ROYAL COMMISSION INTO MISCONDUCT IN THE BANKING, SUPERANNUATION AND FINANCIAL SERVICES INDUSTRY

SUBMISSIONS OF THE AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION CONSUMER FINANCE

1. The Australian Securities and Investments Commission (**ASIC**) makes the following submissions in response to certain of the questions identified by the Commissioner and by Counsel Assisting as arising out of the case studies considered during the Royal Commission's first round of hearings, concerning:

   (a) Remuneration Structures;

   (b) Credit Cards and Transparency;

   (c) Breach Reporting;

   (d) Remediation; and

   (e) General Conduct obligations.

2. ASIC has identified aspects of its regulatory experience that it considers may assist the Royal Commission to answer the questions raised. ASIC has also identified features of a good financial services industry – that is, one that is efficient, resilient and fair[1] - in order to assist the Royal Commission with its deliberations. In the context of consumer credit, central among those features are that:

   (a) financial products do what they say they do, and that their design and the manner of their distribution and sale does not take advantage of consumer biases or lack of knowledge about the product;

   (b) mistakes and harm caused to consumers by breaches of the law and by conduct falling below community expectations, are rectified and remediated quickly and effectively;

   (c) the regulatory regime acts as a credible deterrent, including by giving strong powers to regulators to address both misconduct and consumer detriment.

[1] The 2014 Financial Services Inquiry led by David Murray stated that the ultimate purpose of a financial system is to facilitate growth in the economy by meeting the financial needs of its users. It found that to successfully perform this function, a financial system must be efficient, resilient and fair.

<u>Remuneration structures</u>

Conflicts

3. Counsel Assisting have asked in substance whether volume-based remuneration and incentive structures for lender employees, mortgage brokers and car dealers create an unacceptable risk that those persons will prioritise sales over legal obligations to consumers, or lead to poor consumer outcomes.[2]

4. ASIC has long recognised that conflicted remuneration is a misaligned incentive that can and does create a supply-side driver of poor conduct.

5. In March 2017 the Government published the findings of ASIC's *Review of Mortgage Broker Remuneration*[3] (**Report 516**), the object of which was to determine the effect of current remuneration structures on the quality of consumer outcomes. ASIC found that brokers almost universally receive commissions paid by the supply side of the market and that a standard commission model, made up of an upfront and a trail commission, is found across all remuneration structures.[4] Brokers are also paid bonus commissions and lenders' staff are paid bonus payments. That model creates conflicts of interest in two primary ways. First, the broker may recommend a product or strategy to maximise their commission (a product strategy conflict). Second, the broker may recommend a particular lender because they will receive a higher commission from that lender (a lender choice conflict).

6. ASIC also found that rewards and incentives provided by lenders in the form of variable compensation or bonus payments played a significant role in driving conduct by affecting the priorities of lenders' staff, which in turn affects an entity's culture, encouraging and reinforcing particular conduct.[5]

7. Those conflicts can, and in ASIC's experience do (as documented in Report 516), result in misconduct and poor consumer outcomes. In the consumer credit market,

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[2] T976.15-23; T982.1-10; T986.36-44; RCD.9999.0003.0001 at .0013 [41(b)]; RCD.9999.0003.0001 at .0016 [55(b)]. The questions are said to arise from the NAB Introducer case study, the CBA Brokers case study, the Westpac car loans case study and AHL Broker fraud case study.

[3] Report 516

[4] See Report 516 at [26].

[5] Report 516 at [936].

consumers' biases or lack of understanding about financial products reduce their ability to place demand-side pressure on financial services entities, for example by choosing financial products that are better aligned with their own interests or by switching financial products or financial service providers. As a result, these misaligned incentives on the supply-side of the transaction have substantial space to influence the conduct of financial services entities, their employees and representatives.

8. Misaligned incentives can cause poor consumer outcomes due to their type, structure and quantum. For mortgage brokers, ASIC found that some types of misaligned incentives created an unacceptable risk of poor consumer outcomes – such as bonus commissions (including volume-based commissions) and bonus payments. This is why ASIC proposed in Report 516 that industry move away from these types of incentives. ASIC also proposed that the structure of the standard commission model for brokers be improved to reduce the risk that brokers will encourage consumers to borrow more than necessary (by having lenders pay upfront commission based on the net amount borrowed rather than the gross amount borrowed).

9. In Report 516 ASIC also observed that the quantum of remuneration paid to referrers who operate under a statutory exemption which significantly limits their role, may give them an incentive to do more than is permitted under the exemption (such as assisting the consumer to apply for the loan – which is not allowed under the exemption) to ensure that the loan application is successful and they receive their commission.

