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

Submission on Key Policy Issues

Background Paper 24

This paper was prepared by the Treasury.

Australian Government

The Treasury

Financial Services Royal Commission

Submission on key policy issues

13 July 2018

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INTRODUCTION

1. Treasury welcomes the opportunity to provide a separate submission to the Royal Commission concerning three matters that go to the heart of the instances of misconduct and failures to meet community standards brought to light during the hearings to date. These three matters are:

   - the culture and governance of financial (and other) firms and the related regulatory framework;
   - the capability and effectiveness of the financial system regulators to identify and address misconduct; and
   - conflicts of interest arising from conflicted remuneration and integrated business models.

2. In examining these matters, this submission does not make recommendations, but seeks to set out the issues involved, the current regulatory framework and how it developed, and the trade-offs involved in various responses to these matters that the Commission could consider. Future hearings may raise additional issues requiring consideration.

3. We have identified the three matters from the case studies to date that point to: numerous failures by firms to adhere to existing regulatory obligations and deal openly and honestly with the regulators; an indifference by a number of firms to delivering good consumer outcomes, as well as a lack of investment by some firms in systems and processes to monitor product performance and staff conduct; and at times an unsatisfactory attitude and approach to remediation where issues have been identified.

4. While it is for the Commission to reach a judgment on how systemic these problems and the underlying causes are, *prima facie* these outcomes reflect instances of failures of leadership, governance and accountability at an industry, firm and business unit level. Where misaligned incentives and conflicts of interest have been present, the underlying failings and the poor outcomes have been exacerbated.

5. Competitive forces have been unable to fully temper these problems and hold firms to account. In part this is due to the advantages of incumbency and continuing barriers to entry for new firms. It also reflects a lack of effective demand-side pressure. Consumers, when interacting with the financial system, face products and services that are inherently (or by design) complex, opaque and typically have long durations; conflicted advice can worsen the problem. With ineffective competition, profitability can remain high for financial firms even if consumer outcomes are poor. Their shareholders (both retail and institutional) can remain largely complacent about governance and culture, and consequently poor conduct can persist.

6. The evidence suggests that while financial system regulators have been alert to the problems and have taken action, they have not yet been able to change the underlying behaviours of many of the firms and industries involved.

7. To address concerns surrounding poor consumer outcomes and other matters, many of which have been identified in the course of previous work by the regulators and other inquiries, a wide-ranging financial system reform agenda has been underway. That agenda marks a continuation of a move away from an over-reliance on disclosure to protect retail customers.[1] In response to the recommendations of the 2014 Financial System Inquiry, 23 reforms have been completed or substantially completed and others are currently in Parliament or being consulted on ahead of introduction.[2] These reforms include strengthening powers for regulators to take actions, improving the competitive landscape and increasing protections for consumers. However, legislative change is inevitably a drawn out process with Parliament's time limited by the multitude of issues before it. Page five sets out the reform agenda to which the Government has committed.

8. The terms of reference require the Commission to determine whether, taking account of that reform agenda, any further changes are necessary to the legal framework, practices within financial firms or to the financial regulators to minimise the likelihood of future misconduct. One broad choice the Commission faces is the extent to which its recommendations should focus on new regulations to address the specific instances or types of misconduct identified or look more broadly to influence the culture and governance of financial firms, and the industry more broadly, and improve the effectiveness of regulators.

9. In our view, the financial system and the regulatory framework cannot perform efficiently when there is a disregard by financial firms to adherence to the law and broader community standards and expectations regarding their trustworthiness. Fundamentally, responsibility for complying with the law rests with those to whom the obligations apply.

10. Effective leadership, good governance and an appropriate culture within financial firms and the industry is key to ensuring good outcomes for consumers. Good systems, improved cultural norms and a more professional ethos within firms and the industry can reduce the need for prescriptive regulation that imposes significant regulatory costs. They can drive a more timely alignment between community expectations and changing customer needs than is achievable by slow moving regulations. Where good governance and culture is established, those regulations that are required can be more effective. While regulatory levers to effect such a change are limited, well-targeted regulation and effective regulators play an important supporting role, and the Commission itself should act as a catalyst for change.

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1 Treasury's information note to the Royal Commission on the overview of the Australian regulatory framework provides further details on how the approach to the regulation of the system has evolved.

2 Further reforms have also been implemented in response to FSI by regulators.

11. How the regulators carry out their role and their effectiveness is something the hearings have begun to explore. This is a critical issue, with strong, effective and respected regulators being the lynchpin of the regulatory framework.

