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Australian Government

The Treasury

Financial Services Royal Commission

Submission

Interim Report

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INTRODUCTION

1. Primary responsibility for misconduct lies with financial firms, their boards and senior executive teams. To address the widespread misconduct evidenced, the Royal Commission's (the Commission) Interim Report makes a forceful case for reassessing the complexity of the current regulatory framework, how firms engage with compliance, and how regulators seek to enforce the law. A mere tinkering around the edges is unlikely to be effective, nor is, as recognised by the Commission, layering volumes of additional laws on top of the existing system without more fundamental change.

2. The Interim Report calls for a policy response that addresses three key questions:

   - To what extent can the law be simplified so that its intent is met, rather than merely its terms being complied with, and how can this be done?
   - Should the approach to addressing conflicts of interests change from managing conflicts to removing them, either by banning all or some forms of conflicted remuneration and sales or profit-based remuneration and/or changing industry structures?
   - What can be done to improve compliance with the law (and industry codes), and the effectiveness of the regulators, to deter misconduct and ensure that grave misconduct meets with proportionate consequences?

3. Treasury agrees that these are key questions, but would also add a fourth:

   - What more can be done to achieve effective leadership, good governance and appropriate culture within financial services firms so that firms 'obey the law, do not mislead or deceive, are fair, provide fit for purpose service with care and skill, and act in the best interests of their clients'? [1]

4. Answers to each of these four questions would form the pillars of any comprehensive policy response to what the Commission has publicly exposed. However, there is no single simple answer to each, and policy responses require tailoring to achieve appropriate trade-offs against other objectives as set out in the Commission's terms of reference — such as access to and cost of financial services for consumers, competition, and financial stability.

5. The consideration of appropriate trade-offs would also need to take into account not only each individual change, but the aggregate impact of the changes taken as a whole, and the sequencing of how such changes are to be implemented. A large-scale system-wide change, if not appropriately coordinated to take into account the interactions between reforms, could cause significant disruption. Such changes could also have a disproportionate impact on smaller firms that have a lesser ability to absorb significant additional regulatory costs. Ultimately, these costs would be expected to be borne, at least in part, by consumers.

1 Financial Services Royal Commission, *Interim Report* (2018) (*FSRC Interim Report*), vol. 1, 290.

6. Treasury's starting position, consistent with our previous Policy Submission, is that boards, senior executives and shareholders must take responsibility for their conduct.[2] The evidence heard and the Interim Report make it clear that conduct must improve.

7. Gaps in the regulatory framework or weaknesses in the enforcement of that framework do not absolve firms of their responsibility to act lawfully. The policy paradigm set by any reforms following the Commission should be one where the policy framework and the regulators require boards to take ownership of their conduct and culture and the consequences of them. It should also require the industry to engage with the intention of the law rather than focus on technical compliance. Compliance breaches and penalties must not be regarded as part and parcel of doing business. In addition to better leadership within financial firms, improved regulatory settings and a change of approach by regulators would assist.

8. The law governing financial services is undoubtedly complex, necessitated by the complexity and range of the activities across the risk-reward spectrum that it seeks to regulate – a level of complexity and prescription may be inherent and necessary to support effective regulation of the sector. This complexity, however, is also a consequence of the piecemeal evolution of the legal framework. Overtime, as particular issues have emerged, the policy response has taken into consideration the requests by financial firms for greater clarity and certainty of their obligations – leading to additional layers of prescription in the legal framework.

9. An improved financial services law would see the primary law being used — where possible — to set the enduring framework and principles, with rules and regulations that are more easily amended and updated being used to provide more detail where necessary. Co-regulation or self-regulation via industry codes would continue to represent a useful supplementary level of rule-making.

10. The challenge is that meaningful simplification would take time, careful planning, and political will across the Parliament and over the medium term. Moreover, it would rely for its success on cultural change within firms away from technical compliance and towards adherence with the intent of the law. It could also require revisiting substantive policy issues — for example, consideration of the merits of existing exemptions. It will also require the Commission to consider carefully the number and types of recommendations that it makes for specific changes to legislation to support a more principles-based policy framework going forward.

11. The Interim Report does look for a simple, consistent approach in the laws that exist to manage conflicts of interest — particularly in relation to remuneration. The stark conclusion to be drawn from the Interim Report is that where self-interest clashes with duties and consumer outcomes, self-interest, particularly where motivated by financial incentives, will likely win — and that the current systems in place to manage or mitigate such outcomes too often fail.

12. While appealing in its simplicity, blanket bans are not the right answer, even if there is a case for banning or modifying certain forms of remuneration. Not all intermediaries are the same; there are differences between financial advisers and other financial product brokers, and between different product markets, that need to be considered. Any loss of competition or efficiency would ultimately have negative consequences for consumers and the community. The likely benefits of change should exceed the inevitable costs and disruption.

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2 Treasury, *Background Paper 24: Submission on key policy issues* (2018) (*Treasury Policy Submission*), 2.

13. Banning particular forms of remuneration within firms may be equally, if not more, problematic. Any changes, legislative or otherwise, should ensure that firms are required to take more responsibility, not less, for having suitable remuneration practices in place.

14. Boards, executives, shareholders and the wider industry need to address the broader governance, system and cultural failings that the Commission has laid bare. Stronger enforcement of the law and adjustments to remuneration arrangements will assist, but cannot be relied upon alone. Greater accountability is needed from boards and senior executives — to support this, the Commission may wish to consider extending the application of the recently introduced Banking Executive Accountability Regime (BEAR) to other financial services entities, as well as the scope of conduct to which the BEAR applies.

15. Regulator effectiveness should also be considered. For the regulators, their regulatory posture and approach to enforcement is an important issue that they have already begun to revisit. Leadership and adequacy of resources and powers remain vitally important. Action on these is already under way. New members and commissioners have been appointed to the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC), the Government has introduced the industry funding model for ASIC, provided additional resources and has flagged it will actively consider what more may be needed. The Government is also enhancing powers of the financial system regulators — the product intervention powers for ASIC, currently before the Parliament, has the potential to have a significant impact.

16. The Interim Report also asks whether the regulatory architecture should change, inviting scrutiny of both APRA and ASIC's regulatory remit. While some adjustments may be worth considering, including potentially giving ASIC a greater conduct role in superannuation, in our view a clear case for substantially changing the current architecture has not yet been made.

17. In responding to the specific questions asked by the Interim Report, the sections that follow largely address issues that relate to the four key questions discussed above. The issue of responsible lending obligations (RLOs) is also discussed, given the importance of mortgage financing to households and the economy. The submission seeks to build on Treasury's previous Policy Submission, and for some issues we have not repeated what we have said before. For example, on grandfathering of otherwise banned conflicted remuneration, or on the merits of structurally separating advice from financial product manufacturer. The table at Appendix A identifies where questions asked by the Commission in its Interim Report have been addressed in previous Treasury submissions.

SIMPLIFYING THE FINANCIAL SERVICES LAW

18. The Interim Report asks whether the financial services regulatory regime is too complex, and whether it should be radically simplified.

19. Treasury's view is that:

    - The existing financial services law is undeniably complex, reflecting the dynamic and diverse nature of financial services, the existence of numerous and complex products, and the often high stakes, particularly for consumers, given that housing and superannuation are the two biggest assets of Australian households.

    - As noted in the Interim Report, laws are to be obeyed, and ultimately society demands that people be held to account for their misconduct. For that to occur, the law must be both simple enough to understand and certain enough to comply with.

    - While there is a case for improving how the law is designed and maintained over time, it is not the law which has been the principal driver of the misconduct examined by the Commission. It has been the willingness of some industry players to disregard the law and to put their own interests ahead of those to whom they owed a duty.

    - Experience has shown that law reform is a major exercise, and careful planning and sequencing would be required to ensure that attempts to re-write it do not simply add to the problem.

20. We agree with the Commission's view that adding a new layer of law or regulation would add a new layer of compliance cost and complexity.[3] A challenge that the Commission faces is that additional and specific regulation of financial services, of the sort implicit in many of the questions asked by the Interim Report and following the superannuation and insurance hearings, would — if introduced — likely exacerbate the existing problem of legislative complexity.

21. A related but separate matter for policy-makers is what can be done to reduce any unnecessary costs of complying with the financial services law. These costs can take many different forms, such as the additional systems or staff time required in firms, or the need to provide additional information (for example, of detailed expenses) by consumers. Cost reduction and simplification do not always coincide. For example, additional law to assist with the rationalisation of legacy products could reduce costs and improve consumer outcomes, but would likely add to legislative complexity.

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3 FSRC Interim Report, vol. 1, 290.

THE CURRENT LAW IS COMPLEX

22. Australia's financial services law spans multiple statutes and has grown substantially over time, with the development of both the underlying policy positions and the legislative framework being incremental and at times piecemeal.

23. There have also been requests by financial firms, and the legal professionals advising them, for certainty of how laws are to apply. Reflecting these demands and the increased complexity of financial markets and products, the legislative framework has become increasingly tailored for particular segments of the regulated population, resulting in a large number of exceptions, carve-outs or entirely bespoke regimes within the broader legislative framework.

24. Narrowly prescribed law has also been used by part of the regulated population to shift risk by being able to point to a specific exemption or safe harbour, or by relying on literal compliance with the rules instead of complying with their intent.

25. For example, following intense lobbying from financial services firms, policymakers stepped back from a principles-based approach to the best interests duty of a provider of personal financial advice services. As a result, the current law now sets out the duty (subsection 961B(1)), but then also sets out seven steps which if taken treat the duty as having been complied with (subsection 961B(2)). Without that safe harbour, the adviser would be required to make professional judgements about whether advice is in the best interests of the client and be honest in advising the client accordingly. With the safe harbour, advisers may instead be concerned with ensuring they have complied with the various steps rather than acting in the clients' best interest.

26. The stock of these prescriptive rules has grown over time, and the financial services law has become increasingly convoluted, resulting in a legal framework with elements which are disparate, unclear and arguably conflicting. The resulting law is also compendious: the *Corporations Act 2001* (Corporations Act) alone is currently 3579 pages in length; Chapter 7, dealing with financial services, consists of some 891 pages in the Act and 467 pages in the Regulations. On average, the Corporations Act, the *Australian Securities and Investments Commission Act 2001* (ASIC Act) and regulations made under those Acts has grown by 153 pages a year since 2001.

27. In some instances the legislation contains substantial further detail about how the law may be complied with. Other obligations may be found in the regulations, class orders (which may modify the application of the Act or regulations), or conditions which may be imposed on a licence (or similar). There is also an additional layer of regulatory guidance. This provides some necessary flexibility for the law to adapt to changing market circumstances but also adds to complexity.

28. Decisions taken on legislative design — what material is included in primary legislation, regulations, class orders and what should be left to firms and industry to grapple with — has varied over time resulting in inconsistencies in design and a lack of a clearly discernible legislative design philosophy across the law.

COMPLEXITY IS ONLY PART OF THE PROBLEM

29. While the existing law is complex, there is a tendency among those whose behaviour the Commission has criticised to cling to this as an excuse.

30. Complexity and prescription may distract from the underlying principles of the existing law, but those principles still exist, and it is incumbent on the regulated population to comply with the spirit as well as the form of the law.

31. As recognised in the Interim Report, granular prescription has enabled a compliance culture of 'ticking boxes', which can distract from complying with the underlying objectives of the law. Major changes to the risk management approach of boards and management in some firms will be required to correct this.

32. Without significant cultural change and a willingness by the regulated population to engage with the intent of the law, simply reforming the law is unlikely to provide much benefit.

PRINCIPLES OF A NEW LEGAL FRAMEWORK

33. The Interim Report sets out some broad principles that should inform the construction and operation of financial services law.

34. A principles-based approach has many attractions: it promotes simplicity and efficiency by stating the outcomes sought or obligations imposed, but leaves the regulated population free to find the most efficient way of achieving that outcome.