10. ASIC considers that the evidence in the first round of hearings of the Royal Commission is consistent with the findings and conclusions expressed in its Report 516. Indeed, evidence was given to the Royal Commission on behalf of the banks, recognising that incentive structures contributed to the problems emerging in the evidence. The evidence also revealed that conflicts and poor consumer outcomes of

the kind found by ASIC in Report 516 emerged in the context of lender employees and car dealers.[6]

11. ASIC has recognised that brokers have an important role to play in the home loan market. In a well-performing market, brokers can help match consumers with an appropriate product, help consumers navigate the application process and improve consumer understanding generally. Brokers can also contribute to competition among lenders. However, remuneration structures can inhibit the consumer and competition benefits that can be achieved by brokers.[7]

12. ASIC also found poor practices by lenders and their representatives in the car finance industry, especially around 'flex commissions' and add-on insurance products.[8]

13. Based on these findings in different parts of the credit industry, ASIC's position is that certain volume-based remuneration structures generate conflicts of interest that create an unacceptable risk of poor consumer outcomes. In particular ASIC has identified the following as unacceptable:

    a) Flex commissions in the car dealer channel; and

    b) Soft dollar payments and volume bonuses in the mortgage broking channel (although ASIC cannot unilaterally prohibit these payments).

14. In relation to *other* forms of volume-based remuneration in the credit sector, ASIC has signalled that relevant industries be provided with opportunities to improve current structures so as to assess whether positive consumer outcomes can be consistent with certain conflicted remuneration models. For example, ASIC has suggested that the 'standard commission' model in the mortgage broking industry be improved so that it is not solely related to loan size, and that an industry review be conducted within 3 years to assess whether this model is consistent with better consumer outcomes (and to test the impact of the removal of soft dollar and volume bonuses).

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[6] See, eg, T84.45 – T85.23, T124.15-30, T153.42-46 (Waldron XN); T240.6-26, T241.36-40, T262.17-22 (Huggins XXN); T425.26-29 (Boddy XXN); .44-45-T178.1-40 (Waldron XXN); T753.4-29, T 754.5-26, T755.12-45, T778.8-27 (Godkin XXN); T818.20-44, T818.20-44, T820.24-38 (Mendelson XXN); exhibit 1.158 - Witness Statement of Michael Saadat (WIT.0001.0003.0001) at [10-[19].

[7] Report 516 at [20]-[22].

[8] See the evidence of Michael Saadat, exhibit 1.158 (WIT.0001.0003.0001)

15. When considering whether the degree of risk arising from conflicted remuneration is *unacceptable*, ASIC suggests one marker of unacceptable risk is that it cannot be meaningfully or consistently managed by compliance measures and monitoring programs.

16. In this connection it has been ASIC's experience that disclosure alone is not an effective means of dealing with the risks created by conflicts of interest in remuneration structures, as is does not sufficiently alter either supplier or consumer behaviour, and thus does not prevent poor consumer outcomes. The conflicts embedded in remuneration can be particularly difficult for consumers to understand: for example, consumers would face very significant difficulties trying to weigh up the impact of different forms of soft dollar benefits provided by different lenders to brokers. Moreover, in the financial services context, the adverse impact of conflicts is real. This is why ASIC had advocated the removal of certain volume-based remuneration as unacceptable, rather than relying on disclosure to address the associated risks.

Flat fees

17. Counsel Assisting have asked whether upfront and trail commissions should be replaced with flat fee payments by lenders to brokers. ASIC notes that the regulator in the Netherlands has implemented flat fee remuneration arrangements (where the flat fee is paid by the consumer to the broker),[9] as ASIC understands it, without undermining the existence of a healthy mortgage broker sector.

18. A flat fee (paid by the lender to the broker) would appear to avoid product strategy conflict, decoupling the size of the commission or payment from the size of the loan removes the incentive to recommend larger loans. In so far as one lender might offer a larger flat fee than another lender, the possibility of lender choice conflict remains. Furthermore, where flat fees are applied, fee-disclosure has the potential to be more effective, because comparisons between competing products may be more readily made (as the current commission-based remuneration structure, which includes contingent volume-based commissions, lacks sufficient transparency).

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[9] Report 516 at [222].

19. ASIC's view is that any reforms considered for this area should take into account how a shift to a fee-for-service model might affect:

    (a) the mortgage broker market - such as market consolidation;

    (b) the broader mortgage loan industry - such as change in dynamics between smaller and larger lenders, market concentration, and contestability; and

    (c) consumers - including consumer access, choice of products and services, and consumer decision making.