12. Australia has, in general, been well-served by its financial system regulators, the Australian Securities and Investments Commission (ASIC) and Australian Prudential Regulation Authority (APRA). They are also well-regarded by peer regulators in other countries and by international standard-setting bodies and organisations. The Commission represents an opportunity to build on their current strengths and address areas of relative weakness. Doing so requires consideration of a range of issues. Regulators need to be respected and have clarity of roles and responsibilities. The remit of regulators must be matched with appropriate capabilities (including the level of resources, leadership and regulatory powers, such as an appropriate degree of rule-making power). Regulators also need to act as a community and work cohesively.

13. The hearings have also pointed to cases where specific regulatory changes may be needed to address particular issues, including in respect of financial advice, but there are limits to how far this can go. Without substantive change to firm culture and attitudes to compliance with regulation, the effectiveness of new regulation is likely to be limited. Similarly, without a change in culture, attitudes and the level of professionalism within financial firms, regulatory gaps can be exploited and arbitraged. While each new targeted regulation can appear straightforward, the cumulative effect on a complex regulatory system may detract from the system's effectiveness.

14. The Commission faces the challenging task of assessing the implications of potential reforms for the economy generally, for access to and the cost of financial services, for competition in the financial sector and for financial system stability. Trade-offs between these objectives are sometimes required. Regulations also impose a cost, ultimately borne by consumers, both directly and indirectly through affecting the dynamism and efficiency of the financial system and of the broader economy. They can also have unintended consequences, and once introduced can be difficult to reverse.

15. Recommendations for regulatory reform need to be weighed against the potential impact on the objectives and functions of the financial system, and based on evidence of a systemic and significant problem when assessed against the volume of services and products the industry provides. The objectives of the financial system are, simply, to meet the financial needs of the community and facilitate a dynamic, stable and growing economy. To do so the financial system must fulfil its many functions, including providing credit and liquidity to households, businesses and government, assisting individuals to manage their savings, enabling effective risk management, delivering payment services and facilitating price discovery.

16. The provision of credit to the economy is one of those key functions of the financial system. Credit allows business to finance investments and maintain working capital, and facilitates a range of commercial transactions. For households, it can allow them to invest in their own home or an investment property and to smooth consumption over time (for example, by allowing the purchase of a car or consumer durable to be brought forward). Changes to the regulatory framework can, if not carefully designed, reduce access to and increase the cost of credit and in the short-term disrupt credit flow and the economy.

17. The financial system that has evolved to provide these functions is the largest sector in the economy, making up around 9 per cent of GDP and employing over 430,000 people.[3] Deregulation in the 1980s, compulsory superannuation in the 1990s and ongoing technological change has seen rapid growth in the system and in the range and complexity of financial products and services, changes to business models and methods of distribution, and increased interconnectedness with global markets. Financial assets relative to GDP have quadrupled since mid-1970s— now exceeding 400 per cent of GDP.[4] Banks currently hold over $873 billion in household deposits and provide around $713 billion in finance to businesses. Financial firms enable 24.2 million electronic payments by credit and debit cards to be made each day, provide 3.3 million households a mortgage over their primary residence, enable 3.6 million insurance claims to be lodged annually against personal general insurance policies, provide 13.9 million people with life insurance and allow 14.8 million people to accumulate savings for their retirement through superannuation.[5] Notwithstanding problems of misconduct, overall the system remains financially sound.

18. To be efficient in providing all this, and more, a financial system must ultimately allow consumers — both households and businesses — to make their own decisions, organise their own affairs, take risks and, in turn, bear the consequences of their decisions. The regulatory framework aims to ensure that there is integrity in the system, including in the provision of advice, so that consumers in making decisions can understand the risks and can interact with firms with confidence. When financial products are too complex (or inherently too risky) for retail consumers to understand and make informed decisions about, stronger protections apply. But there will always be a need for consumers to take responsibility for their own decisions and actions.

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3 Australian Bureau of Statistics (ABS) 2017, *National system of accounts 2016-17*, cat. no. 5204.0. Note: uses gross value added at basic prices (total industrial value added).

4 Ellis, L 2016, *Financial Stability and the banking sector*, speech at the Sydney Banking and Financial Stability Conference, 12 July, and Treasury calculations using RBA and ABS data.

5 Data comes from APRA 2018, *Monthly Banking Statistics May 2018*; Reserve Bank of Australia 2018, *C1, C5 Payments Data*; Australian Bureau of Statistics 2018, *Australian National Accounts: Finance and Wealth*, *Mar 2018,* cat no. 5232.0; Commonwealth of Australia 2017, *Review of the financial system external dispute resolution and complaints framework: Final Report*, page 7.