35. At its most fundamental, this principles-based approach requires trusting the regulated population to exercise professional judgement in both the design of compliance processes and in applying the rules to novel or more difficult cases. Boards and management must provide incentives for their staff which encourage good behaviour and discourage misconduct. Risk management processes must evolve beyond a focus merely on the minimum effort required for technical compliance with the letter of the law. Boards and management must ensure that their systems and processes empower and support their staff in exercising professional judgement. And that judgement should consider the legal principle as the floor for action and behaviour, not the ceiling.

36. The Commission has recognised the importance of the role of boards and management in making this transition, and also identified areas where more needs to be done, such as around remuneration.

37. Asking boards, management and staff to exercise professional judgement requires in turn a degree of acceptance that they will sometimes get those judgements wrong. This must be reflected in any regulatory framework supporting the law, as well as regulator and community expectations.

38. A regulatory approach that condemns and punishes even an inadvertent breach of a legislative principle would, over time, discourage market participation and innovation, and also encourage a compliance culture of ticking boxes. To support a principles-based approach, regulators must have the capability, range of powers and necessary flexibility to tailor their responses to the circumstances. Where a mistake may be properly remedied, indifference to the law, negligence or intentional misconduct should be met with proportionate (but increasingly severe) consequences.

39. This need is reflected in the existing legislation, which provides a wide range of tools to the regulators to allow flexibility and discretion as well as providing for a proportionate response.

40. More prescriptive subordinate regulation can support principles-based legislation in situations where there is a clear understanding of the right way to do things or the prohibited forms of conduct such that bright lines can be drawn. This is important for effective regulation and ensuring good outcomes for consumers.

DESIGN OF A NEW LEGAL FRAMEWORK

41. Principles-based regulation requires a commitment from policy-makers to the regulatory architecture. For example, the Corporate Law Economic Reform Program originally intended that the rules governing the conduct of all financial intermediaries 'would be expressed as general legislative principles. Detailed procedures which provide guidance on how the principles will be satisfied may be developed by the regulator and industry associations.'[4]

42. Clearly setting out the policy intent and developing the supporting legislative architecture provides a strong basis for future policy and legislative development, so that any necessary reforms can be developed according to this architecture.

43. The design of a regulatory system that is expected to deal with complex and evolving subject matter should only enshrine in legislation those fundamental ideas and principles that can be expected to endure, informed by a clear policy framework.

44. Primary legislation that is complex and highly prescriptive requires regular updating to ensure it remains fit-for-purpose. Where fundamental policy change is not involved, amendments to legislation made by the Parliament are typically difficult to achieve. Sitting days are limited, and higher priority new policy measures can squeeze out maintenance of existing laws.

45. By contrast, principles are adaptive. They do not require frequent changes to the overarching statute. When a principle is correctly distilled there is little need for ongoing legislative amendments, particularly when contrasted with more prescriptive granular approaches.[5]

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4 Treasury, *Corporate Law Economic Reform Program Proposals for Reform: Paper No. 6* (1997), 99.

5 An example of this style of drafting can be found in the duties which a director owes to a corporation, under sections 180, 181 and 182 of the *Corporations Act 2001*. These principles are adaptive to the full range of activities a director may engage in. The principles have been 'unfolded' by the regulator through extensive guidance and the courts through enforcement.

46. Subsidiary instruments, such as formal regulations, class orders or other binding legislative instruments are more easily maintained or amended and may be used to contain the essential operational detail of the framework. Other forms of non-binding regulation, such as guidance from the regulator, also inform the content of principles-based obligations in the primary law or subordinate law, and can be changed as needed.

47. Ongoing maintenance of such a regulatory regime, conducted with a clear policy and law design framework to guide future development of the regime, is preferable to the infrequent application of a 'new broom'.

IMPLEMENTATION RISKS

48. To re-write and consolidate the existing legislative framework might be desirable, but the experience is that, in practice, it carries risks against which the potential benefits of simplification must be weighed.

49. Even narrowly focused law reform involves considerable costs. For example, businesses' compliance systems may become redundant and need to be replaced. Smaller entities are disproportionately impacted due to their lower ability to absorb costs which has an associated anti-competitive effect. There are unavoidable opportunity costs, such as the impact on businesses of uncertainty from the time of the announced reform until it is well advanced or completed, and unfinished reforms can create further complexity and uncertainty.

50. Historically, large-scale legislative reforms have required substantial resources and time to implement, and have tended to suffer from both significant scope creep and changes in policy intent. They have also involved a considerable call on government and the Parliament. Changes to priorities over time have led to long-term and large-scale reforms being watered down, poorly implemented or simply abandoned part-way through.

51. For example, during the 1990s the Tax Law Improvement Project sought to simplify aspects of the tax law to make it easier to understand. The aim of the Project was limited to improving the expression and structure of the existing law, rather than revisiting any underpinning policy. The process was never completed, and the overall value of changing the drafting of the legislation without allowing any capacity for policy change, however minor, proved limited.

52. Because legislative reform of the scale needed to achieve useful simplification is unlikely to be achieved in the life of a single parliament, it usually requires a commitment from successive governments. Even limiting reform to Chapter 7 of the Corporations Act (often identified as a major source of complexity) may require three to four years of effort, if not more.

53. In any large legislative reform process, aspects of the underlying policy are likely to be contested. Clearly articulated policy settings would be required to ensure any policy reforms are delivered consistently and efficiently.

54. Should such reform be considered desirable, it would therefore be sensible to plan and schedule it over at least the medium-term. To mitigate the risks set out above, further work to identify the areas of greatest opportunity or where the greatest benefits are likely to be gained from simplification would be necessary prior to beginning a reform process.

REFORMING INDUSTRY CODES

55. The Interim Report asks whether industry codes of practice, such as the Banking Code of Practice, should be given legislative recognition and application — or be made by regulation in the manner of the *Competition and Consumer Act 2010* (CCA).

56. Treasury's view is that:

- Financial services codes are intended to be a vehicle for industry to self-regulate and set standards on how to comply with, and exceed, various aspects of the law, however, the current framework for development and enforcement of codes has a number of limitations.

- The Government has accepted in-principle those recommendations of the ASIC Enforcement Review that address many existing limitations of the codes framework, but there may be scope to further enhance enforceability without requiring legislative recognition.

- To continue to enable industry self-regulation while ensuring adequate standards of practice are established, consideration could be given to additional flexible rule-making powers similar to the CCA.

LIMITATIONS TO THE CURRENT CODES FRAMEWORK

57. There are a number of arrangements currently in place for codes that apply in financial services industries and under the CCA. Table 1 provides an overview of the different arrangements that exist, and the model proposed by the ASIC Enforcement Review Taskforce (the Review).

58. The current framework for codes in the financial services industry has a number of limitations:

- *Standards set by the codes may not be adequate* — codes are intended to improve confidence in the relevant industry and to provide a set of best practice guidelines to which participants should adhere.[6] However, the codes set standards at the level which is agreed to by the members of the industry body that owns the code and these may not add much to what the law requires or there may be deficiencies in the standards that are set when viewed from consumers' perspective.

- *Gaps in code subscription* — the benefits of industry codes may not be available to some consumers because not all players in the industry or providing the financial services are code subscribers.

- *Limited monitoring and enforcement of compliance with the codes and consequences for breaches* — codes are not required to meet minimum standards of enforceability as they

6 Commonwealth of Australia, *ASIC Enforcement Review Taskforce Report* (2017) (*ASIC Enforcement Review*), 31.

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are not required to gain ASIC approval, with the effect that compliance may be perceived as aspirational rather than expected.

- *Limited penalties for breaches of the code* — while codes are taken into account where a dispute is lodged with an external dispute resolution body, there are limited sanctions for systemic breaches of the code — weakening their ability to achieve general deterrence.

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Table 1 — Codes of practice in the financial services industry and under the *Competition and Consumer Act 2010*

Code	Mandatory	Content	Monitoring	Consequences of breaches
Financial services codes — 11 codes (pre-ERT)[7]	No	Industry	Code compliance committee/tribunal	• Taken into account in dispute resolution — Banking Code is additionally incorporated into consumer contracts • Sanctions available to code-monitoring body set by the code
Financial services codes (ERT Model)	Yes — for activities/industry prescribed by ASIC	Industry — subject to ASIC approval	Code-monitoring body approved by ASIC	• Taken into account in dispute resolution. ASIC can require code to be incorporated into contracts with consumers • Sanctions available to code-monitoring body set by the code — ASIC approval to consider adequacy of governance arrangements including monitoring and sanctions
ePayments Code	No, but will be mandated[8]	ASIC	ASIC	• Consumers entitled to compensation if non-compliance contributes to an adverse complaint or delay in resolving complaints • ASIC monitors compliance
Code of Ethics for Financial Advisers	Yes	Independent Government body (FASEA)	Monitoring body set out in the ASIC-approved compliance scheme[9]	• Monitoring body can impose sanctions, such as a warning, rectification, financial sanction, and in extreme circumstances revocation of industry association membership. Monitoring body must notify ASIC of any breaches and sanctions imposed • Breaches can also be taken into account in dispute resolution
Competition and Consumer Act mandatory codes — 5 current codes[10]	Yes	ACCC — code must be declared by regulations	ACCC	• Aggrieved parties can follow complaints procedures set by the code including mediation (Franchising, Horticulture, Wheat Codes), dispute resolution (Oil Code), and breach of contract (Horticulture Code) • The ACCC can seek court order for compensation and issue a public warning notice • For civil penalty provisions in a code, the ACCC can issue civil penalties through infringement notices or seek a court-imposed civil penalty
Competition and Consumer Act voluntary codes — Food and Grocery Code	No — opt-in basis	ACCC — code must be declared by regulations	ACCC	• Aggrieved suppliers can seek arbitration or mediation • The ACCC can seek court order for compensation and issue a public warning notice • For civil penalty provisions in a code, the ACCC can issue civil penalties through infringement notices or seek a court-imposed civil penalty

7 The Customer Owned Banking Code of Practice, Financial Planning Association of Australia's Code of Professional Practice, General Insurance Code of Practice, Insurance Brokers Code of Practice, Mortgage and Finance Association's Code of Practice, Australian Collectors and Debt Buyers Association Code of Practice, and Life Insurance Code of Practice are financial services codes that are not ASIC-approved. The Financial Planning Association Professional Ongoing Fees Code and the revised Code of Banking Practice are ASIC-approved.

8 The Government has agreed that ASIC would mandate baseline consumer protections in the ePayments Code, subject to the code being fit for purpose and technologically neutral, in its response to the Financial System Inquiry — this recommendation was reiterated by the Productivity Commission in its report, *Competition in the Australian Financial System* (2018) (*PC Financial System Competition Report*).

9 ASIC has issued guidance on criteria to be used for its approval in *Regulatory Guide 269: Approval and oversight of compliance schemes for financial advisers* (2018).

10 The Franchising Code of Conduct, Horticulture Code of Conduct, Wheat Port Code of Conduct, Oil Code of Conduct, and Unit Pricing Code are prescribed mandatory codes.

ASIC Enforcement Review addresses most but not every issue

59. The Review recommended the creation of an approved codes regime whereby ASIC would have the power to determine the activities, and industry sectors, for which ASIC-approved codes would be required. Entities engaging in activities covered by approved codes would also be required to be a subscriber. These recommendations have been agreed to in-principle by the Government, subject to the Commission's final report.

60. The Review recommendations, if implemented, would provide ASIC with an effective power to address shortcomings in the contents and standards set by the code in the course of the approval process. It would also allow ASIC to act to address any gaps in code subscription.

61. The Commission's hearings into SME lending, remote and regional issues, and insurance have also highlighted that another key failure of the current framework for codes is the absence of real consequences for systemic breaches of the code. The result is that compliance with the code may be seen as optional or aspirational rather than the norm.

62. The Review recommended that the robustness of enforcement provisions should form a key requirement in ASIC's approval process and that approved codes be binding and enforceable against subscribers through both the dispute resolution framework and through contractual arrangements with a code-monitoring body where ASIC considers appropriate. The code contents must also be drafted to be enforceable — ASIC's approval would require the code to set out clear service standards that do more than reiterate the legal obligations.

