher priced, which will inadvertently push lending into the unregulated shadows of the financial services system;

(b) focusing solely on greed and poor intent, where competency, complacency and operational and compliance discipline were also to blame. Intervening to fix apparent greed will not rectify the more subtle causes of the conduct;

(c) too extreme a shift in regulation and regulatory approach may encourage a more adversarial relationship in an environment where complex and changing regulation creates practical challenges of compliance, and where a system of breach reporting and remediation can actually be effective (even if it has not been as effective as it should have been in the past).

Are changes in law necessary? Should the financial services law be simplified?

259. The Group considers that the regulatory and legislative framework is complicated, but considers that it has, overall, struck an appropriate balance between the objectives of stability, fairness, competition and efficiency. While the Group does not consider that the current regulatory and legislative framework impedes effective risk management and enforcement, there are areas for improvement. Any changes to the legislative framework must be able to anticipate and adapt to change and provide clear and certain guidance to industry.

260. There are a number of further issues which should be considered in any change to the law:

(a) **Simplification** – the risk of prescriptive regulatory guidance is that compliance becomes focused on process and inputs rather than outcomes. The Group agrees with the Commissioner that wholesale change to the law is not the answer. The uncertainty of a fundamental re-write of financial services laws would, in the Group's view, be too destabilising and risks unintended consequences. Simplification of the law is clearly desirable, but it is not essential and would be difficult to implement in practice. However, that is not to say that it should not be aspired to - but the challenges in achieving the goal effectively need to be recognised and an approach that focuses on simplifying regulation where there has been identified customer harm or where the industry has struggled to understand and meet its obligations appropriately, balances the benefits of simplification in key areas against the potential for unintended consequences that may result from wholesale changes.

(b) **Interpretation** – there will always be areas of the law open to different interpretation. In those instances, guidance from regulators as to their interpretation will greatly assist the industry. In formulating guidance, there should be widespread industry consultation so that the final form of guidance is meaningful and practical.

(c) **Overlapping guidance from regulators** – while policy intent may be aligned and consistent, there are often practical implications from overlapping regulation. Where those overlaps are identified, steps should be taken to develop coordinated and consistent guidance.

(d) **Consistent definitions** – where terms are used in multiple forms of legislation or regulation, definitions should, as far as possible, be consistent.

(e) **Consistent application** - wherever possible, application of regulation across the industry (and in particular non-bank participants) should be consistent.

261. International experience on the implications of an uneven regulatory playing field for growth of less-regulated sectors is instructive. In the United States, non-bank lenders, who are subject to less restrictive capital rules, have grown strongly since the GFC and have issued more than 50% of residential mortgages in 2018. Similarly, following tightening of bank lending in the UK, the value of

the high-interest, short-term (“payday”) loans market is estimated to have grown from GBP900 million in 2009 to GBP2.2 billion in 2012 before this type of lending came under the mandate of the Financial Conduct Authority.

262. Finally, the Group supports the extension of breach reporting obligations to ACL holders. The ASIC Enforcement Review Taskforce Report of December 2017 made this recommendation and it was accepted in principle by the Government in April 2018. The Group considers that there are differences between the designs of the two regulatory regimes that require bespoke guidance. For example, the financial services regime is more principles based than the consumer credit regime and particular guidance on the application of the significance test for technical breaches is required to ensure a focus on requiring the reporting of significant breaches. There should be a sufficient transitional timeframe for implementation. The reporting processes should be harmonised for dual AFS licensees and ACL holders. Further, the matters required to be contained in credit licensees' annual compliance certificates should be modified to remove duplication with the breach reporting regime.

Should carve outs and exceptions be reduced or eliminated? In particular, should: grandfathered commission; point of sale exceptions to the NCCP Act; funeral insurance exceptions; be reduced or eliminated? (IR Vol 1, pg 346)

263. The Group has set out its position in respect of each of the above questions at paragraphs [66], [138] and [207].

How should entities manage conduct and compliance risks? (IR Vol 1, pg 346)

264. The work that the Group had already commenced, and which it now has underway following the APRA Report, means that it has had to think carefully about how it should manage conduct and compliance risks.