19. Greater consumer engagement would also promote more effective competition in the financial system. Financial advice and related intermediary services, such as mortgage broking, that serve the interests of consumers also have an important role to play in enabling such competition. While not directly a matter for the Commission, a lack of effective competition has been a matter of concern for successive governments. As the 2015 Harper Review found, better informed and engaged consumers are important for effective competition in markets, and the introduction of open banking (as part of a broader consumer data right) alongside encouraging development of new consumer-focussed technologies is core to that.[6] Recent efforts have also focused on removing regulatory advantages favouring particular firms (for example, relating to prudential requirements or perceptions of implicit government support) and reducing barriers to new entrants. The Government has also received the Productivity Commission's final report into competition in the financial system, and is currently considering its recommendations.

6 Commonwealth of Australia 2015, *Competition Policy Review: Final Report*.

Action to strengthen consumer outcomes in the financial sector

	2017	2018 onwards
Inquiries with potential for legislative reform (excluding Parliamentary inquiries)	Open banking review Review of the external dispute resolution framework ASIC Enforcement Review	PC competition in the financial system review PC superannuation efficiency and competitiveness review
Enhancing competition and resilience	- Major bank levy - Crowd-sourced equity funding - Use of the term 'bank' - APRA reserve powers for non-ADI lenders - Dedicated ACCC financial competition unit	- Regulatory sandbox - Further reforms to assist new bank entry - Open Banking reforms - Asia Region Funds Passport - Corporate collective investment vehicles - Stronger bank resolution powers - Mandatory comprehensive credit reporting - ASIC competition mandate - Expanding choice in superannuation - Superannuation portfolio holdings disclosure - UK FinTech Bridge - Clearing and settlement facilities reforms - Enhancing access to capital for mutual-owned firms - Banning superannuation exit fees - Enhancing APRA's prudential powers in superannuation
Making products suitable	- Life insurance commissions capped - Credit card reforms	- Product intervention power for ASIC - Design and distribution obligations - Raise professional standards of financial advisers - Small amount credit contracts reforms - Extend unfair contract terms to insurance - Rationalisation of legacy products - Improve disclosure for general insurance - Stronger licensing and banning power for ASIC - Superannuation fee protections - Limiting default insurance in superannuation - Improved superannuation account consolidation regime - Strengthening the MySuper authorisation test
Monitoring that products deliver what they promise	- Protect client monies - Banking Executive Accountability Regime	- Enhanced whistleblowing protections - Strengthening financial benchmarks - Insurance claims handling* - Reforming superannuation governance - Disclosure of ownership interests for financial advisers and mortgage brokers - New offences and disgorgement remedies to deter misconduct - Enforce industry codes* - Strengthen MySuper outcomes assessment - Rename 'general advice'
Enhancing regulators and redress	- Industry funding for ASIC - Additional funding for ASIC to improve data analytics and increase surveillance activities - Additional funding for APRA to modernise its data collection and dissemination system	- New Deputy Chairs for ASIC and APRA - Directions and other powers for ASIC* - ASIC staffing flexibility - Australian Financial Complaints Authority - Stronger penalties to punish misconduct - New infringement notices - Strengthen breach reporting - Expanding penalties and direction powers for APRA in superannuation - Modernising business registers - Director identification numbers

* The Government has agreed in principle to these reforms, pending the findings of the Royal Commission.

MISCONDUCT BY FIRMS: CULTURE AND GOVERNANCE

20. No financial system or industry exists without misconduct. However, the extent and types of misconduct evident during the Commission's hearings point to some serious failings in the financial sector. These include persistent failures to meet legal obligations, engaging in conduct that clearly falls below community standards and expectations, delays or failures in reporting such breaches to the regulator and resistance to compensating consumers when misconduct or other problems are identified. All this raises questions of why so much misconduct has occurred, and why the current regulatory settings have not corrected these problems.

21. The discussion of 'why' often focuses on culture and governance, both within individual financial firms and within the industry. Culture is a general term to describe the shared values and norms within an organisation.[7] There is no straightforward or discernible formula of how the culture within a firm is established or how it evolves over time. However, primary drivers of corporate culture include:

- the corporate governance framework the board establishes for a firm and the business objectives and strategies set within that framework;
- decisions the board and senior management make within that framework in relation to the allocation of accountability for compliance with obligations that apply to the company; and
- the design and implementation by the board and senior management of remuneration and other incentives for employees of the firm.