20. ASIC notes that the Productivity Commission is considering this issue as part of its current inquiry into competition in the financial services industry.[10]

CIF reforms

21. Counsel Assisting have asked whether the program of reforms in the mortgage broking industry announced by the Combined Industry Forum (**CIF**) in 2017 will ameliorate the conflicts of interest that Counsel Assisting have identified. Among other things, the CIF response to ASIC's Report 516 recognises the potential for volume-based commissions and bonus-payments paid to brokers and aggregators to put good consumer outcomes at risk, and recognises ASIC's expectation that the industry moves away from those commission and payment structures.[11] ASIC considers that the program represents a positive step by the industry towards addressing the concerns raised in ASIC's Report 516. It is of note that the CIF included a representative of consumer advocates.

22. Whether or not these industry-led changes will be sufficient remains to be seen. ASIC also notes that the Productivity Commission is examining mortgage broker remuneration in its inquiry into competition in the Australian financial system.[12] The Productivity Commission's draft report recommends that mortgage aggregators owned by lenders be required to act in the best interests of customers.[13] ASIC remains supportive of continued strengthening of standards across the mortgage

[10] Report 516 at [222]

[11] CIF Response to ASIC Report 516, p13-14

broking industry, and considers that higher standards should apply to all mortgage broking businesses (regardless of ownership structure).

23. ASIC is currently conducting a shadow shop of mortgage brokers to better understand the consumer experience when purchasing home loans. While remuneration practices may have an impact on home loan choice, ASIC recognises that a range of other factors can influence home loan product choice and that the purchase experience may vary across channels. The research objectives are to:

    (a) identify what factors, beyond commission, can affect how consumers purchase home loans and which products they purchase;

    (b) identify the critical events in the purchase process and understand key inputs and decision-making criteria at critical events; and

    (c) understand how consumer behaviour may be influenced during the loan purchase process.

24. The intention of the shadow shop is to follow actual consumers through their home loan purchase journey (including both loans purchased via brokers and direct from lenders). ASIC expects to have the results of the shadow shop by the end of 2018 or early 2019. The results of this will inform ASIC's regulatory work, including its advice to Government on whether law reform is required.

Overcoming impediments to structural reform

25. Counsel Assisting have asked whether the “first mover” issue discussed in the CBA’s evidence[14] is a genuine commercial impediment to change in respect of broker remuneration and if so, what can be done to overcome it.

26. ASIC considers that collective action problems can, at times, make industry-wide reforms difficult for industry participants to achieve, and may therefore require regulatory action. In particular, in markets with complex products and information

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[12] See http://www.pc.gov.au/inquiries/current/financial-system#report.

[13] Productivity Commission Draft Report, *Competition in the Australian Financial System* (January 2018) at 30, 35, 104, 228 <accessible at http://www.pc.gov.au/inquiries/current/financial-system/draft/financial-system-draft.pdf.

[14] T982.4-7.

asymmetry between suppliers and consumers, collective action problems can arise in respect of long-standing remuneration structures that prevent a single lender or intermediary moving away from conduct that leads to poor consumer outcomes. Collective actions problems are structural, including where consumers choosing between competing complex products cannot discern when a first-mover has made a change that benefits them and as a result, the first mover does not obtain the benefit of having moved first and loses the benefit of the entrenched position. First mover problems also relate to culture within the industry. They can result in an industry as a whole persisting with practices that are problematic because “everyone else in the market is doing it”. A collective action problem can remain pervasive due to:

(a) the lack of a specific legal provision that addresses the practice (and thus prevents a regulator from taking formal action against the conduct);

(b) the existence of competition-law considerations that may create a real or perceived barrier for industry participants to collectively move away from practices that create poor consumer outcomes (for example, restricting or moving away from commission-based remuneration structures); and

(c) limited regulatory tools to assist structural change.

27. In evidence received by the Royal Commission in a different context (the banning of flex-commissions in the car finance industry) the benefit of a regulatory power that facilitates intervention in a market was demonstrated.[15] However, it should be noted that ASIC's powers to intervene in this way are limited.

28. One regulatory tool that can facilitate structural change in the face of first mover problems that is currently under consultation by the Commonwealth Government, is a product intervention power that includes the power to prohibit remuneration structures that create unacceptable risks to consumers.