63. The code administration body would monitor compliance and could refer systemic breaches to ASIC for further investigation (for example, for non-compliance with general licensing obligations), and would be expected to have the ability to sanction subscribers for breaches.[11] The code administration body is chosen by the industry body that owns the code.

Enhancing compliance with codes of practice

64. The Interim Report points, however, to cases of non-compliance with the Code of Banking Practice in particular, and suggests that ASIC should be given power to enforce the provisions of a code akin to the CCA.

65. For codes to be meaningful rather than tokenistic, there needs to be reasonably effective mechanisms in place to ensure adherence. How this is done does, however, raise a much broader question of whether the current industry codes move from a self-regulatory or co-regulatory model to one where (as in the CCA) they are in effect rule-making by the regulator.

66. Currently, and also viewed from the perspective of a more principles-based regulatory framework, as discussed above, self-regulatory or co-regulatory industry codes provide a vehicle for industry to engage with the intent of the law and set itself appropriate and consistent standards for conduct.

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11 ASIC Enforcement Review, Recommendation 22.

67. A number of different arrangements exist to give effect to a code and ensure compliance (as set out in Table 1). Currently a number of codes are monitored by a Code Compliance Committee with the administration and secretariat function provided by an independent team within the Financial Ombudsman Service (FOS) (soon to be replaced by the Australian Financial Complaints Authority (AFCA)).[12]

68. An option to further strengthen oversight of the codes, while maintaining it as a co-regulatory approach, would be for ASIC to also separately approve the code-monitoring arrangements for approved codes — similar to its role in approving code of ethics compliance schemes for financial advisers. This approach would ensure that code compliance bodies have the necessary capability, powers and resources to meaningfully monitor and enforce compliance with the code.

69. Further consideration could also be given to the requirement for a single arrangement for code-monitoring across all approved codes. This approach could enable the monitoring function to leverage economies of scale and provide sight of systemic breaches by firms across different codes — which may indicate a poor overall firm culture. With FOS, and in the near future AFCA, performing the secretariat function for a number of codes, and noting there could be additional synergies with its external dispute resolution function, there may be a case for AFCA to take on this role.

70. Such an approach would entail a greater monitoring function, and require additional resourcing for and otherwise strengthening of the existing secretariat function performed by AFCA, while maintaining the current structure of an independent decision-making committee comprised of industry, consumer, and independent experts for each industry or activity. This could also result in a consolidation of committees where there are overlapping codes, such as in the banking industry.

71. While there are synergies with AFCA's external dispute resolution functions, consideration would need to be given to the potential impact on AFCA's overall functioning — particularly if implemented while AFCA is still in the early stages of operation.

Industry codes could operate alongside rule-making powers

72. The industry codes framework in the CCA is different in its function to that for the financial sector industry codes, as reflected in the 2017 *Industry Codes of Conduct Policy Framework*.[13] Part IVB of the CCA provides the ability to make industry-specific regulations to supplement the economy-wide principles set out in the rest of the Act.

73. The prescribed codes are used by the ACCC to regulate the conduct between industry participants or in dealing with consumers to achieve minimum standards of conduct in an industry where such standards cannot be otherwise achieved. In effect, they represent the exercise of regulation-making power by the ACCC, and not self- or co-regulation.

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12 The Financial Ombudsman Service's Code Compliance and Monitoring team provides the secretariat function for the Banking Code of Practice, the Customer Owned Banking Code of Practice, the General Insurance Code of Practice, the Insurance Broker's Code of Practice, and the Life Insurance Code of Practice.

13 Commonwealth of Australia, *Industry Codes of Conduct Policy Framework* (2017).

74. Of the six existing codes under the CCA, five are mandatory and one is voluntary. Further, currently only the Franchising Code and Horticulture Code contain the highest civil penalties, and only for breaches of certain provisions of those codes deemed to be serious or egregious in nature. The other codes are subject to an infringement notice regime for breaches of civil penalty provisions.[14]

75. Adopting the CCA approach of allowing the regulator to directly enforce the provisions of a code, along with the Review recommendations of ASIC being able to decide where a code is required, mandate membership and approve content, would, however, represent in effect the assumption of a regulation-making power by ASIC.

76. An alternative option that could be considered by the Commission is to separately provide ASIC with a flexible regulation-making power, similar to that in the CCA. Treasury's Policy Submission discussed options for increasing ASIC's rule-making ability.[15] Adopting a model similar to that in the CCA requires consideration of that broader issue, including how widely such a power should be cast and what accountability mechanisms or constraints should accompany it. Such a power could operate alongside existing self-regulatory model for industry codes, with ASIC determining which aspects of the codes should be given legislative recognition.

77. If a flexible rule-making power is provided to ASIC, further consideration would be required to assess whether the ERT recommendations in relation to the codes remain appropriate, given ASIC would potentially have the ability to address separately the issues that motivated them. This may also provide a more flexible mechanism to address circumstances where some industry sectors, for example sectors made up of a large number of diverse players with little shared interest and no strong industry body, may be unable to generate an appropriate code.

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14 The Industry Codes of Conduct Policy Framework provides a useful discussion on which aspects of industry codes may be suitable for legislated standing.

15 Treasury Policy Submission, 35–37.

FIRM REMUNERATION, CULTURE AND GOVERNANCE

78. The Interim Report asks a number of questions about the appropriateness of incentive-based remuneration practices for consumer-facing staff of banks, their managers and senior executives.

79. Treasury's view is that:

- Remuneration practices that enable, if not encourage, an excessively profit-oriented culture are inconsistent with existing regulatory requirements to have adequate arrangements to manage conflicts of interests. The case for change is convincing, including change to the regulatory framework, to ensure that conflicts arising from remuneration are addressed.

- Boards of financial firms have, and must ultimately retain, the responsibility for ensuring that the remuneration practices of the firm are adequate.

- Changes, legislative or otherwise, should ensure that firms and their boards and senior executives are required to take more responsibility, not less, for having suitable remuneration practices in place. The focus should be on implementing policies that increase the effectiveness of governance arrangements and accountability for remuneration rather than prescribing or prohibiting certain remuneration practices.

- The recently implemented BEAR provides an example of a principles-based approach to having firms align incentive-based remuneration with the right behaviours. The systemic poor conduct uncovered by the Commission merits consideration of whether the application of the BEAR should be broadened to other financial sector entities and broader conduct.

80. While the questions in the Interim Report are posed in the context of banking, these questions are equally relevant to other sectors of the financial services industry, if not to other sectors in the economy.

BOARDS SHOULD BE RESPONSIBLE FOR SETTING APPROPRIATE REMUNERATION PRACTICES

81. Boards and senior executives of financial firms have responsibility for ensuring that the remuneration practices of the firm are adequate. Incentive-based remuneration can be set to both reward the right behaviours (conduct, efficiency, performance) and financially punish wrong behaviours after the event.

82. Compensation and related performance management mechanisms, if set appropriately, help signal the importance that financial firms place on acceptable standards of behaviour, including compliance with related laws, regulations and supervisory expectations.

83. The current regulatory framework largely does not prescriptively mandate how firms should or should not remunerate their staff, with the exception of a ban on conflicted remuneration for financial advice, and caps on commissions for sale of certain life insurance products.

84. However, the Interim Report pointedly states that 'all the conduct identified and criticised … was conduct that provided a financial benefit to the individual and entities concerned', concluding that existing remuneration arrangements, and approaches to enforcement and supervision, have been inadequate to overcome conflicts between self-interest and adherence to the law or consumer outcomes.[16]

85. The Interim Report notes that remuneration practices have started to shift away from direct links between remuneration and profit through the adoption of balanced scorecards. However, it also details how the design of such scorecards still often fails to sufficiently weaken the link between sales or profit and remuneration.[17]

86. The findings of the Interim Report highlights that it would be naive to assume that banks would willingly, and expediently, change their remuneration practices across all levels of the organisation to address the risks of continued misconduct without regulatory or supervisory intervention.

87. While the current remuneration practices of prudentially regulated firms are influenced by the standards and guidance issued by APRA, there has been recognition by APRA, and by prudential regulators internationally, that more needs to be done to ensure that remuneration practices set by firms are appropriate.

88. Following the global financial crisis, the initial regulatory focus for prudentially regulated firms concentrated on alignment between remuneration and prudent risk-taking — reflecting the experience of the crisis. More recently, however, there has been recognition that a focus on prudent risk management can fail to adequately monitor and address conduct risks — which are, by their nature, more difficult to measure. There is an increased coalescence of regulatory methodology (primarily by prudential regulators) that seeks to explicitly bring the management of 'conduct risks' within the traditionally financially-focused risk management framework — including the push to better align remuneration to desirable conduct.[18] For example, the Financial Stability Board sets out in its recently updated guidance principles for appropriate remuneration practices that:

- ultimate responsibility for ensuring accountability for misconduct lies with the board;
- boards should set compensation practices that promote ethical behaviour and compliance with laws and conduct standards; and
- senior management should hold management more broadly to account for setting and communicating the right conduct standards.[19]

89. As amply evident from the Commission's work, such a principles-based approach is only likely to be successful where it is supported by strong oversight by regulators empowered with penalties that are too big to be simply viewed as 'the cost of doing business'.

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16 FSRC Interim Report, vol. 1, 301–2.

17 FSRC Interim Report, vol. 1, 308–9.

18 See, for example, the European Banking Authority, *Guidelines on remuneration of sales staff to reduce the risk of mis–selling and resultant conduct costs for firms* (2016) (EBA/GL/2016/06).

19 Financial Stability Board, *Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices, the use of compensation tools to address misconduct risk* (2018).

THE BEAR IS ONE APPROACH TO INCREASE ACCOUNTABILITY

90. The BEAR is one example of a regulatory approach to increasing executive accountability, including for misconduct, and has been described in previous Treasury submissions.

91. Among other things, the BEAR imposes obligations on senior executives and directors to act with honesty and integrity, and with due skill, care and diligence and take steps to prevent matters that adversely impact an entity's prudential standing or reputation. These obligations are deliberately principles-based and require banks to determine the practices and conduct that fall short of these obligations. The regime also requires banks to create clear lines of accountability and register senior executives with key functions with APRA. The BEAR is purposely targeted at the top end of firms: senior executives and directors. The core principle of the BEAR is to hold those with responsibility for running a financial firm to account for failures to meet a firm's obligations.

92. One approach to address the Commission's concerns could be to strengthen the BEAR's focus on remuneration. This could take the form, for example, of requiring a senior executive to have explicit accountability to ensure that remuneration policies and principles set by the board are appropriately cascaded throughout the organisation.[20] Such an approach may prove a more effective means of achieving the intended objectives of the Productivity Commission in recommending the establishment of a Principal Integrity Officer.[21]

93. One further option for addressing the sales-oriented culture across the financial services industry more broadly would be to extend the BEAR. The most obvious step would be to extend it to other entities regulated by APRA. The BEAR could also be extended, as noted in Treasury's Policy Submission, to apply to conduct that has a broader impact than just the entity's prudential standing and reputation. This would ensure that the BEAR could capture the broad range of misconduct identified by the Commission, some of which may not be captured by the current scope of the BEAR.

94. Broadening the scope of conduct to which the BEAR applies would more directly create individual accountabilities for conduct risk. The application to conduct would require ASIC to have responsibility for co-administering the BEAR, and so also require close coordination between regulators.

95. Extending the BEAR to conduct and across the financial sector would be consistent with the approach taken in the United Kingdom and Hong Kong. However, as noted in Treasury's Policy Submission, there are downsides that would need to be considered.[22]

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20 The legislation for the Banking Executive Accountability Regime currently prescribes the human resource function as one of the responsibilities that require an accountable person to be identified and registered. Accountability for ensuring that a board's remuneration policy is appropriately implemented would foreseeably also reside with this function.