22. These drivers do not operate in isolation, and nor do they fully lie in the control of boards or management within individual firms. The drivers of culture are also shaped by the prevailing market dynamics and level of competition, the expectations of shareholders and the community at large, the practices adopted as industry norms and the obligations arising from the regulatory framework and steps regulators take to enforce them.

23. Despite their conduct failures, many financial firms have continued to generate strong profits assisted by a lack of effective competition in the financial system. In these circumstances, boards seem to have had their 'senses dulled'[8] to the significance of the misconduct by their firm and its employees, and shareholders have had little incentive to intervene in response to the misconduct.

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7 O'Reilly, C.A. and J.A. Chatman 1996, 'Culture as social control: corporations, culture and commitment', *Research in Organisational Behaviour*, vol 18, pages 157-200.

8 APRA 2018, *Prudential Inquiry into the Commonwealth Bank of Australia*, page 3.

24. These shortfalls in performance and conduct invite consideration of whether the Government should modify the regulatory settings that apply to governance frameworks, accountability and remuneration arrangements of firms. They also invite an assessment of whether regulators are sufficiently deterring misconduct through their supervision, surveillance and enforcement activities.

25. In considering possible regulatory responses to these failings, Treasury's analysis starts with two key principles:

- first, the responsibility for a firm's culture ought to rest with the firm, rather than the government; and
- second, it is desirable to rely on competitive forces to address problems with firms' cultures where possible.

26. Clearly, however, the extent of competition in Australia's financial system has not mitigated or addressed the misconduct witnessed, and cannot ensure fair treatment of consumers.[9] The challenge is designing appropriate regulatory responses that provide legal certainty and market integrity, and address identified market failures such as principal-agent conflicts, information imbalances and established behavioural biases.

27. This section examines how the current regulatory framework applies to governance frameworks, accountability and remuneration, and seeks to identify reasons these current mechanisms have not been as effective as they need to be. To assist the Commission's consideration of whether additional regulatory responses to the failings are appropriate, the submission discusses some of the trade-offs relevant to considering substantial revisions to corporate governance regulation. The important role regulators play in holding firms to account, and deterring misconduct, through enforcement and other actions, is discussed in the subsequent section.

CORPORATE GOVERNANCE REGULATORY FRAMEWORK

28. 'Corporate governance' refers to "the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled within corporations. It encompasses the mechanisms by which companies, and those in control, are held to account".[10] Governance captures not only the role and function of the board and senior management but also the firm's risk management systems that identify relevant risks. These include misconduct, compliance functions that are designed to ensure the company acts consistently within the law, operational controls, and systems to ensure effective flows of information to the board.

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9 Commonwealth of Australia 2014, *Financial System Inquiry: Final Report*, page 9.

10 HIH Royal Commission 2003, *The Failure of HIH Insurance, Volume 1: A Corporate Collapse and Its Lessons,* page xxxiv, cited in ASX Corporate Governance Council 2014, *Corporate Governance Principles and Recommendations: 3rd edition*, ASX Corporate Governance Council, page 3.

29. There is a core set of regulatory provisions that apply to corporate governance. These include the duties imposed on directors, and the periodic and continuous reporting requirements that apply to companies to ensure transparency to the market. These provisions recognise that there are divergent interests and information imbalances between the owners of a company (the shareholders, the principals) and the managers of the company (directors and executives, the agents). They are designed to ensure the shareholders are empowered to hold their agents to account. Without effective corporate governance standards, boards and executives can misuse their position of power in relation to their shareholders (and their customers) for personal gain and in ways that can fundamentally damage the financial sector and economy.

30. More granular corporate governance standards, including guidance on the size, composition and skills of the board, corporate reporting and disclosure processes and risk management systems, are described for listed companies in the ASX Corporate Governance Council Principles and Recommendations.[11] These principles are not mandatory, but are instead applied on a 'if not, why not' approach.

31. Financial firms subject to prudential regulation have specific additional governance and risk management obligations under APRA's regulatory framework, in part because of their complexity and systemic importance.[12] Reflecting its compulsory nature and the trust structure which governs it, there are also specific governance obligations that apply in respect of superannuation.[13]

32. Under their corporate governance frameworks, boards can allocate responsibility to particular individuals to ensure compliance with obligations under the *Corporations Act 2001* (Corporations Act) and other provisions that apply to the company. This corporate accountability is in addition to the individual accountability that attaches to people in relation to their conduct (for example, as directors, or as providers of financial services).

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11 ASX Corporate Governance Council 2014, *Corporate Governance Principles and Recommendations: 3rd edition*, ASX Corporate Governance Council.