29. If legislated, such a power would have application in consumer credit markets, and beyond. The Financial System Inquiry found that early intervention by ASIC could be more effective in reducing harm to consumers compared with waiting for a breach of law or significant consumer detriment, to occur. As a consequence it recommended

[15] Exhibit 1.158, Evidence of Michael Saadat, at [5]-[64]

introducing a pro-active intervention power that would enhance the regulatory toolkit available where there is risk of significant consumer detriment.[16] The Government accepted the recommendation. The consultation period on the Commonwealth Government's proposed *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018* (Cth) closed in February 2018. If enacted, the law will empower ASIC to regulate (by requiring alteration to) or if necessary, ban potentially harmful financial and credit products where ASIC is satisfied that a financial product has, will, or is likely to result in significant consumer detriment.[17]

30. The exposure draft contemplates that the power will apply to all products that may be provided by a person in the course of engaging in a credit activity (credit contracts, mortgages and guarantees, and consumer leases). It is proposed that the notion of *detriment* take its ordinary meaning, covering a broad range of harm that may arise from any number of sources associated with a product, including its features, defective disclosures, poor design or inappropriate distribution.[18]

31. The power could have significance for issues of remuneration and first mover problems of the kind identified by Counsel Assisting. ASIC considers that the intervention power is intended to, and in any case should, extend to allowing ASIC to make prohibitive orders in respect of the remuneration that is linked to a product. Given that significant consumer detriment in financial services is caused by the misaligned incentives constituted by remuneration structures, a product intervention power that can reach those structures would equip ASIC to help break first mover deadlocks that emerge in the future, by expression prohibiting remuneration structures that result in significant consumer detriment.[19]

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[16] Financial System Inquiry (Final Report), November 2014 at p.206; Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2017 (Cth), Exposure Draft, Schedule 2.

[17] Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2017 (Cth), Exposure Draft Explanatory Memorandum at [2.7]

[18] Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2017 (Cth), Exposure Draft Explanatory Memorandum at [2.13]

[19] See Peter Kell, 'A Better Toolkit for ASIC' (Speech given at the Thomson Reuters Regulatory Summit 2017, Sydney, 6 June 2017) 6.

32. As noted below, and for the reasons below, the extension of proposed design and distribution obligations to consumer credit products is also desirable, as improved and ongoing transparency can also assist to overcome the 'first mover' impediments.

CREDIT CARDS AND TRANSPARENCY

33. Counsel Assisting have asked whether the terms and conditions provided to consumers in respect of credit cards specifically, and credit products generally, are too complex for consumers to understand the circumstances in which they will be liable to pay fees.[20]

34. Key elements of an efficient, resilient and fair financial services system are that financial products do what they say they will do, and that the design of financial products does not take advantage of consumer biases or lack of knowledge about the product.

35. Complex product terms that are not adequately understood by the consumer have those failings. Thus, the problem is not one of transparency alone, but whether the products work in such a way as to exploit known consumer behavioural biases. By way of example, a credit card product operating in this way might, through the advertising associated with its distribution, target consumers with less likelihood of repaying the full balance on their credit card every month, so that they ultimately end up with higher interest rate cards.

36. Credit products have inherent features that rely on a higher level of consumer trust in comparison to many other retail goods and services, as asymmetries can be particularly hard to overcome. Consumers' biases or lack of understanding about financial products reduce their ability to place demand-side (i.e. consumer) pressure on financial services entities, for example by choosing financial products that are better aligned with consumer interests or by switching financial products. As a result, supply-side incentives (including misaligned incentives) continue to influence the conduct of financial services entities.

[20] RCD.9999.0003.0001 at .0025 [93(a)].

37. ASIC's experience is that poor and unnecessarily complex product design (which includes the design of product terms) has resulted in consumers misunderstanding the terms and conditions of the financial products they purchase. This has also made it difficult for consumers to effectively compare financial products offered in the market.

38. ASIC is has commenced a thematic review of the credit card market which will include detailed consideration of these issues and which will be publicly reported in mid-2018.

39. ASIC's experience is that disclosure is often not the most effective means of addressing complex product design and information asymmetry. It has been recognised for some time that disclosure alone is not working to drive fair consumer outcomes – for example, disclosure alone is unlikely to correct the effect of broader market structures and conflict that drive product development or distribution practices that result in poor consumer outcomes.

40. Given the inherent limitations of product disclosure ASIC expects that a product intervention power will also be of real assistance in addressing these issues, by empowering ASIC to require credit providers to take steps should their disclosure in respect of particular products prove to be inadequate to meet community expectations and cause significant detriment to consumers. The potential advantages of such a power are two-fold.

    (a) It is expected that the power is to be made available even when the inadequate disclosure does not result in a contravention of the law, but when it results in consumer detriment;[21]

    (b) Second, the power will equip ASIC to take targeted and tailored action to require credit providers to take action which is likewise targeted and tailored. In some cases, a product is reasonable for more financially experienced consumers, but sales incentives and inadequate disclosure see that product ending up in the wrong hands.[22] A product intervention power would allow an order to be made

[21] Exposure Draft, *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2017*, paragraphs 1022CC(1)(b) and 1022CC(3)(b) (*Corporations Act 2001* (Cth)), paragraphs 301C(1)(b) and 301C(3)(b) (*National Consumer Credit Protection Act 2009* (Cth)).