21 The Productivity Commission recommended banks appoint a Principal Integrity Officer with responsibility to report to the board, and ultimately ASIC, on remuneration practices, as a mechanism for dealing with conflicted remuneration: see PC Financial System Competition Report, Recommendation 9.2.

22 Treasury Policy Submission, 17–18.

INTERMEDIARIES' REMUNERATION AND DUTIES

96. The Interim Report asks whether intermediaries should be subject to rules generally similar to the conflicted remuneration prohibitions applying to the provision of financial advice and if intermediaries other than financial advisers should owe the consumer a duty to act in that consumer's best interests.

97. Treasury's view is that:

- The conflicted remuneration of intermediaries can result in substantial consumer harm and requires attention in those areas where it remains. However, the conflicted remuneration prohibitions should not automatically apply to all intermediaries. Instead, their application should be considered on a case-by-case basis.

- For mortgage brokers and life insurance brokers, given the potential downsides of an immediate prohibition, consideration could be given to allowing ASIC to first evaluate the effect of recent and current reforms before using its powers to intervene further if needed.

- For mortgage brokers, consideration could be given to introducing a positive duty on brokers to act in the interests of their consumers, with the scope and content of any duty informed by the nature of the service provided and other relevant parts of the regulatory framework.

INTERMEDIARIES NEED TO BE CONSIDERED ON A CASE-BY-CASE BASIS

98. The conflicted remuneration of intermediaries can result in substantial consumer harm and requires attention in those areas where it remains. As reflected in the Interim Report, intermediaries sit in between the provider of a financial product and the consumer, and include introducers or referrers, advisers, and brokers of various sorts.

99. Intermediaries' own interests may conflict with those of the providers and consumers, and — as the Interim Report explains — with the duties they may owe those parties. Only rarely, if at all, can all conflicts be avoided. As noted in Treasury's Policy Submission, when markets function well, commercial practices evolve to try and manage the multiplicity of interests and potential conflicts.

100. The nature of those conflicts, the potential for direct detriment to consumers arising from them, and the indirect effects for markets and consumers will, however, differ by intermediary. Differences will arise from, among other things, the nature of the intermediary's function, their importance and place in the distribution chain, the level of consumer engagement and producer control, and the degree of competition in the relevant market.

101. Hence, while it may be attractive to contemplate simply banning 'conflicted remuneration' across the board for intermediaries on the basis that it will temper misconduct to some degree, the Commission also needs to consider the implications for consumers' access to and the cost of particular financial services, for competition in relevant markets, and for the economy more broadly.

102. What is appropriate, and what will work in practice, is potentially different for each of financial advisers, mortgage brokers, life insurance brokers, and other intermediaries.[23] We would also caution against seeking to simply transpose regulatory frameworks from different jurisdictions, though it is worth considering such examples. Those frameworks are often products of a jurisdiction's regulatory landscape and other features or historical circumstances unique to it.

103. Given their focus in the Interim Report, mortgage and life insurance broking are discussed further below, but other types of brokers would raise different issues again.

Mortgage broking remuneration and duties

104. Mortgage brokers play an important role for consumers in the home loan market by matching consumers' borrowing needs with suitable loan products and assisting consumers through the application process. They also promote competition, which ultimately benefits consumers, by acting as an important distribution channel for smaller lenders, particularly those with fewer branches, and promoting competitive home loan products at the expense of uncompetitive products.

105. In using a broker, the consumer may reasonably expect that the mortgage broker will help them obtain a loan that is competitively priced, has features that they would find useful in their circumstances, and that they can afford to repay. When compared to the financial advice relationship, the mortgage broker and client relationship is much narrower. A consumer will seek the services of a mortgage broker for the purchase of a specific financial product and for a limited purpose, such as obtaining a loan to buy a home, refinancing a mortgage on their existing home or refinancing for another personal purpose. As a consequence, the potential conflicts are more limited than for financial advice, notwithstanding the significance of mortgages to consumers.

Nature of conflicts in the mortgage broking

106. The mortgage broking commission model can create conflicts of interest that can lead to poor consumer outcomes.

107. Probably the most noteworthy of these — and one that was evident in the hearings — is that a broker's receipt of a commission depends on a successful loan application. This creates an incentive for a broker to take steps to ensure the loan is approved, even where doing so would not meet responsible lending and other obligations. It is analogous to the incentive a financial adviser faces to not recommend 'doing nothing'. However, this conflict would also arise were payment of a non-value-based upfront fee (if still dependent on a successful application) to replace current value-based upfront and trail commissions; indeed, the conflicts could be worsened absent existing claw-back mechanisms and trail commissions as the broker does not stand to lose the fee received if the loan ceases to perform.

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23 Oxera, *Regulating remuneration systems: effective distribution of financial products* (2015) https://www.oxera.com/publications/regulating-remuneration-systems-effective-distribution-of-financial-products/.

108. The current value-based commission structures can also provide an incentive to brokers to recommend a loan that is larger than needed and particular lenders or loan types if they will pay a higher commission. However, the strength of these incentives, particularly with the phasing out of volume and campaign commissions, and other changes being implemented by industry such as commission only being paid on funds drawn down, appears generally much weaker than the conflict above or the conflicts that motivated bans of conflicted remuneration for financial advisers.[24]

Potential for consumer detriment

109. As noted by the Interim Report, ASIC's 2017 *Review of mortgage broker remuneration* report found that consumers who acquire a loan through a mortgage broker have (on average): loans with higher loan-to-value ratios (LVR); larger loans in dollar terms and more interest-only loans; and an increased likelihood of falling into arrears.[25] It is not clear if borrowers seeking loans with these characteristics are more likely to use brokers, or whether brokers 'nudge' borrowers into loans with these characteristics.

110. Treasury's Policy Submission noted that the differences identified by ASIC in its mortgage-broking review do not *prima facie* appear so large that they provide compelling evidence of major problems that require a wholesale change to the existing standard commission structure.[26] ASIC's report, likewise, did not recommend the removal of value-based commissions altogether.

111. ASIC observed that some types of incentives, such as volume and campaign-based commissions, posed higher risks than others.[27] ASIC proposed that industry move away from these forms of remuneration and the Combined Industry Forum has recently indicated that its members have ended these payments.[28] Commissions only being paid on drawn down amounts and amounts that do not take into account offset balances will also address issues identified by ASIC that can lead to the creation of larger loans.[29]

112. While the Interim Report places considerable weight on the findings of ASIC's report as evidence of harm from value-based commissions *alone*, ASIC's findings reflect those other aspects of the commission structure that have been or are being phased out. ASIC also noted that the timing of data collected for its report meant that other measures that have been taken by regulators to improve industry standards, including for brokers, are not reflected in its findings.[30]

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24 ASIC's review into mortgage broker remuneration found that consumers going through broker channels obtained loans with higher loan–to–value ratios, typically between 1 and 4 per cent: see ASIC, *Report 516: Review of mortgage broker remuneration* (2017) (*ASIC Report 516*), 14. This means that for a $500,000 loan, a mortgage broker's *additional* upfront commission based on this higher LVR would be around $26 to $104 on a typical upfront commission rate of 0.54 per cent.

25 ASIC Report 516, 14 and 16.

26 Treasury Policy Submission, 59.

27 ASIC Report 516, 11.

28 Combined Industry Forum, 'No more volume–based bonuses for mortgage brokers' (Media Release, 28 August 2018) <http://www.customerownedbanking.asn.au/media–a–resources/media–release–alerts/1295–combined–industry–forum–media–release–no–more–volume–based–bonuses–for–mortgage–brokers>.

29 ASIC Report 516, 24 and 79.

30 ASIC Report 516, 6.

113. ASIC was also unable to determine following its review whether consumers who used a mortgage broker were subject to poorer consumer outcomes as, ultimately, this depends on whether the loan meets the consumer's requirements and objectives.[31] For example, there may be circumstances, such as when a young person seeks to acquire their first home, where it is in their interests to borrow an amount which results in a high LVR and is required to be paid off over a longer period of time. Such an outcome cannot simply be presumed to be inconsistent with RLOs; nor can it always be characterised as a conflict of interest.

Indirect effects for markets and consumers

114. Removing the ability of lenders to pay commissions to mortgage brokers would require brokers to charge consumers an upfront fee for the service provided. Although payment of the upfront fee should, in time, be offset by a reduction in other loan costs, estimates of what consumers may be willing to *directly* pay a broker, of no more than $1000, are well below the average value of commissions currently paid by lenders.[32] The Productivity Commission's report into competition in the financial system also concluded that if consumers were required to pay for the services provided by mortgage brokers, this would be unlikely to be pro-competitive.[33] Removing commissions could, therefore, threaten the competitiveness of the mortgage broker distribution channel.

115. If mortgage broking activity diminishes, this could have a significant detrimental impact on competition in the mortgage market.[34] The potential beneficiaries of any lessening of competition would be the major banks with established branch networks.

116. As the above factors demonstrate, at this stage it is not clear that mortgage brokers should be subject to the conflicted remuneration prohibitions. While the variety of mortgage broker remuneration models around the world suggests that current arrangements in Australia should not be seen as set in stone, and the Netherland's approach of moving to upfront non-value-based charges by brokers and direct lenders may merit further consideration, the costs of change and risks of unintended consequences also need to be factored in.

117. As suggested in Treasury's Policy Submission, it is worth considering flexible and less prescriptive approaches. The Product Intervention Power, currently before Parliament, will enable ASIC to intervene in this area to target aspects of remuneration structures if ASIC finds that there has been, or is likely to be, significant consumer detriment. Further, imposing an additional duty on mortgage brokers, may also help address a number of the conflicts that have the potential to create poor consumer outcomes.

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31 ASIC Report 516, 14.
32 Treasury Policy Submission, 62.
33 PC Financial System Competition Report, 333.
34 Treasury Policy Submission, 56.

Additional obligations for mortgage brokers

118. As identified in Treasury's Policy Submission, given brokers act as trusted advisers for consumers with respect to housing finance, consideration could be given to introducing a positive duty on brokers to act in the interests of their consumers.[35] Rather than replicating the duty imposed on other intermediaries, such as financial advisers, the scope and content of any duty should be informed by the nature of the service provided and other relevant parts of the regulatory framework, for example, RLOs and the implied warranties provisions of the ASIC Act.[36] It should also reflect an appropriate legislative architecture (as discussed in the section on simplifying the financial services law).

LIFE INSURANCE BROKING REMUNERATION

119. With effect from 1 January 2018, the conflicted remuneration prohibitions were amended in their application to certain life insurance products. These changes did not ban the payment of conflicted remuneration entirely. Instead, they phased-down the maximum upfront percentage of the premium allowed to be paid as a commission to 60 per cent from 1 January 2020 and set a maximum rate of 20 per cent for ongoing trailing commissions. The reforms also require clawback of 100 per cent of the upfront commission if the policy lapses in the first year and 60 per cent of the upfront commission if it lapses in the second year.[37]

120. The Interim Report asks why the continued payment of commissions to intermediaries who sell life insurance should be allowed. It also asks what evidence there is to show that the costs of doing away with commissions would outweigh the benefits of improving the quality of advice.[38] In considering these questions, it is again important — as for mortgage brokers — to consider the nature of the conflicts, the potential for consumer detriment and the indirect effects for markets and consumers.

Nature of conflicts

121. ASIC's 2014 *Review of retail life insurance advice* found that for life insurance distributed under personal advice models, advisers were typically paid under commission arrangements. It identified that upfront commission models, which are the dominant model for distributing life insurance products, can create an incentive for advisers to: write new business; increase the sum insured or the level of cover; and replace a client's existing product.[39] The *Review of Retail Life Insurance Advice* (Trowbridge Review) came to a similar conclusion.[40]

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35 Treasury Policy Submission, 63.
36 Section 12ED of the *Australian Securities and Investments Commission Act 2001* (*ASIC Act*).
37 *Corporations Amendment (Life Insurance Remuneration Arrangements) Act 2017*.
38 FSRC Interim Report, vol. 1, 97–98.
39 ASIC, *Report 413: Review of retail life insurance advice* (2014) (*ASIC Report 413*), 24–26.
40 John Trowbridge, *Review of Retail Life Insurance Advice: Final Report* (2015) (*Trowbridge Review*), 22.