12 Relevant standards include (but are not limited to): APRA 2017, *Prudential Standard CPS 510: Governance*; and APRA 2018, *Prudential Standard CPS 220: Risk Management,* and associated guidance.

13 *Superannuation Industry (Supervision) Act 1993* (Cth), ss 52(2) (trustees) and 52A(2) (directors).

33. Corporate accountability obviously rests at the entity level, but boards can 'individualise' this accountability, in the sense of attaching consequences for particular employees if a legal obligation is met or not met, in order to better ensure the company's compliance with the relevant obligation. The Government has taken the step of mandating this individualising of accountability for Authorised Deposit-taking Institutions (ADI) through the introduction of the Banking Executive Accountability Regime (BEAR). This regime provides an enhanced accountability framework for ADIs and persons in director and senior executive roles (accountable persons). An ADI must ensure that it has clearly defined accountability statements for each accountable person and an accountability map covering its ADI group.[14]

34. Another essential element of corporate governance is the setting by the board and senior management of remuneration arrangements and policies, and managing the incentives those remuneration practices create. Australian companies have more latitude when designing their remuneration practices than in some other jurisdictions.[15] Listed companies need to comply with transparency obligations in the form of a remuneration report, and there are some shareholder approval requirements applicable to termination and other payments for disclosing entities and bodies corporate.[16] Remuneration reports provide detailed information on remuneration paid to the company's key management personnel;[17] there is very little reporting or regulation of remuneration polices that apply to the employees of financial services firms more generally, including frontline staff. Remuneration reports are subject to a 'two-strike' shareholder vote each year, with a board spill resolution to be put to shareholders if there are two consecutive years of a negative shareholder vote on the remuneration report of 25 per cent or more.[18]

35. Prudentially regulated firms are subject to more intensive regulation of remuneration, including the requirement to establish a board remuneration committee and a remuneration policy.[19] More recently, the BEAR has put in place additional requirements for ADIs. Under the BEAR, ADIs must defer a minimum percentage of a senior executive's variable remuneration for a minimum of four years and have a remuneration policy that provides for the reduction of deferred variable remuneration where a senior executive has not met their obligations under the BEAR.

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14 *Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Act 2018* (Cth), ss 37FA and 37FB.

15 For example, the United Kingdom has introduced pay ratio disclosure requirements for listed companies to annually publish and justify pay difference between chief executives and staff. See Department for Business, Energy & Industrial Strategy, 2018.

16 *Corporations Act 2001* (Cth), s 300A and Division 2 of Part 2D.2.

17 *Corporations Act 2001* (Cth), s 300A(1)(c).

18 *Corporations Act 2001* (Cth), ss 250U and 250V.

19 APRA 2017, *Prudential Standard CPS 510: Governance*, section C.

CORPORATE GOVERNANCE AND ACCOUNTABILITY FAILINGS

36. Evidence at the hearings to date suggests significant corporate governance failings in some financial services firms. Boards of some financial services firms have not:

- always sufficiently prioritised oversight of the conduct of their employees to ensure it is lawful;
- ensured their risk management systems are effectively identifying when this conduct causes harm or risk;
- sufficiently challenged management about inadequate addressing of issues; and
- always ensured that they have the information they need to discharge their duties.[20]

37. There has also been evidence that some firms have had a culture of delaying providing information about possible breaches to the regulator or have provided incomplete or inaccurate information.[21]

38. The report of APRA's prudential inquiry into the Commonwealth Bank of Australia (CBA) also found that the degree of attention and priority afforded to the governance and management of non-financial risks at CBA was inadequate for a significant financial firm.[22] The report found that the board lacked urgency in responding to risk management and misconduct issues, and did not sufficiently challenge management about inadequately addressing issues or the quality of information flows. There has also been evidence at the hearings of senior managers not being held accountable for misconduct and poor customer outcomes that occur within their lines of responsibility.[23]

39. Additionally, the House of Representatives Standing Committee on Economics' review of the four major banks has considered accountability within major banks.

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20 For example, evidence in relation to Aussie Home Loans (Royal Commission transcript, 23 March 2018, page 983), Westpac (Royal Commission transcript, 27 April 2018, page 1957), ANZ (Royal Commission transcript, 27 April 2018, page 1965-69), AMP (Royal Commission transcript, 27 April 2018, page 1973-76).