[22] See Peter Kell, 'A Better Toolkit for ASIC' (Speech given at the Thomson Reuters Regulatory Summit 2017, Sydney, 6 June 2017) 6.

that certain disclosure be made, absent which a particular transaction is not to be entered into.

41. The proposed power is not a prudential tool, and will not necessarily prevent all product failures. However, it will assist ASIC to reduce the number of people for which the risks of a product are misaligned with their financial situation, objectives and needs.

42. ASIC notes that the Government's proposed design and distribution obligations,[23] if extended to consumer credit products, would also assist in ensuring better consumer outcomes in the credit card market effectively introducing a 'product governance' framework. It is *not* currently proposed that those obligations extend to consumer credit products. ASIC's position is that they should so extend.

43. The introduction of a 'product governance' framework under the design and distribution obligations would strengthen issuer and distributor accountability to ensure that products are designed with consumer needs in mind and are marketed at appropriate sections of the population. Although consumer credit products are subject to responsible lending obligations in the National Credit Act, these obligations only require a credit product be *not unsuitable* in meeting the requirements and objectives of the consumer.

44. The proposed design and distribution obligations, if extended to consumer credit products, would strengthen the product governance framework for credit products by:

(a) Overcoming gaps in the current regulatory regime across the life-cycle of financial products and promote better, fairer outcomes for consumers by encouraging products that are appropriately designed for the consumers for whom they are intended;

(b) Requiring distribution processes and controls that reduce the chance that products will be issued to consumer for whose objectives, financial situations and needs they are not appropriate; and

[23] Treasury, Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2017, exposure draft legislation, released for consultation on 21 December 2017.

(c) Creating a dynamic and responsive product re-evaluation process where product design is reviewed and improved in response to feedback and experience.

45. ASIC expects that these obligations would formalise what the community already expects a well-run financial services business would do. The ultimate success of those obligations will depend on how widely they will apply and the enforcement mechanisms and penalties associated with non-compliance.

<u>Breach Reporting</u>

Compliance by Financial Services Licensees

46. Counsel Assisting have asked questions concerning the adequacy of mechanisms for compliance by financial services licensees with their obligations under s 912D of the *Corporations Act 2001* (Cth) (**Corporations Act**) to make a written report to ASIC of any significant breach of the obligations within s 912A.

47. Breach reporting is an important part of the financial services regulatory framework because there is a clear and long standing expectation, within Australia's financial services regime and the community, that financial services firms will be proactive in identifying, reporting and rectifying market problems to lift industry standards (this is also a characteristic of a good financial services industry). It is also one of the principal mechanisms by which ASIC obtains information and, for that reason, breach reporting is critical because it establishes the basis upon which ASIC may undertake a range of actions. These actions include identifying misconduct and compliance issues with specific licensees as well as more generally in the market, taking steps to remedy misconduct, and taking regulatory and enforcement action where appropriate.

48. ASIC does not and cannot take enforcement action in response to every breach report. It is important to note that beyond facilitating enforcement action and ASIC's involvement in remediation (as to which, see below), breach reporting serves the important purpose of assisting ASIC to identify trends and patterns in behaviour, and informs ASIC's decisions about the strategic allocation of its resources. Furthermore, breach reporting is an important aspect of the accountability of regulated entities.

49. For some time, ASIC has held concerns that banks and AFS licensees are either not reporting breaches to ASIC, or not reporting breaches in a timely and consistent

manner. ASIC's experience is that there can be long gaps between the commencement of an internal investigation by an AFS licensee and the making of a report to ASIC.

50. ASIC is undertaking specific work to address these concerns. In June 2016 ASIC commenced a breach reporting surveillance project, the key objective of which is to review the adequacy and effectiveness of the breach reporting framework and the extent that culture is a driver for compliance with these obligations. The project includes surveillance of the practices of 12 banking groups (four major and eight large to small banks) and their licensees.

51. As a result of this work (which is not yet complete) ASIC has identified a number of potential reasons for this delay, including the lack of capacity of banks and AFS licensees to identify breaches due to deficiencies in their compliance systems, the lapse of time between the occurrence of a breach and consideration of the subjective determination of its 'significance', and/or delay in conducting internal investigations.[24]

52. A delay in breach reporting undermines ASIC's capacity to take appropriate and timely enforcement or regulatory or remedial action, or to deal with entities and the broader market constructively. It may increase the risk of consumer loss or detriment. ASIC's experience is that where breaches or likely breaches have been reported early, ASIC is, generally, able to engage with the relevant entity co-operatively to ensure proper or 'appropriate' rectification. Early or timely reporting also allows ASIC to work with entities to improve their compliance procedures.