Potential for consumer detriment

122. The incentives created by an upfront commission model can affect the quality of advice consumers receive. As part of its review, which was finalised in July 2014, ASIC assessed the quality of personal financial advice provided to consumers about life insurance products. The review found that in 37 per cent of cases, consumers received advice that failed to meet the relevant legal standard. It also found that where an adviser was paid under an upfront commission model, this had a statistically significant bearing on the likelihood of the adviser giving advice that did not comply with the law.[41] ASIC's report also identified that policies distributed under an upfront commission model lapsed at higher rates than other remuneration models.[42]

123. Where a broker fails to provide appropriate advice to their clients, this can lead to consumers acquiring products that have inferior policy terms, paying more for an equivalent amount of cover, and having claims denied where they previously had cover. The nature of life insurance means where these outcomes occur, they can have a considerable impact on an individual.[43]

Indirect effects for markets and consumers

124. The main argument in favour of moving immediately to a complete ban on commissions is that it will remove entirely the potential for remuneration to bias the advice provided to the client along the lines described above.

125. However, neither the Financial System Inquiry nor the Trowbridge Review recommended removing commissions entirely. This was because of a concern that removing commissions could adversely affect the life insurance distribution channel if providers left the market, making it more difficult for consumers to obtain suitable life insurance advice.[44]

126. Removing commissions and requiring consumers to pay upfront for advice in relation to life insurance products could result in consumers not purchasing life insurance products. This would result in further under-insurance in circumstances where consumers are already often not independently motivated to purchase life insurance products.[45] Although the majority of individuals hold life insurance through a group arrangement, such as their superannuation fund, these arrangements can provide more limited cover and may not be a substitute for consumers who wish to purchase life insurance tailored to their individual needs and circumstances.[46]

127. It could also result in more consumers purchasing through non-advised or direct channels, which have fewer consumer protections and where there is evidence that consumers are having poorer outcomes through high lapse rates and unsuccessful claims.[47] The Interim Report has also brought out the problems that can exist for these types of distribution channels.[48]

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41 ASIC Report 413, 40–42.
42 ASIC Report 413, 38.
43 ASIC Report 413, 5 and 54.
44 Commonwealth of Australia, *Financial System Inquiry: Final Report* (2014) (*FSI Final Report*), 220; Trowbridge Review, 26.
45 FSI Final Report, 219.
46 ASIC, *Report 498: Life insurance claims: An industry review* (2016) (*ASIC Report 498*), 34–35.
47 ASIC, *Report 587: The sale of direct life insurance* (2018) (*ASIC Report 587*), 7.
48 For example, the sale of add–on insurance: FSRC Interim Report, vol. 2, 51–64.

The net benefit from banning life commissions is currently unclear

128. The remaining upfront commission payments still have the potential to lead to misaligned incentives and poor consumer outcomes. However, at this time, having regard to the indirect effects described and that the impacts of the reforms that commenced only this year are not yet observable, consideration could be given to allowing time for these changes to take effect. Also relevant is the fact that industry is still adjusting its business models in line with the legislated phase-down in commissions and moving to an immediate (and unexpected) ban would have a disruptive impact.

129. The Government has committed to an ASIC review of the sector in 2021 to assess whether the reforms have better aligned the interests of advisers and consumers, and whether further reforms are required. Of note, the legislation empowers ASIC to vary the level of permissible commissions in the future, including down to zero.

FINANCIAL ADVISERS: INDIVIDUAL LICENSING AND COMPENSATION

130. The Interim Report asks what is gained by the current regulatory structure which allows licensees to authorise individuals to provide financial services on their behalf and whether there would be advantages in individually licensing financial advisers and bringing them under ASIC's direct supervision. The Interim Report also asks whether there ought to be a mechanism for compensation of last resort.

131. Treasury's view is that:

- There have been significant failures by financial services licensees to supervise those operating under their licences, and the regulator has to take suitable action against the licensees for their failings. The regulatory framework has failed to prevent advisers who engaged in poor conduct from moving between licensees.

- When combined with increased ASIC enforcement, recent reforms, along with any other recommendations the Commission may make, have the potential to provide an appropriate response to address these issues, even if some reforms will require time to take effect. Licensing of individual advisers as well as firms could help further address these problems, though the additional costs may outweigh the benefits. The licensing of advisers only, and not entities, could impose significant costs on advisers.

- If individual licensing is adopted, the recommendations of the *2017 Review of the Financial* System *External Dispute Resolution and Complaints Framework* (EDR Review), including those related to a compensation scheme of last resort, require further consideration.

THE CURRENT LICENSING FRAMEWORK HAS BENEFITS AND FAILINGS

132. As discussed in Treasury's submission following the financial advice hearings, the current licensing framework — which imposes the obligation to hold a licence at the entity level, rather than on the individual financial adviser — is intended to both require and incentivise the licensee to maintain a level of supervision of its representatives' activities. It also seeks to ensure that regulatory resources are more effectively targeted. Recent changes have seen a significant move towards increasing the responsibilities of individual advisers by directly imposing obligations on them, while retaining legal obligations at the entity level. In this regard, the current framework already incorporates many aspects of dual licensing.

133. For the current framework to work effectively, licensees must meet their legal obligations and supervise their representatives' activities. The Interim Report provides numerous examples of where this has not occurred. Evidence before the Commission has demonstrated that licensees have been making decisions on how much to invest in supervision having regard to potential consequences for themselves, which have been limited, rather than their consumers, which have been significant.

134. Additionally, the Interim Report finds that there is a lack of information-sharing between financial services licensees, disciplinary bodies and ASIC which can mean that individual advisers who engage in poor conduct can move easily between licensees.

135. Further factors, unrelated to the licensing framework, that have contributed to poor quality advice received by clients have been the lack of professional standards and the conflicts of interests arising from some of the business models operated by advisers. These have been discussed in the Treasury's Policy Submission.[49]

REFORMS TO ADDRESS THE FAILINGS ARE UNDERWAY

136. Reforms currently underway, coupled with additional enforcement by the regulator, should result in firms increasing investment in compliance and supervision. Reforms that should increase incentives for firms to better monitor the conduct of individual advisers include increasing the level of civil penalties (including by basing penalties on turnover, or benefits gained or losses avoided) for breaches of the law and enhancing ASIC's power to ban individuals from managing financial firms, in line with recommendations of the ASIC Enforcement Review. Additionally, the BEAR — depending on whether and how it was extended to financial advice firms — could increase accountability for senior executives with regard to monitoring and supervision of individual advisers.

137. While increased supervision and monitoring of advisers would impose costs, there is also scope for technology to assist licensees in more effectively supervising their advisers, for example, by enhancing the ability to store and audit advice provided by an individual adviser.[50] In addition, the professional standards reforms will raise the standards of and impose minimum entry requirements to become a financial adviser, and improve the disciplinary processes of financial advisers, although it will take time for the reforms to have their full effect. The requirements to belong to an ASIC-approved code-monitoring body, the prohibition on an adviser changing code-monitoring schemes while under investigation, and mandatory reporting of breaches by a monitoring body to ASIC and the adviser's licensee, should reduce the incidence of advisers who engage in poor conduct moving between licensees.

INDIVIDUAL LICENSING HAS COSTS AS WELL AS BENEFITS

138. An alternative to the current licensing framework would be the individual licensing of advisers, either under a dual licensing system where both the entity and individual are licensed, or a system in which only the individual is licensed.

49 Treasury Policy Submission, 45–46.
50 Westpac, *Round 2 hearings submission to the FSRC* (2018), 14.

Dual licensing has potential advantages but may not deliver net benefits

139. One model for a dual licensing system would involve all financial advisers being individually licensed by ASIC. This would increase ASIC's ability to ensure that only appropriate individuals become (and remain) financial advisers. However, it would also impose considerable costs on advisers and on ASIC, which would be required to vet each individual adviser, both at the stage of approving the licence and through an ongoing monitoring and enforcement role. This could add sizeable regulatory costs to the system if it is to be a meaningful process. Those costs would be passed through to individual advisers (including ASIC's costs via its industry funding model), potentially deterring new entrants, and ultimately increasing the cost of advice for consumers.

140. Another model for dual licensing that has been put forward is for the licensing and supervision of individual advisers to be undertaken by a body separate to ASIC.[51] Such a body, with a singular remit and dedicated resources would provide greater focus on monitoring and supervision – potentially leading to more timely disciplinary action. However, some of the factors that can contribute to disciplinary action taking time (for example, the need to substantiate the complaint and ensure natural justice is provided) would remain under a separate regulatory body.

141. Further, as Treasury has previously identified, if the Commission were to consider a move to dual licensing, consideration would need to be given to which obligations should be imposed at which licence level, and what resources would be required for regulating each licence level.[52] It would be important to ensure that entities are not able to hand over responsibility of the actions of its employees and accountability for actions that they have control of (for example, planning software or advice templates) and that consumers affected by misconduct still have legal recourse against entities with sufficient financial resources to pay claims.

142. Overall, while dual-licensing merits consideration, it is not clear that the benefits outweigh the costs, particularly given the reforms currently underway.

Removing entity licensing may not improve outcomes

143. Another type of individual licensing model is one where only the financial adviser is licensed. Entity licensing would be removed altogether and responsibility for the provision of financial services would rest solely on the individual adviser.

144. An argument typically put forward in support of this model is that it would increase the individual accountability of advisers. However, as noted above, advisers are already subject to a number of personal legal obligations and sanctions, including civil penalties and banning orders, and the professional standards requirements will further increase individual accountability. One area where advisers are not currently personally liable is with regard to remediating consumers for poor advice. Transferring the remediation obligation to advisers would enhance their personal accountability but would also necessitate consideration of alternative mechanisms to provide for consumer redress (discussed below).

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51 Westpac, *Round 2 hearings submission to the FSRC* (2018), 25.

52 Treasury, *Round 2 hearings submission to the FSRC* (2018), 14

145. The removal of entity licensing would also result in a reduction in the intensity of supervision of financial advisers by firms, as they would no longer be required to oversee the conduct of their representatives. This would remove an important layer of supervision of advisers that, notwithstanding has had some failings to date, could be made more effective and which firms should have a real long-term interest in making work. While a regulatory body would have an enhanced role in licensing the individual adviser, it would not be a substitute for the ongoing monitoring and supervision that a licensee, acting properly, should provide.

146. Individual licensing also has the potential to impose significant costs on individual advisers where they are required to comply with the general licensing obligations. For example, the costs associated with being appropriately trained, ensuring compliance with the law, having adequate professional indemnity insurance and being a member of the Australian Financial Complaints Authority. Another implication would be that the obligation to remediate the consumer for failure to properly provide services would fall on the individual adviser. A lack of 'deep pockets' compared with a firm would be one of the major drawbacks of this model of individual licensing, and require the development of an alternative approach to redress.

Adopting individual licensing would have implications for compensation schemes

147. In September 2017, the EDR Review Panel provided its Supplementary Final Report to Government.[53] The EDR Review recommended a forward looking, limited and carefully targeted compensation scheme of last resort (CSLR) be established, restricted initially to financial advice. The review also recommended design features of such a scheme. The Government has deferred its consideration of the Supplementary Final Report until the Commission's final report.

148. The EDR Review took the view that both the Corporations Act and the *National Consumer Credit Protection Act 2009* (NCCP Act) impose obligations on licensees to have arrangements in place for providing compensation where certain losses occur. As a result, consumers (including small businesses) have the reasonable expectation that they will be compensated for such losses.