21 For example, evidence in relation to AMP (Royal Commission transcript, 27 April 2018, pages 1937, 1939-41, 1972), CBA (Royal Commission transcript, 27 April 2018, page 1946), ANZ (Royal Commission transcript, 27 April 2018, page 1963), NAB (Royal Commission transcript, 27 April 2018, page 1977); see also ASIC 2017, *Report 515: Financial advice: Review of how large institutions oversee their advisers*, page 35.

22 APRA 2018, *Prudential Inquiry into the Commonwealth Bank of Australia*, page 11.

23 See for example Aussie Home Loans (Royal Commission transcript, 23 March 2018, pages 986-87) and Westpac (Royal Commission transcript, 27 April 2018, page 1955).

40. Misconduct encouraged by remuneration structures has been demonstrated. Evidence to the hearings suggests that conflicts of interests in remuneration structures, and remuneration structures with an emphasis on financial measures (rather than consumer measures) have been a significant factor in misconduct and poor consumer outcomes.[24] The regulatory issues regarding conflicts of interest and remuneration are discussed later in this submission. These issues are not limited to front line staff and exist for senior management where the behaviour driven by misaligned incentives more substantially influences firm culture.

41. APRA's recent review of remuneration practices found that downward adjustments of individual executives' remuneration in situations of poor risk outcomes were rare, as was application of *malus* clauses where adverse outcomes emerged in later years.[25] This was even the case in examples where more junior staff had faced remuneration consequences, while the executive with overall line responsibility had not. This finding was echoed in the report of the prudential inquiry into the CBA, which found that the CBA board had not until recently held the CEO and group executives to account for adverse risk, compliance and customer outcomes by materially reducing remuneration.[26]

SHORTCOMINGS OF CURRENT REGULATORY INTERVENTIONS

42. In light of the extent of corporate governance, accountability and remuneration-driven failings, it is clear that the current regulatory framework and its enforcement are not delivering satisfactory outcomes.

43. The primary corporate governance provisions (that apply across all firms and not just financial firms) are designed to empower shareholders to hold boards to account for any problems, including misconduct, in a company. However, shareholders' interests do not necessarily coincide with customers' interests, particularly in the short-term; indeed much of the misconduct has generated significant returns to the firms that have flowed through to healthy dividends.[27] Of course, when misconduct affecting consumers threatens profitability and reputation, the response of shareholders can be quick and strong.[28]

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24 Examples include evidence in relation to NAB (Royal Commission transcript, 27 April 2018, pages 971 and 974) and CBA (Royal Commission transcript, 23 March 2018, pages 978-79).

25 APRA 2018, *Information Paper: Remuneration practices at large financial institutions*, pages 21-22.

26 APRA 2018, *Prudential Inquiry into the Commonwealth Bank of Australia*, page 57.

27 Byres, W 2018, *The incentive to fly safely*, speech to the AFR Banking & Wealth Summit 2018, 4 April.

28 Uribe, A 2018, 'AMP shareholders deliver historic first strike against AMP', *Australian Financial Review*, 10 May 2018, viewed 3 July 2018, <https://www.afr.com/business/banking-and-finance/financial-services/amp-shareholders-deliver-historical-first-strike-against-amp-20180510-h0zvki>.

44. Specific transparency mechanisms, such as the two-strikes rule in relation to remuneration reporting, are designed to empower shareholders rather than consumers, and can be exercised in relation to non-remuneration related concerns.[29] Even when strikes are remuneration-related, shareholders may not be agitating for remuneration designed to meet consumer interests. For example, the 2016 strike in relation to the CBA remuneration report was arguably in part because the remuneration framework was too highly weighted to non-financial measures (i.e. shareholders were reportedly unhappy with the 'soft', non-financial targets CBA had included in its performance standards).[30]

45. Particular corporate governance rules are either non-binding or sufficiently general that they appear to be ineffective in countering the desire for short-term financial gain when it is at the expense of consumer outcomes and consequent risks to shareholder value if of significant magnitude.[31] As mentioned above, the ASX Corporate Governance Council Principles and Recommendations are non-binding, and the governance and remuneration requirements introduced under APRA Standards have not yet been sufficiently effective in ensuring boards are properly identifying and managing non-compliance with the law, and non-financial risks.

46. Many of the laws regarding the provision of financial services that apply directly to companies, including licensing provisions, attach at the corporate level, and some boards and executives have not sufficiently allocated accountability to individuals to ensure the company complies with them. In many cases information systems have been under-developed, so companies are not able to determine the extent of their non-compliance and the identification of non-financial risks.[32] These practical shortcomings have made many of the provisions ineffective in changing behaviour. These failures by boards and senior management to ensure companies' obligations are met, through making someone responsible for it, may be in part because the penalties associated with breaches are relatively low compared to the profits being made, and possibly because the likelihood of detection and enforcement action for breaches has been relatively low. Systematic detection of breaches is obviously challenging when there is a very large regulated population and finite resources to weed-out this behaviour.