53. There is a lack of consistency among entities in identifying when a breach is "significant" and required to be reported to ASIC. The inconsistency may arise from the fact that under the current legislative construction the requirement that a breach be "significant" involves subjective judgment and that, generally, the internal risk matrices applied by entities do not quantify or specify what should be considered to be "significant". In ASIC's experience, the difficulty in identifying whether a breach is

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[24] T103.4-46, T104.1-46, T105.11-46, T106.1-21, T115.26-39 (Waldron XXN); T516.18-35, T517.5-29,T518.7-21, T518.23-45, T523.41-47-T524.1-46, T528.9-47, T616.20-46, T617.1-32 (Van Horen XXN).

significant results in inconsistent breach reporting and an overall underreporting of breaches.

54. ASIC's breach reporting surveillance project is due for completion in July 2018. The outcomes of the project will inform consideration of the issues mentioned above and ASIC's regulatory response.

55. The Government included in the terms of reference for the ASIC Enforcement Review Taskforce,[25] consideration as to the adequacy of the frameworks for notifying ASIC of breaches of law, including the time frame in which notification is required to be made, and whether the obligation to notify breaches should be further clarified.

56. The Taskforce noted concerns about the subjectivity of the "significance" test and proposed that the current test be retained but that the Act should be amended to provide that significance is to be determined by reference to an objective standard. That could be achieved, for example, by providing that licensees are required to notify ASIC of matters that a reasonable person would regard as significant having regard to the factors set out in s 912D(1)(b) of the Corporations Act, with the ability to prescribe additional factors by regulation.[26] ASIC supports that position.

57. The Taskforce also proposed that, in order to improve certainty and reduce subjectivity in assessing the existence of obligations to report, the trigger for reporting could be modified so that it is clearly based on an objective assessment of the information available to the licensee. The Taskforce proposed that that could be achieved by having the notification period commence from when the licensee becomes aware or has reason to suspect that a breach has occurred, may have occurred, or may occur; rather than when the licensee determines that the relevant breach has occurred and is significant.[27] ASIC supports that position (and numerous other proposals made by the Enforcement Review Taskforce).

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[25] Treasury, Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2017, exposure draft legislation, released for consultation on 21 December 2017.
[26] ASIC Enforcement Review – Position and Consultation Paper 1 – Self Reporting for Contraventions by Financial Services and Credit Licensees, 11 April 2017 (**Taskforce Paper No.1**) at [25]-[29]
[27] Taskforce Paper No. 1 at [47]

Consequences of non-compliance

58. Counsel Assisting's question is directed to licensees' ability to comply with breach reporting obligations. There is another very significant element of the efficacy of the law in this context, namely the range of consequences (in particular penalties) available for non-compliance.

59. In its position and consultation paper[28] the Enforcement Review Taskforce noted ASIC's concern that there is lack of flexibility in sanctioning failures to report. There is presently only a single, criminal pecuniary penalty that is relatively low ($10,500 in the case of an individual and $52,500 in the case of a corporation).[29] The Taskforce said that the fact that there is solely a criminal sanction paradoxically may both encourage a focus by licenses on being certain that there is a breach before they report (incentivising delay) and discourage a collaborative approach between ASIC and licensees, noting that as things stand, the sanction will only be available where the criminal standard of proof can be met.[30]

60. The Taskforce took the preliminary view that there should be a civil penalty in addition to a criminal one for both failure to report and delay in reporting. The Taskforce expected that the introduction of a civil penalty may result in ASIC taking enforcement action in relation to breach reporting obligations more often, particularly because it could seek a civil penalty for any breach of s 912D of the Act when it takes civil penalty proceedings relating to the subject matter of the breach itself, and that may result in ASIC being able to generally deter failures to breach report more effectively. Moreover, while civil penalty proceedings can be complex, the addition of this option may increase the willingness of licensees to report to ASIC.[31] The Taskforce also consulted on the preliminary view that ASIC should be empowered to issue infringement notices to AFS licensees for simple or minor contraventions that do not involve a deliberate failure to report.[32]

[28] Taskforce Paper No.1
[29] Taskforce Paper No.1 at [14]
[30] Taskforce Paper No.1 at [53]
[31] Taskforce Paper No.1 at [58]-[59]
[32] Taskforce Paper No.1 at [60]

61. It is ASIC's view that if those changes were implemented they would significantly enhance the effectiveness of the reporting regime and ASIC's ability to act against breaches of the regime. Having a range of penalties allows ASIC to calibrate its response, applying sanctions of greater or lesser severity commensurate with the misconduct. The community expects ASIC to take strong action against corporate wrongdoers. Effective enforcement is therefore critical for ASIC in promoting investor and consumer trust and confidence and ensuring a fair and efficient financial system.