149. The Review found that the current system — which requires firms (other than prudentially regulated firms) to have in place adequate arrangements for compensation largely through professional indemnity insurance (PII) — does not adequately ensure that such losses are always compensated. However, the costs to competition and access to financial advice for consumers to address these shortcomings would be significant.[54]

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53 Commonwealth of Australia, *Supplementary Final Report: Review of the Financial System External Dispute Resolution and Complaints Framework* (2017) (*EDR Review*).

54 Firms may fail to compensate losses due to, for example, potential misalignment between policy coverage and the causes of the loss, or due to firms having insufficient financial resources to meet excess requirements for tier policy where multiple losses require compensating. Additionally, the review also took into account that PII is a product to insure the firm against losses, not the consumer, therefore consumers do not have direct recourse to a payment made to the firm from a PII policy.

150. While moral hazard was raised as a potential risk, the EDR Review found that there was no evidence to substantiate that establishing a CSLR would result in consumers changing behaviour to have less regard to potential losses due to such a scheme being established.[55] The EDR Review considered that existing limited schemes with respect to parts of the financial sector were operating successfully and they also noted that the United Kingdom has a single comprehensive compensation scheme covering its financial services sector.[56]

151. The EDR Review recommendations for a CSLR were made in the context of licensing obligations — including the recommendation that the obligation to provide compensation apply to the licensee rather than the individual adviser — and of large prudentially regulated firms with deep pockets standing behind a large segment of the adviser population. These settings mean that only a small number of entities have failed, and would be expected to fail, to meet their compensation obligations.

152. However, the risk of more than a small number of failures would be expected to increase should there be a greater proportion of advisers not operating under licences of large firms. This could arise either as a result of a shift to individual licensing or — to a lesser extent — an acceleration of the current trend towards advisers operating under their own licences.

153. The increased risk of failure to meet compensation obligations may be mitigated, to some extent, by increased professionalisation within the sector, but is unlikely to be completely offset. Accordingly, the recommended design of a CSLR — and in particular the way in which such a scheme would be funded — would require reconsideration.

55 EDR Review, 49–50.
56 EDR Review, 48.

RESPONSIBLE LENDING OBLIGATIONS

154. The Interim Report asks whether the test applied by the lender to satisfy RLOs should remain as 'not unsuitable' and how lenders should assess suitability (in particular for home loans).

155. Treasury's view is that:

- Recent years have seen a significant strengthening of banks' assessments of loan serviceability in mortgage lending due to action by ASIC and APRA, which is relevant to evaluating the effectiveness of RLOs.

- It is reasonable for lenders to take into account costs when assessing suitability for the purposes of complying with the law, and these assessments should evolve to reflect the availability of data, technological advances and other regulatory changes.

- Further changes to RLOs could negatively affect credit availability, with consequences for the economy and for households. These impacts should not, however, be overstated.

'NOT UNSUITABLE' REMAINS THE RIGHT STANDARD FOR THE RLOS

156. The RLOs in the NCCP Act came into effect on 1 July 2010, establishing the requirement that a credit licensee must assess whether the provision of credit is unsuitable or not. As with any new regulatory regime, there has been a period following its introduction where industry has worked to embed the requirements and regulators have provided additional guidance to clarify the operation of the law.

157. The Commission has identified evidence of conduct failing to meet these obligations, and lenders have been too slow to take on board their RLOs. However, from 2014 onwards, there has been a significant focus on mortgage lending practices and standards by both ASIC and APRA that has resulted in substantially improved assessments being conducted by banks in relation to mortgage lending which has led to more responsible lending.[57]

158. Action taken by the regulators to improve compliance with RLOs and improve serviceability standards has been wide-ranging, and includes:

- ASIC revised its regulatory guidance on *RG 209 Credit licensing: Responsible lending conduct* (RG 209) in 2014 and issued an information sheet, *Responsible lending disclosure obligations* (INFO 146) setting out credit disclosure obligations under the NCCP Act. ASIC has announced

57 Reserve Bank of Australia, *Financial Stability Review* (October 2018) (*Financial Stability Review October 2018*); Wayne Byres, 'Preparing for a rainy day' (Speech delivered at an Australian Business Economists lunchtime briefing and discussion, Sydney, 11 July 2018) <https://www.apra.gov.au/media–centre/speeches/preparing–rainy–day>.

its intention to review RG 209 next year.[58] ASIC is also conducting a review into interest only home loans.[59]

- APRA has standardised many elements of mortgage loan assessments bringing tighter standards and greater consistency to authorised deposit-taking institutions (ADI) through its *Prudential Practice Guide APG 223 — Residential Mortgage Lending* (APG 223) — most recently reviewed in 2017. APG 223 sets out, for example, that ADI's serviceability criteria should include (amongst others):

  – consideration of any existing and ongoing debt commitments (both secured and unsecured), interest rates and outstanding principal on such debt and any evidence of delinquency;

  – various buffers and adjustments in its serviceability assessment model to reflect potential increases in mortgage interest rates, increases in a borrower's living expenses and decreases in a borrower's income, particularly for less stable income sources;

  – applying a buffer of the higher of at least 2 per cent over the loan's interest rate or a floor of 7 per cent to assess the serviceability of the borrower to ensure that potential increases in interest rates do not adversely affect a borrower's capacity to repay a loan; and

  – for interest-only loans, to assess the ability of the borrower to meet future repayments on a principal and interest basis for the specific term over which the principal and interest repayments apply, excluding the interest-only period.

159. ASIC is also taking enforcement action against Westpac, which will assist to clarify what kind of conduct will be in breach of the RLOs.[60] The courts are considering the matter and the outcome is likely to give further indications of what behaviour is expected.

160. While minimum expense benchmarks (such as the Household Expenditure Measure (HEM)) have been overused, this is now generally being corrected, and serviceability assessments take into account a much broader suite of considerations and apply considerable buffers to determine what level of credit is suitable.[61]

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58 ASIC, *ASIC's Corporate Plan 2018–2022: Focus 2018–19* (2018), 14.

59 ASIC, '17-341MR ASIC update on interest-only home loans' (Media Release, 11 October 2017) <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2017-releases/17-341mr-asic-update-on-interest-only-home-loans/>.

60 ASIC, '18-255MR Westpac admits to breaching responsible <lending obligations when providing home loans and a $35 million civil penalty' (Media Release, 4 September 2018) <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2018-releases/18-255mr-westpac-admits-to-breaching-responsible-lending-obligations-when-providing-home-loans-and-a-35-million-civil-penalty/>. This matter is still under consideration – Justice Perram conducted a further hearing on 24 October 2018 and has adjourned the matter while he considers the issue.

61 Wayne Byres, 'Preparing for a rainy day' (Speech delivered at an Australian Business Economists lunchtime briefing and discussion, Sydney, 11 July 2018) <https://www.apra.gov.au/media–centre/speeches/preparing–rainy–day>.

161. There has been less focus on lending practices in the other areas where the Commission has identified shortcomings in meeting RLOs — for example, car finance, credit card limits and overdrafts. In these areas of credit provision, continued effective action by regulators, rather than a change to the NCCP Act, would generally appear to be appropriate.

162. The separate question of whether the legal requirement for RLOs should remain as 'not unsuitable' or be strengthened raises the issue of whether consumers should expect less of themselves, and more of lenders, when arranging a mortgage in particular. It is not obvious that they should. The current competition and consumer protection regulatory framework is built on the presumption that consumers ought to be able to choose which lender they wish to approach for a loan and what type of loan they would like. If a consumer wants advice about this choice, they can go to a mortgage broker — and it is reasonable to consider, as the Interim Report does, what should be asked of brokers in providing that advice.

163. For other types of credit, additional specific consumer protections can also apply when judged necessary. For example, from 1 January 2019 credit card providers will be required to conduct affordability assessments based on a consumer's ability to repay the credit limit within a period specified by ASIC, (which ASIC has specified as three years), and existing requirements for small amount credit contracts require lenders to obtain and review 90 days of bank account statements before granting a loan.[62]

Reasonable inquiries for suitability should evolve with changes in technology, data and regulatory guidance

164. The inclusion of specific prescriptive rules in the law setting out how suitability ought to be assessed, for example concerning household expenditure benchmarks, may not be desirable. Such an approach would not easily accommodate changes in the availability of data and technology. Such changes should influence what are reasonable inquiries or steps under the NCCP Act and, over time, can be expected to result in an increase in the substantive requirements of the RLOs. In this context, two recent regulatory developments are noteworthy:

- The recent adoption of comprehensive credit reporting (CCR) by the four major banks will begin to give lenders greater visibility of borrowers' other credit facilities, including credit cards. This will assist lenders to more accurately consider individual consumers' debt commitments and potential related expenses.

- The pending introduction of an open banking regime from 1 July 2019 will give consumers the right to access and share their personal banking data with approved third parties. Similar to CCR, open banking should provide lenders with greater ability to accurately assess consumers' expenses and circumstances in an efficient manner.[63]

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62 See the *National Consumer Credit Protection Act* 2009; *Treasury Laws Amendment (Banking Measures No. 1) Act 2018*, Schedule 5 and *ASIC Credit (Unsuitability-Credit Cards) Instrument 2018/753,* section 5.

63 All major banks will make data available on credit and debit cards, deposits and transactions by 1 July 2019 and on mortgages by 1 February 2019. Data on all other products recommended by the Open Banking Review will be available by 1 July 2020. All other banks will make data available with a 12 month delay.

165. Reflecting that suitability is continuing, and should continue, to evolve to reflect broader developments, it may be unhelpful to set in a prescriptive manner what a lender should do to assess suitability. There should be an expectation that, where system-wide changes such as CCR and open banking occurs that enable lenders to undertake more granular assessments, credit providers should reflect such changes in how they approach assessment of suitability.

166. While it is appropriate to expect firms to adopt such technology, consideration will be necessary to take into account that such changes, while beneficial in the long run, may come with implementation costs and so take time to be adopted by all firms.

167. Expectations on the use of new and emerging technology and standards would most appropriately be set by the use of regulatory guidance, and all the evidence is that the regulators have been active in providing such guidance.[64]

168. Given the continued efforts by regulators to ensure that RLOs and sensible lending standards are applied properly by lenders, there does not appear to be a strong case for change to the current RLOs. Improvements to the availability of data to lenders and technological changes are likely to naturally strengthen what is reasonably required by a lender to meet their RLOs.

Changing obligations may affect credit availability but broader impacts should not be overstated

169. More broadly, Treasury notes that there has been public discussion of the impact of potential changes to RLOs (whether through changes to how the existing obligations are applied in practice or to the legal obligation) for the availability of credit for consumers and the economy more broadly. As these economy-wide impacts are a relevant factor for the Commission to consider in making any recommendations, an overview of the issues is provided below.

170. Changes in lending standards can have implications for credit availability and have distributional effects.

171. If lending standards were to be tightened further, households or businesses that are the most credit-worthy would be expected to continue to have good access to funding, though at the margin some borrowers will fail to meet the higher standards of creditworthiness and will have more restricted access to credit. Depending on the magnitude of the changes, tightening standards, assuming it does not result in a substantial shift of activity to less regulated (non-bank) lenders, would at the margin restrict the overall supply of credit and have flow-on effects for the economy.

64 For example, APRA has commented on the need for banks to make significant improvements to IT systems in order to be able to use comprehensive credit reporting.

172. The price and availability of credit is important for the economy. Across all sectors credit facilitates investment and consumption, by both providing a mechanism to fund expenditure and by reducing uncertainty through mitigating the effects of idiosyncratic shocks on income. If working efficiently, financial intermediation by banks and non-bank firms channels funds to the most productive and valued investments and consequently boosts economic activity in both the short and long run. In the case of consumer lending, the efficient allocation of credit requires, among other things, lenders to discriminate between more and less resilient consumers. There is a strong alignment between the lending practices required to ensure credit is allocated efficiently and to meet RLOs.

173. Given the relationship between credit availability and macroeconomic performance, the value of a sound and trusted system of credit provision cannot be overstated. As has been demonstrated by recent experience in a range of countries, lax lending standards and poor credit allocation that boost economic activity in the short term can come at the cost of longer-term performance when a segment of borrowers fail to perform.