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29 Fox, J 2012 'Executive remuneration – where are we up to?', Governance Institute of Australia, 6 March 2012, viewed 11 July 2018, <https://www.governanceinstitute.com.au/news-media/blog/2012/mar/executive-remuneration-where-are-we-up-to/>.

30 Commonwealth Bank of Australia 2017, *Annual Report 2017*, *Message from the Remuneration Committee Chairman,* page 63.

31 It is worth noting that a large number of regulated financial institutions are not publicly listed, therefore corporate governance rules that apply to publicly listed firms (as discussed in this section) do not apply.

32 See for example, Aussie Home Loans (Royal Commission transcript, 23 March 2018, page 986); AMP (Royal Commission transcript, 27 April 2018, pages 1938-39 and 1950), CFPL (Royal Commission transcript, 27 April 2018, pages 1945-6), Westpac (Royal Commission transcript, 27 April 2018, pages 1957-8), and ANZ (Royal Commission transcript, 27 April 2018, page 1968); and CBA (Royal Commission transcript, 1 June 2018, pages 3036-37).

47. The Government has taken steps to address these deficiencies. For example, the BEAR is designed to address the fact that the banking sector has not implemented sufficient accountability mechanisms of its own accord to meet community expectations. Under the BEAR, it is intended that where there is inappropriate behaviour in an ADI, more of the impacts are felt within the organisation, rather than in the community.[33] To address the identified deficiencies of some of the size of penalties associated with Corporations Act breaches, the government established the ASIC Enforcement Review Taskforce, and has agreed, or agreed in principle, to its recommendations. These proposed reforms are discussed later in this submission.

48. There are also challenges associated with our law design, in that the regulatory framework applicable to the provision of financial services is a complex web of principles-based provisions and highly prescriptive provisions. Counsel Assisting the Royal Commission noted these challenges at the conclusion of the Round 2 hearings, specifically inviting parties with leave to appear to address this point in written submissions.[34]

49. Finally, the level of enforcement of the existing provisions appears not to have been sufficient to change behaviour and significantly limit misconduct. As discussed further in the following section, in light of the Commission's hearings, recent events and proposed new powers, ASIC could adopt a regulatory strategy with a greater emphasis on enforcement in relation to breaches of the financial services law, and there could also be scope for APRA to focus more on the risk culture of its regulated entities.

OPTIONS FOR FURTHER REFORM

50. In considering possible responses to the misconduct and corporate governance failings observed, we start from the premise that regulatory intervention by the government is best considered only after it has been determined that a market based option, or self-regulation, would not be effective. Self-regulation, in the case of companies, may be through effective empowerment of shareholders or through more independent and effective board members. The degree to which people in financial services consider themselves professionals, and change their conduct accordingly, also affects the extent to which additional regulatory intervention is required. There is also the option of co-regulation through industry bodies or codes. The essential role of regulators in changing behaviour of companies, through their supervision, surveillance and enforcement activities, is discussed later in the submission.

51. In the case of government directly regulating to influence the drivers of culture, it is essential to consider long-term costs and benefits, even though this can be difficult to do. Key considerations include:

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33 Treasury 2017, *Banking Executive Accountability Regime: Regulation Impact Statement*, pages 7–8.

34 Royal Commission transcript, 27 April 2018, page 1985–86.

- Ownership of decision making – regulation that prescriptively dictates how boards should function and what matters are considered by the board can risk boards becoming focused on compliance rather than actively setting direction and taking ownership of decision making and risk management within firms. An interventionist approach from government risks the accountability for firm behaviour increasingly being viewed as partly the responsibility of government.
- The regulatory burden and costs of compliance – poorly targeted interventions can impose high compliance costs that adversely impacts efficiency in the system and may have disproportionate effects on smaller entities and therefore competition.
- Dynamism and innovation – prescriptive regulation can stifle the ability of boards and senior management to establish governance and remuneration practices that are adaptive and flexible to meet changing strategies and to reflect changes in community and market expectations.
- The timeliness of regulatory interventions – it can take years within our system to design and pass parliamentary reforms, which increases the risk that regulatory interventions will not be suitable once implemented.
- Impact on other industries – while the financial services industry has many regulations particular to it, many corporate governance provisions apply to all companies. The impact of reforms designed to address financial services failures on other companies needs to be assessed.