62. An overarching priority should be to ensure that the enforcement regime provides adequate incentives for co-operation with ASIC, whether as a deterrent to misconduct or as an incentive to co-operation after misconduct has occurred (that is, for breach reporting and remediation). The lack of a civil penalty for a breach of the self-reporting obligation inhibits ASIC's ability to respond to wrongdoing flexibly in a way that is effective and proportionate to the nature of the misconduct. Introducing a civil penalty provision would facilitate regulatory responses appropriate to address and deter misconduct that may not be criminal.

Extension of reporting obligation to credit licensees

63. The Commissioner has asked whether credit licensees should also be subject to reporting obligations similar to those applicable under the *Corporations Act* to entities holding Australian Financial Services Licences.[33]

64. Credit licensees are required, by way of general conduct obligations under s 47 of the National Credit Act, to put in place and maintain adequate compliance arrangements and systems to ensure that they comply with the Act and the conditions of their credit licence. The obligations on credit licensees are an important way of influencing licensee conduct, but those obligations are not supported by any self-reporting obligations in respect of breaches. The *National Consumer Credit Protection Act 2009* (Cth) (**National Credit Act**) does not currently impose a reporting obligation on credit licensees equivalent to that imposed on AFS licensees. Instead, that Act requires credit licensees to lodge an annual certificate of compliance with ASIC.

[33] T987.5-21.

65. As was apparent from the evidence in the AHL broker fraud case-study[34] the compliance certificate regime is not a ready substitute for the self-reporting obligation to which AFS licensees are subject. The information required in the certificate is high-level and generalised. ASIC is not able to test the veracity of credit licensee responses without undertaking surveillance or issuing notices to obtain additional information. Credit licensees are not required to provide details of any negative response to ASIC to assess whether a breach has occurred, what it entails, whether it is significant or not, the effect (if any) on consumers or the adequacy of the licensee's remedial action, if any. There is no obligation to provide to ASIC information about breaches in a timely way.

66. Credit licensees should be subject to breach reporting obligations equivalent to those imposed on AFS licensees. However, there is an important caveat to that submission. The extension of breach reporting obligations will only be of value if reforms are made to the enforcement regime supporting the breach reporting obligations (as discussed above), including the availability of civil penalties. Furthermore, the value of the extension of the obligations to credit licensees also rests on the adoption of the enhancements to breach reporting regime discussed above, as proposed by the Enforcement Review Taskforce (and supported by ASIC).

<u>Remediation – Addressing Customer Detriment</u>

ASIC guidance and regulatory powers

67. Counsel Assisting have asked whether it is acceptable for a bank to decline a request by a regulator to identify and remediate customers who obtained an overdraft facility in circumstances where the lender had not complied with its responsible lending obligations.

68. The starting point for considering this issue is that a good financial system should have as a core value that when harm is caused to consumers by breaches of the law and conduct falling below community expectations, it is remediated quickly and effectively. Not uncommonly, the amounts of money involved in financial services

[34] T383.22-45, T384.1-46 (Harris XXN); T419-22-47, T420.1-30 (Boddy XXN).

transactions are comparatively large, and lack of proper remediation can detrimentally affect consumers in a very real way.

69. ASIC's experience is that banks typically do not outright decline requests to remediate; the focus of the difficulty is most often the extent and nature of the remediation that the bank is prepared to offer, including issues such as the population of consumers that are covered by the program, the methods for assessing the amounts of remediation, and the communication with affected or potentially affected consumers. The remediation may be increased incrementally, commonly after protracted negotiation with ASIC.

70. ASIC considers that banks (and other licensees) should prioritise customer redress when their misconduct or non-compliance results in customer detriment, including by complying with ASIC's requests. When ASIC makes requests to institutions to identify and remediate customers who have suffered detriment, it is in the interests of customers and the community generally for those institutions to comply with ASIC's requests. Where ASIC has formed the view that remediation is appropriate and necessary and has made such a request, a failure to comply with ASIC's request is likely not to meet community expectations or generally accepted standards.

71. It is important to note that ASIC does not have an ability to direct a bank or other licensee to identify and remediate customers who may have been affected by non-compliant conduct. Only a court can make such orders.

72. The Enforcement Review Taskforce proposed that ASIC should have the power to direct financial services or credit licensees in the conduct of their businesses, and that legislation providing for this power should specify the kinds of directions that can be made.[35]

73. ASIC has been able to pursue and achieve significant remediation outcomes by negotiation, in the absence of a direct statutory power, which has at times been protracted.[36] However, ASIC considers that it would be assisted in its work within this

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[35] ASIC Enforcement Review – Position and Consultation Paper 8 – ASIC's Directions Power, 8 November 2017 at [9]

[36] T578.2-17; T619.38-46, T620.1-16 (Van Horen XXN); T832.14-32, T834.32-45, T835.1-4, T842.4-41, T844.24-32 (Mendelson XXN) Witness Statement of Michael Saadat (WIT.0001.0003.0001) at [110]-[116].

area, and in particular in relation to addressing customer hardship, by having a regulatory power to be able to make directions about the nature and conduct of any program to assess claims for restitution or compensation.