174. There is little evidence to suggest that the recent tightening in credit standards, including through APRA's prudential measures or the actions taken by ASIC in respect of RLOs, has materially affected the overall availability of credit.[65] However, the composition of credit within the mortgage market has changed, with investor credit growth slowing substantially, while owner occupied credit growth has only slowed a little. Further, to the extent that firms are correcting lax credit assessment practices, there has likely been an improvement in the credit quality of marginal borrowers.

175. For the Commission in arriving at its recommendations, and then for Government in responding to those recommendations, it will be important to take into account the effects of credit availability on economic activity in both the short and long run. In considering these effects, the Commission could be mindful of three dimensions that will bear on the macroeconomic impact of any changes to the RLOs or their application:

- Will the changes improve lenders' allocation of credit in favour of more resilient borrowers (that is, will the changes improve the *efficiency* of credit allocation)?
- What will be the cost implication for lenders and how will this be passed on to borrowers (the *price* impact)?
- How many borrowers are likely to lose access to credit as a result of the changes (what will be the *volume* impact)?

176. Answering these questions is not straightforward. Nonetheless, a number of initial observations appear relevant:

- The Commission's findings that some lenders have not consistently undertaken reasonable inquiries to verify the financial position of potential borrowers, suggests that not all possible information (including quality of information) relevant for differentiating between the quality of borrowers has been fully utilised across the industry. This suggests that,

65 Financial Stability Review October 2018, 32–36.

particularly with the application of additional technology and data already in train, current reforms should result in some improvement in the efficiency of credit decisions.

- It is not possible to be precise as to how particular changes in lending standards would flow through to consumers as more expensive credit. Nonetheless, changes at the margin are likely to result in only small changes to the overall cost of credit products relative to the effect of other factors, such as banks' funding costs, that affect the price of credit.

- Analysis by the Reserve Bank indicates that in the case of the mortgage market most borrowers comfortably meet existing serviceability criteria and in effect borrow well below the maximum loan size available given their capacity to meet repayments.[66] A small minority of borrowers are at or above these thresholds. The majority of the market would thus be unaffected by a modest tightening in standards but a segment of the market would be at risk of having the size of their loans reduced. In practice, this is likely to mean that for marginal borrowers access to credit will be delayed as they will be required to take additional time to build a larger deposit of their own funds to make a purchase.

177. Overall, these considerations suggest that the housing market has the capacity to absorb some adjustment in the application of lending standards necessary to meet the requirements of existing RLOs without imposing unwarranted risks to macroeconomic outcomes. At the margin, changes in the availability of credit will have an impact on economic activity. For this reason the calibration and timing of any adjustments would need to be carefully managed. But appropriately managed, ensuring the industry consistently meets the requirements of existing laws will likely enhance rather than detract from macroeconomic performance.

66 Reserve Bank of Australia, *Minutes of the Monetary Policy Meeting of the Reserve Bank Board* (2 October 2018) <https://www.rba.gov.au/monetary-policy/rba-board-minutes/2018/2018-10-02.html>.

REGULATORY ARCHITECTURE AND REGULATOR EFFECTIVENESS

178. The Interim Report asks if the regulatory architecture should change. In particular, it asks if ASIC's remit is too large, and if it were to be reduced, who should take over those parts of the remit that are detached and why would that be a better arrangement overall. It also asks whether some tasks would be better detached from APRA, and raises questions about ASIC's approach to enforcement.

179. Treasury's view is that:

- There is a strong rationale for retaining the twin peaks structure: conduct and prudential regulation involve necessarily different functions that are most efficiently met when they are the responsibility of separate but mutually supporting regulators.
- Changing ASIC's existing remit should not be done lightly, as improvements to effectiveness can be achieved in other ways and measures have recently been, or are being, implemented that do so.
- In the context of the Commission and financial services, the functions that should be kept together are those that go to the integrity of the market for financial services: administering the necessary licensing regimes for financial services (including consumer credit); ensuring consumers are protected from harm associated with inappropriate products and contracts; enabling consumers' access to redress via dispute resolution and compensation; and enforcing the relevant law.
- Changes to ASIC's approach to enforcement to make it more court-based would need to be balanced against the resources available to both it and the court system, and should ensure that ASIC retains the flexibility to respond proportionately to breaches of the law.

THE TWIN PEAKS MODEL REMAINS APPROPRIATE

180. Any adjustment of the regulatory architecture should begin with consideration of whether Australia's 'twin peaks' model of financial regulation — where responsibility for conduct and disclosure regulation lies with one regulator (ASIC) and responsibility for prudential regulation with another (APRA) — should be retained. The twin peaks model considers regulation from two different regulatory angles, rather than dividing regulation along industry or product lines. As noted in Treasury's Policy Submission, that model has served the financial system and economy well and remains appropriate.[67] It has also been adopted by a number of other countries.[68]

67 Treasury Policy Submission, 21.

68 International Monetary Fund (IMF), Financial Sector Assessment Program (FSAP) Update*, Kingdom of The Netherlands Financial Sector Supervision: The Twin Peaks Model* Technical Note (2011), 6–7.

181. Conduct and prudential regulation necessarily have different purposes. Prudential regulation, with its focus on firm and industry-wide resilience, requires a more intensive supervisory approach and a focus (though not singular one) on financial risks. Conduct regulation focuses on consumer protection and market conduct, and has to be applied to a far larger and diverse regulated population. Such differences require different skills and capabilities, and different regulatory approaches to matters such as supervision and enforcement. As a consequence, prudential and conduct functions are best carried out by separate regulators; an agency with both functions risks favouring one regulatory approach at the expense of the other.

182. As noted in Treasury's submission in response to the questions arising from the superannuation hearings, one option for addressing the regulatory issues identified in that context would be to give ASIC greater conduct responsibilities in superannuation and allow APRA to focus on prudentially-related matters. This would represent a closer alignment with the twin peaks model.

THE FUNCTIONS OF A FINANCIAL SERVICES CONDUCT REGULATOR

183. ASIC is Australia's integrated corporate, markets, financial services regulator. In filling these roles, ASIC carries out a number of complementary functions. The 2014 Financial System Inquiry pointed to synergies between ASIC's existing functions, which would be lost if those functions were to be moved to other agencies, though synergies among some of those functions are arguably less marked than for others.[69]

184. In the context of financial services, the functions that are core to the conduct regulator under the twin peaks model — and that should be kept together — are those which go to the integrity of those markets: administering the necessary licensing regimes for financial services; preventing consumer detriment from inappropriate products and contracts; enabling consumers' access to redress via dispute resolution and compensation; and enforcing the relevant law. It would be less efficient and involve higher risk if these functions were to be dealt with by separate regulators. The value of keeping the above functions together should be borne in mind if considering, as suggested in the media, whether ASIC's responsibility for consumer protection in financial services should be transferred to the ACCC.[70]

185. ASIC also has responsibility for financial market regulation and corporation regulation. There are benefits that arise from the regulator for financial services also having regulatory responsibility for markets, and to some extent corporations — not least because the same regulator is responsible for the oversight of the issuance of certain financial products such as securities and derivatives, as well as for the protection of the investors and consumers who buy them. There are synergies also, for example, in the regulation of market intermediaries such as stockbrokers, supervision of market infrastructure providers and oversight of listed corporations, as well as reviewing the raising of funds and disclosure.

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69 FSI Final Report, 235.

70 Peter Martin, ''Benefit of hindsight': ASIC may have been wrong body to protect consumers', *Sydney Morning Herald*, (24 April 2018), <https://www.smh.com.au/politics/federal/benefit-of-hindsight-asic-may-have-been-wrong-body-to-protect-consumers-20180424-p4zbec.html>.

186. Other responsibilities are less central to ASIC's regulatory functions and not reflected in the remits of many comparable regulators internationally. When ASIC no longer has a significant registry role, as is currently planned, the utility in a single regulator having such wide responsibilities and the continued operational advantages of some of its current functions may be less evident.

REMIT IS ONLY ONE ELEMENT OF REGULATOR EFFECTIVENESS

187. Remit is only one of a suite of factors which impact the effectiveness of a regulator. Experienced and capable staff, access to adequate powers and penalties, adequate and reliable funding, and a robust regulatory culture are other key drivers of effectiveness.

188. The Interim Report has rightly highlighted the voluminous and complex nature of the legislation for which ASIC is responsible and on which it has to provide guidance, and how these have grown over time.[71] But the impact of the breadth of remit on a regulator is largely a function of its leadership and resourcing (including staffing). With strong leadership and adequate resources (including staff), a broad remit is not a problem. If some responsibilities are shifted from ASIC to another agency then the overall resource demand is largely unchanged — only the allocation of the resources has changed.

189. However, any shift in responsibilities between bodies would have a transitional cost (including the risk of loss of experienced staff and the need for systems in the new agency to be updated to accommodate the new responsibilities), may impose additional coordination costs, involve a period of regulatory uncertainty and could require substantial legislative change.

THE GOVERNMENT IS ADDRESSING REGULATOR EFFECTIVENESS

190. As noted in previous Treasury submissions, the Government has recently taken a number of actions to improve regulator effectiveness. These have included steps to add resources at senior leadership levels of ASIC and APRA, improve their powers and relevant penalties, and increase funding and flexibility in the use of resources for ASIC in particular. The Government has also renewed the Statement of Expectations for both regulators to make them clearer and more strategic.[72]

191. These changes will assist the regulators, in particular ASIC, respond to the issues raised for them by the Commission. Both ASIC and APRA have indicated that they are reconsidering their enforcement approach in light of the current Commission.[73]

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71 FSRC Interim Report, vol. 1, 294.

72 ASIC responded with its Statement of Intent on 8 August 2018 setting out its regulatory mission to (among other things) act against misconduct to maintain trust and integrity in the financial system.

73 James Shipton, Opening Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 19 October 2018, <https://asic.gov.au/about-asic/news-centre/speeches/parliamentary-joint-committee-on-corporations-and-financial-services-opening-statement-asic-chair-james-shipton-19-october-2018/>. Wayne Byres, Opening Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 25 October 2018, <https://www.apra.gov.au/media-centre/speeches/opening-statement-25-october-2018>. John Price, 'ASIC's strategic focus and key priorities over the next year: Improving conduct and restoring trust' (Speech delivered at the Risk Management Association Annual Chief Risk Officer Conference 2018, Melbourne, 4 September 2018).

APPROACHES TO ENFORCEMENT

192. The Interim Report suggests that ASIC's starting point for enforcement should be aligned with that of the prosecution agencies of the federal, state and territory governments, and states that its starting point should be '…whether it can make a case that there has been a breach and, if it can, then ask why it would not be in the public interest to bring proceedings to penalise the breach'.[74]

193. Treasury notes that on one reading, this appears to advocate for a variation on the two-stage test adopted in the Commonwealth Director of Public Prosecutions' (CDPP) *Prosecutions Policy of the Commonwealth*, which is based on having sufficient evidence to prosecute and determining that it ***is*** in the public interest to commence proceedings.[75]

194. That said, and as the Interim Report correctly points out, litigation is a powerful tool for a regulator. The case for strategically bringing criminal and civil cases, both to punish misconduct and to send a message to the market, including one of deterrence, is a strong one. Court action can also be used to settle uncertainty as to the breadth and operation of particular provisions.

195. At the same time, ASIC has responsibility for licensing as well as for enforcing the law, and regulators with licensing responsibility are expected to use a range of regulatory and enforcement tools to set operational boundaries and influence licensee behaviour. A greater focus on litigation does not remove the need for the regulator to retain a wide range of tools and have the discretion to use them to ensure a proportional response to breaches of the law.

196. Litigation necessarily imposes heavy demands on the regulator's resources including specialist staff, evidence collection and retention, counsel costs, provision for adverse costs orders. As the Interim Report acknowledges, litigation, particularly corporate litigation, is time consuming, expensive and technically challenging.[76] All actions will also not be successful, and community understanding and acceptance that an effective regulator will not win all court actions is important.