265. As noted in section 8.1 (paragraphs [156] to [159]) above, the Plan contains clear and measurable responses to each of the APRA Report’s recommendations, supported by a timeline and executive accountabilities. The Plan has been endorsed by APRA and is subject to a comprehensive assurance framework. Promontory Australasia (Sydney) has been appointed by APRA as the independent reviewer and has and will continue to provide quarterly progress updates against the Plan to APRA. The APRA Inquiry also made recommendations in relation to the Group's remuneration framework, which complement the Sedgwick recommendations which the Group is implementing.

How should APRA and ASIC respond to conduct and compliance risk? Should the regulatory architecture change? Are some tasks better detached from ASIC? Are some tasks better detached from APRA? What authority should take up any detached task? Should either or both of ASIC and APRA be subject to external review? (IR Vol 1, pg 346)

266. As noted above at paragraphs [241] to [243], the Group considers that there has already been significant review of the regulatory architecture and that with the foreshadowed reform to ASIC's regulatory powers, there should be a period of time to review the effect of those changes before any significant reform to the role and responsibilities of the regulators.

What is the proper place for industry codes of conduct? Should industry codes of practice like the 2019 Banking Code of Practice be given legislative recognition and application? (IR Vol 1, pg 346)

267. The Group refers to its response at paragraphs [144] to [149] above.

Should an intermediary be permitted to: recommend to a consumer; provide personal financial advice to a consumer about; sell to a consumer, any financial product manufactured by an entity (or a related party of the entity) of which the intermediary is an employee or authorised representative? Is structural change in the industry necessary? (IR Vol 1, pg 347)

268. The Group does not consider that structural change to the industry is necessary. As noted in paragraph [253] of these submissions, the Group considers there are a number of factors which should be used to promote better behaviour and client outcomes. While the mandated structural separation of financial product manufacturer and financial advice is one such lever, the Group's view is that:

   (a) wholesale change is not required to remedy the issues identified by the Royal Commission; and

   (b) any wholesale change, must and should be, considered after existing legislative reform has been implemented.

269. The Group is of the view that:

   (a) vertical integration provides benefits to consumers and while conflicts of interest exist, these can be effectively managed;

   (b) structural change is likely to have unintended consequences that will adversely affect consumers; and

   (c) the conduct examined by the Royal Commission, and that has emerged across the industry more generally, while occurring in a market where vertical integration exists, was (with some exceptions) not caused by that structure.

Benefits of vertical integration

270. The topic of vertical integration has been the subject of detailed consideration in recent years.

271. First, the FSI undertook a thorough review of the financial services industry, including competition. The FSI specifically examined whether vertical integration was reducing competitive pressures, and concluded that regulatory intervention was unnecessary.

272. Secondly, ASIC in their Report 562 highlighted that vertical integration can offer benefits to both the institution and its customers and can provide economies of scale for the institution, and potentially improve cost efficiencies in the provision of services. ASIC noted that these savings may then be passed on to the customer and improve access to advice.[60] ASIC further noted that customers who obtain financial services from a vertically integrated advice business may also benefit in other ways. They may be attracted to the convenience of a relationship with a single financial institution. They may also value the perceived safety of dealing with a large institution, and have trust and confidence in the ability of the institution to both deliver the services and compensate them appropriately if required.[61] The Group agrees with ASIC's conclusions. Vertically integrated institutions are typically larger, and better capitalised, than stand-alone distribution or product manufacture businesses. This size creates economies of scale that can benefit customers by reducing costs and also increasing investment in innovation and technology.

273. In the Group's view, customers also value safety and strength. When markets are difficult or volatile, vertically integrated institutions can be more stable and are potentially better at managing these conditions. Larger and more diversified institutions also have the capacity to invest larger sums on risk management and compliance frameworks, are subject to more scrutiny in their efforts to do the right thing by customers, and can be effectively supervised using a range of tools, including close and continuous monitoring. They are also safer because they have the financial capacity to stand behind their advice and products.