74. A directions power, to be effective, should be accompanied by effective and flexible penalties for non-compliance. A requirement that entities regularly and publicly report on remediation would also enhance fairness in the financial system.

75. ASIC provides guidance to banks and other institutions about appropriate remediation structures and in relation to proposed engagement and communications with affected customers. ASIC has also provided market guidance on remediation within the specific context of the provision of financial advice.[37] In March 2017, ASIC published *Report 515: Financial advice: Review of how large institutions oversee their advisers*. The Report outlined ASIC's consideration of the large-scale review and remediation of customers who received non-compliant financial advice.

76. ASIC's Behavioural Unit provides remediation-related advice to teams within ASIC in relation the underlying processes to be adopted for a remediation scheme (for example, to assist with identifying barriers to engagement or frictions that may cause customers to drop out of the process) and in ensuring that proposed communications with affected customers are designed to encourage participation and understanding. ASIC utilises these resources when providing guidance to institutions about appropriate remediation structures and customer engagement.

Timeliness of remediation processes

77. Counsel Assisting have asked whether banks have adequate policies to address customer detriment occasioned by misconduct of bankers or third parties such as introducers in connection with home loans and in a timely fashion.

78. ASIC accepts that some remediation programs will be more complex to administer, especially where more complex, individual assessments of loss are required. However, ASIC is concerned about the time that banks take to commence customer remediation once a need to do so has been identified. Once a need for remediation has been identified, it takes a bank on average 217 days to make the first payment to

[37] Regulatory Guide 256.

a customer. ASIC considers that this length of time does not accord with values expressed by banks and is likely to constitute conduct falling below community expectations (and is contrary to the characteristics of a good financial system).

79. ASIC holds the view that it is preferable for remediation programs to incorporate automatic redress to customers rather than requiring customers to opt-in or to provide information or documents to qualify for compensation. Automatic processes results in more affected customers being remediated much sooner. When customer engagement is required, it is necessary to provide sufficient time for customers to respond to each communication from the institution.

80. ASIC also considers that remediation programs would be conducted by institutions more efficiently if they were required to regularly report on remediation programs as part of breach reporting.

81. ASIC anticipates making further submissions (in the second round of hearings) about remediation within the specific context of financial advice misconduct, but which Counsel Assisting may consider relevant to their consideration of the remediation issues raised in the first round of hearings.

Structural reviews and changes

82. Counsel assisting have asked whether banks' remediation and review processes are adequate to prevent a repeat of identified processing errors and to ensure that structural, as opposed to interim, changes are made in response.

83. Where customer detriment has given rise to a need for remediation, ASIC considers it appropriate for the relevant institution to investigate and identify the cause of the loss to customers and to consider whether there should be changes made to the internal systems and processes to avoid similar events occurring in the future.

84. ASIC considers this to be part of the process of redressing consumer detriment. ASIC has noted above that it would be assisted by a regulatory power to be able to make directions about the nature and conduct of any program to assess claims for restitution or compensation. ASIC considers that it would be appropriate for the scope of such a power to include being able to make directions about inquiries and

internal investigations to be undertaken by the relevant institution as part of any remediation or compensation program.

General Conduct Obligations

85. A number of the questions identified by Counsel Assisting relate to the potential failure of banks and licensees to ensure compliance with their General Conduct obligations.

86. Presently, there is no civil penalty available for a breach of General Conduct obligations. This is a very real short-coming in the legislative regime.

87. ASIC submits that the efficacy of any findings by the Royal Commission of breaches of General Conduct obligations, and any recommendations designed to generate change or redress wrongdoing in connection with those obligations, will be largely predicated on the adoption of a supporting change, namely the introduction of civil penalty consequences for breach of General Conduct obligations.

88. The Enforcement Review Taskforce proposed that key provisions imposing obligations on licensees should be civil penalty provisions. [38] ASIC supports that proposal. A civil penalty for licensees' failure to comply with those obligations would greatly enhance ASIC's capacity to regulate the conduct of licensees in a range of circumstance. Such circumstances include those where action to suspend or cancel a licence may be unwarranted or (for example in the case of a major bank) wholly impracticable.

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3 April 2018

[38] ASIC Enforcement Review – Position and Consultation Paper 7 – Strengthening Penalties for Corporate and Financial Sector Misconduct, 2017 at [53]-[54]; [76]-[78]