197. Litigation can also be a slow process, particularly for complex cases, and the courts already have a substantial workload. ASIC reporting indicates that for matters resulting from ASIC investigations, the average time from the commencement of civil proceedings to their conclusion has increased from 15 months in 2013-14 to 27 months in 2016-17.[77] For criminal actions over the same period, the time has doubled, from 22 months to 44 months.

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74 FSRC Interim Report, vol. 1, 277. See also FSRC Interim Report, vol. 1, 280.

75 Commonwealth Director of Public Prosecutions, *Prosecution Policy of the Commonwealth*, https://www.cdpp.gov.au/prosecution-process/prosecution-policy.

76 For example, ASIC's proceedings against the executive directors of Storm Financial Ltd ran over a total period of 7.5 years; 29 interlocutory hearings were conducted prior to the trial: <https://storm.asic.gov.au/proceedings/summary-of-asic-actions/>; <https://storm.asic.gov.au/proceedings/cassimatis-civil-penalty-proceeding/>.

77 ASIC, *Annual Report 2016–17*, 41. When ASIC's time to investigate is factored in, in 2016–17, it could take a total of 51 months (over four years) from investigation to resolution for civil matters, or 66 months (five and a half years) for criminal actions.

198. Both the specific and general deterrence effects of court judgements are substantially weakened by such lengthy delays in the outcome of proceedings, and public denunciation loses much of its sting with the passage of time. An increase to this workload without adequate resourcing would place further strain on the courts (and the CDPP) which may then require commensurate increases in resources to mitigate the risk of regulatory bottlenecks and push case times out even further.

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OVERSEEING THE REGULATORS

199. The Interim Report also asked whether there should be annual reviews of the regulators' performance against their mandate.

200. Treasury's view is that:

- The existing oversight of the regulators is extensive, but is focused on governance and accountability rather than regulators' effectiveness in deterring or addressing misconduct.

- Annual reviews of regulator performance may not improve regulatory effectiveness, and risk merely adding another accountability mechanism.

- There could be benefit from periodic expert reviews of the regulators' capabilities and effectiveness in addressing misconduct and consumer protection matters.

THE REGULATORS ARE HELD ACCOUNTABLE IN MULTIPLE WAYS

201. Independent regulators wield considerable power, and it is only appropriate that they are held accountable for the use of their powers, that suitable checks and balances are in place, and that there is appropriate external oversight to ensure accountability and transparency.

202. As outlined in Treasury's Policy Submission, there is already considerable oversight of the regulators and they are held accountable in many ways.[78]

203. Both APRA and ASIC are subject to the governance and accountability requirements of the *Public Governance, Performance and Accountability Act 2013* (PGPA Act), the Regulator Performance Framework (RPF) and their respective acts.[79] ASIC and APRA table their annual performance and financial statements in Parliament, and conduct annual self-assessments against a range of outcomes-based key performance indicators. APRA and ASIC can also be subject to performance audits by the Australian National Audit Office in addition to their annual financial audits.

204. While the regulators are independent, there is a level of ministerial accountability through ministerial directions powers (though these are very rarely used, given the need to respect regulator independence), the Statement of Expectations and regular bilateral meetings between regulators and the relevant minister. House and Senate Committees on Economics and the Senate Estimates process provide parliamentary oversight, and ASIC in particular comes under further scrutiny from the Parliamentary Joint Committee on Corporations and Financial Services under Section 243 of the ASIC Act.

205. Where appropriate, both APRA and ASIC's decisions are appealable in court or the Administrative Appeals Tribunal, and both regulators' actions are within the jurisdiction of the Commonwealth Ombudsman.

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78 Treasury Policy Submission, 33–34.

79 The *Australian Prudential Regulatory Authority Act 1998* and the ASIC Act.

206. ASIC has additional transparency and accountability obligations under its industry funding model, including consulting with industry on strategic risks and its annual corporate plan to inform its resource allocation and focus. Similarly, APRA has an industry funding model and corresponding transparency and accountability obligations.

EXISTING OVERSIGHT IS NOT ENFORCEMENT-FOCUSED

207. Most of the bodies currently overseeing ASIC and APRA also oversee a wide range of other regulators and organisations. The metrics used to assess performance, like expenditure, apply across all agencies assessed. Typically, the focus is on governance structures and resource use, and not the regulators' strategic choices or an in-depth consideration of their overall performance.

208. While some of the existing accountability mechanisms can be used to assess or question performance, to the extent that it happens, it is typically ad hoc or narrowly cast. For example, Senate or Parliamentary committees may allow for cross-examination of regulators about their enforcement, but tend to do so through the lens of individual cases rather than systemically and only on the basis of public information. Hence, while these bodies and mechanisms provide effective accountability in a number of respects, they are not structured or resourced to provide thorough or systematic assessments of performance in meeting their mandate.

209. Measuring a financial system regulator's effectiveness is, in any case, difficult. The difficulty is heightened by the complexity of the regulatory framework and is reflected in the challenge of identifying meaningful metrics; testing against the same criteria over time shows only relative changes in outcomes, and international comparisons are rarely like-for-like.

210. In the case of ASIC, assessing its effectiveness in deterring and preventing misconduct is inherently difficult; it is hard to measure misconduct not committed. For APRA, prudential outcomes can appear positive until there is a financial crisis or major one-off event; while other parts of its mandate, such as taking account of competition, can involve trade-offs.

Another oversight body may double up on existing accountability mechanisms

211. As noted in the Interim Report, the Financial System Inquiry recommended the establishment of the Financial Regulator Assessment Board (FRAB) consisting of between five and seven part-time members with industry and regulatory experience who would consult extensively with industry and consumer stakeholders.

212. The purpose of the FRAB was to examine how well a regulator had balanced different parts of its mandate (for example, competition over other objectives), allocated resources and responded to strategic challenges, and used particular powers (the proposed product intervention power, in particular). Assessing the effectiveness of regulatory posture was not suggested.

213. As the Inquiry itself noted, increasing the already-large quantity of oversight will not necessarily lead to better overall performance but could add to the administrative burden borne by the regulator.[80]

80 FSI Final Report, 243.

214. More regular and intensive oversight can also risk compromising the independence and internal governance of the regulators. Annual reviews provide very little time between each review cycle for the regulators to implement and entrench any recommended changes. They also increase administrative costs, potentially substantially, and encourage symbolic 'box ticking' to meet a diverse range of obligations and recommendations — precisely part of the problem which already bedevils the regulated population.

215. On the other hand, irregular or ad hoc reviews with the potential for dissimilar terms of reference, conflicting or competing perspectives, measures of performance, or recommendations can have their own problems. When such reviews occur close together, regulators may still be trying to implement the recommendations of the previous review when directed to do something else.

OTHER OVERSIGHT MECHANISMS

216. In its response to the Financial System Inquiry, the Government agreed to periodic consideration of regulators' capabilities, potentially tied to a three year funding model.[81] Periodic in-depth reviews of performance and capability have the potential to provide useful assessments of a regulator's effectiveness overall or in particular areas, and improve its capabilities over time if done properly.

217. The IMF's five-yearly Financial Sector Assessment Program (FSAP) covers both ASIC and APRA, and while it does not examine the regulators' approach to addressing misconduct, it does examine the comprehensiveness of a regulator's enforcement powers and illustrates the characteristics of the sort of regular and in-depth review that can provide a thorough assessment of regulators' effectiveness and identify where capabilities can be improved.[82] While demanding and testing for regulators, it is also valued by them.

218. The FSAP process involves periodic review against consistent metrics and international benchmarks; employs (international) reviewers with deep expertise and experience in the field; has independence from government, industry and the regulator; is distant from regulators' day-to-day oversight and operation; seeks to provide a comprehensive review of capabilities and performance, taking into account strategy, governance and operations; and has an ability to focus narrowly but deeply on particular aspects of a regulator's performance as required.

219. A similar review program akin to an FSAP that was aimed at regulators' performance, capabilities and effectiveness in relation to conduct and consumer protection may, if it could be established with the assistance of relevant foreign agencies or organisations, be worthwhile. Given the significance of conduct issues in other advanced economies and their regulators, and for a number of international organisations, there could be scope to set-up periodic reviews and assessments along these lines.

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81 Commonwealth of Australia, *Improving Australia's Financial System*, Government Response to the Financial System Inquiry, 23.

82 The IMF is conducting an FSAP review of Australia in 2018. The report is due to be presented to the IMF Board for approval in early 2019.

APPENDIX A: INTERIM REPORT QUESTIONS PREVIOUSLY ADDRESSED BY TREASURY

Table 1: Financial Advice

Interim Report Question	Previous Treasury submission
Can conflicts of interest and duty be managed?	Submission on financial advice hearings pages 3–7 Submission on key policy issues pages 41–55 Submission on superannuation hearings pages 9–17
How far can, and how far should, there be separation between providing financial advice and manufacture or sale of financial products?	Submission on financial advice hearings pages 6–7 Submission on key policy issues pages 42–48 Submission on superannuation hearings page 17
Should the grandfathered exceptions to the conflicted remuneration provisions now be changed?	Submission on key policy issues pages 44–45 Submission on superannuation hearings pages 10–12

Table 2: Regulation and the regulators

Interim Report Question	Previous Treasury submission
If the recommendations of the Enforcement Review are implemented, will ASIC have enough and appropriate regulatory tools?	Submission on key policy issues page 29 Submission on financial advice hearings pages 11–13
Are APRA's regulatory practices satisfactory? If not, how should they be changed?	Submission on key policy issues pages 29–31 Submission on superannuation hearings pages 27–28
Are ASIC's enforcement practices satisfactory? If not, how should they be changed?	Submission on key policy issues pages 27–29

Table 3: Entities: Causes of misconduct

Interim Report Question	Previous Treasury submission
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?	Submission on key policy issues pages 17–19
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?	Submission on SME lending hearings pages 5–7

APPENDIX B: FUNDING FOR REGULATORY ACTIVITIES

1. The Interim Report contains budget figures for APRA, ASIC and ACCC drawn from the Portfolio Budget Statements (PBS) showing the total funding for each year for each regulator.[83] For a number of reasons, these total figures are greater than the amount which the Government provides to fund regulatory activities each year.

2. The PBS figures for APRA includes a significant amount of administered funding due to Private Health Insurance Industry risk equalization receipts, which are by law, redistributed to industry.

3. The PBS figures for ASIC includes funds related to the administration of unclaimed monies under the *Banking Act 1959*, *Life Insurance Act 1995* and *Corporations Act 2001*.

4. Entities are also able to carry out regulatory activities using remaining funds from previous years, and these are also reflected in the PBS figures.

5. To assist the Commission, Table 2 sets out the amounts that the Government has provided regulators to conduct their regulatory activities in each year. Average staffing figures are also included for the same reason.

Table 2: Government allocated funds: APRA, ASIC and ACCC

Funding ($'000)	2016–17	2017–18	2018–19
Australian Securities and Investments Commission	402,393	428,365[84]	380,434
Australian Competition and Consumer Commission	181,617	226,754	217,570
Australian Prudential Regulation Authority	129,744	144,012	145,552
Average Staffing Levels	**2016–17**	**2017–18**	**2018–19**
Australian Securities and Investments Commission	1,640	1,726	1,719
Australian Competition and Consumer Commission	772	874	909
Australian Prudential Regulation Authority	606	607	642

Source: ACCC, APRA, ASIC and Treasury

6. On 7 August 2018, the Government also announced additional funding of $70.1 million for ASIC over two years from 2018–19. This additional funding is not included in the 2018–19 figure for ASIC. The availability of this funding will be subject to the passage of the relevant appropriation bills following the 2018–19 Mid–Year Economic and Fiscal Outlook.

83 Financial Services Royal Commission, *Interim Report* (2018), vol. 1, 107.

84 The increase in funding between 2016–17 and 2017–18 relates to higher than budgeted awards of costs in ASIC's favour as a result of legal proceedings.