274. To the extent that conflicts exist, the Group is of the view that they can be managed effectively and do not require structural separation. An integrated business must acknowledge the potential for conflicts and put in place measures including governance (particularly for related-party transactions), risk management (controls and monitoring), remuneration frameworks and processes and sales practices to manage those conflicts.

[60] ASIC Report 562 Financial Advice: Vertically integrated institutions and conflicts of interest January 2018, p 16
[61] ASIC Report 562 Financial Advice: Vertically integrated institutions and conflicts of interest January 2018, p 16

275. In its report, ASIC acknowledged that a vertically integrated business model gives rise to an inherent conflict of interest, which needs to be carefully managed by a AFS licensee to ensure that advice given to the client complies with the best interest's duty and related obligations and is not tainted by that conflict.[62] ASIC also concludes that it should be possible for AFS licensees to effectively manage the conflicts of interest associated with providing personal advice to clients and manufacturing financial products; and it should not be necessary to enforce the separation of products and advice.[63] The Group shares Treasury's position in its submission to the Royal Commission in Background Paper 24 that "*recent structural changes in the industry, recently introduced or soon to be introduced reforms, other potential reforms the Commission could recommend, and heightened attention by firms and ASIC, should be sufficient to mitigate the systemic risks involved — subject to further ongoing scrutiny by regulators*".

Unintended consequences

276. Integrated advice and investment platform businesses have evolved in part in response to the marginal economics of advice distribution, driven by the disconnect between the cost to provide and customers' willingness to pay for upfront financial advice. The Group believes that forced structural separation would threaten the financial viability of AFS licensees, reduce the availability of advice, and increase the cost of advice such that it would be prohibitive for most Australians. Treasury has also warned that structural separation would be complex and disruptive and could have unintended consequences.[64] This is particularly acute given Australia's ageing population, where ready access to financial advice is of particular importance as people approach and then enter retirement. Further, changes in the United Kingdom have arguably resulted in an imbalance in access to financial advice between people from different socioeconomic backgrounds (resulting in people who may need access to financial advice not being able to afford it).

277. The financial strength of integrated businesses also ensures that financial resources are available if compensation is required. The conduct which gave rise to the need for the widely reported remediation activities of the integrated financial institutions was unacceptable. However, those institutions have also ensured that customers are, and will be, compensated for that poor conduct. In that regard it is worth noting the findings from the Financial Ombudsman Service who reported in their annual review 2016-17 that '*[a]s at 30 June 2017, consumers were owed more than $14.1 million (excluding interest) in unpaid FOS determinations. A total of 218 consumers were affected by 39 FSPs [financial services providers] unwilling or unable to comply with 154 determinations. Of these FSPs, half (51%) were financial planners and advisers.*' Unpaid determinations are concentrated in the small-to-medium advisory services sector and are generally the result of a financial services provider having gone into liquidation or administration.[65] AFS licensees of larger institutions are more likely to be able to ensure compensation for their customers.[66]

Cause of misconduct is not vertical integration

278. Finally, it is important to note that the conduct identified by the Royal Commission, and also more generally across the financial services industry, arose largely as a result of misconduct on the part of particular individuals that was not appropriately managed or supervised by the relevant licensee, cultural shortcomings, or inadequate systems and processes that the licensees had in place. It was not conduct that arose directly as a result of the structure of a vertically integrated business. The Group considers that the root cause of many of the conduct issues in financial advice are unrelated to the structural integration of financial advice, investment platforms, and investment and superannuation products. The emergence and persistence of fee-for-no-service issues across the industry were related to inadequate monitoring and detection by advice licensees, not the ownership of those licensees. Whether a licensee is part of an integrated business does not affect its ability to adequately monitor and detect problems within its business.

26 October 2018

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[62] ASIC submission to the Royal Commission – Round 2 – p 4
[63] ASIC submission to the Royal Commission – Round 2 – p 30
[64] Background Paper 24: Treasury submission on key policy issues dated 26 July 2018
[65] FOS response to request for information by the Royal Commission, p 10
[66] ASIC Report 562 Financial Advice: Vertically integrated institutions and conflicts of interest January 2018, p 16