52. When well-designed, however, regulatory interventions can provide benefits by more directly targeting accountability and related consequences, increasing incentives for boards and senior management to focus on the outcomes of their decisions and actions. These can ultimately lead to better consumer outcomes and long-term shareholder returns.

53. With this trade-off in mind, three possible reform options applicable to corporate governance, accountability and remuneration are considered below. Further reforms are discussed in relation to managing conflicts of interest in the final section of the submission.

Direct regulation of corporate governance mechanisms

54. To address concerns about inadequate governance arrangements, an option available to government is to regulate corporate governance in a more direct way. For example, by mandating measures to strengthen the competency, capacity and composition of boards. A number of jurisdictions have recently pursued measures in this area, which indicates the regulatory frontier may be moving.

55. Large, complex financial firms require directors with time and ability to manage other commitments. This has led the European Union to adopt a directive limiting outside employment and board seats for financial firm directors to address the risks of overcommitted directors.[35] Recent reports indicate the Reserve Bank of New Zealand is also considering limits on the number of directorships that can be held at one time.[36]

56. In the Australian context, these options would mark a significant intervention, and there would be costs and challenges with pursuing this approach. Enforcing too narrow a range of current experience and exposure on to directors may reduce their ability to draw lessons from other businesses. By limiting potential income, it may also reduce the attractiveness of being a professional director thus reducing the pool and potential quality of board candidates.

57. Tenure limits on non-executive directors are sometimes proposed as a means of ensuring the independence of non-executive directors, as long durations of service can be viewed as creating too close a relationship between the director and senior management, reducing the ability or willingness of non-executive directors to challenge management effectively.[37]

58. Currently the Australian regulatory framework does not provide for mandatory tenure limits, however, the ASX Corporate Council Governance Principles and Recommendations require disclosure of the length of service of each director, and suggest that the board should regularly assess whether a director has become too close to management or a substantial shareholder after 10 years of service. The United Kingdom Corporate Governance Code similarly does not impose a maximum period of tenure, but does provide that a non-executive director should not be considered independent if they have served on the board for more than nine years.[38] Approaches in other countries vary, with some taking a similar approach to the United Kingdom, while others set legislated tenure limits as a non-executive director, ranging from five to fifteen years.[39]

59. Implementing a mandatory tenure limit on non-executive directors may reduce the aggregate experience on boards and consequently reduce their ability to challenge management. It may also not directly address the concern about independence and performance, which could be addressed by other means such as appropriate board refreshment and succession plans and board performance assessments.

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35 European Banking Authority, *Single Rule Book, Capital Requirements Directive, Article 91(3)*.

36 Parker, T 2018, ‘Reserve Bank plans to crack down on bank boards’, *New Zealand Herald*, 11 June, viewed 5 July 2018 <https://www.nzherald.co.nz/personal-finance/news/article.cfm?c_id=12&objectid=12068300>.

37 Katz, D and McIntosh, L 2016, Director Tenure Remains a Focus of Investors and Activists, *Harvard Law School Forum of Corporate Governance and Financial Regulation*, Cambridge, Massachusetts, <https://corpgov.law.harvard.edu/2016/08/01/director-tenure-remains-a-focus-of-investors-and-activists/>.

38 Financial Reporting Council (United Kingdom) 2016, *The UK Corporate Governance Code*, pages 10–11.

39 Organisation for Economic Co-operation and Development 2017, *Governance Factbook 2017,* pages 98–99, <http://www.oecd.org/daf/ca/Corporate-Governance-Factbook.pdf>.

60. A further option involves reconsidering the maximum term for non-executive directors before they must be re-elected. Currently, directors of listed entities in Australia are required to be appointed for terms of up to three years.[40] This is broadly consistent with approaches in other jurisdictions, which range up to six years.[41] A small number of jurisdictions, including the United Kingdom, have mandatory annual re-election of directors. The United Kingdom introduced annual re-election in 2010 for FTSE350 companies in response to the governance failures that emerged in the global financial crisis, and has recently consulted on extending this principle to all companies with a premium listing.[42] Annual re-election is considered to provide a regular and timely mechanism for boards and shareholders to consider individual director performance, thus improving the focus of directors on the need to be engaged in their role. However, criticisms of annual re-elections include that it would incentivise directors to take a short-term approach to their role, may reduce the experience and the effectiveness of non-executive directors in challenging management and may impose additional compliance costs.

61. All that said, Treasury sees merit in procedures that lead to a refreshing of boards from time to time, but recognises that the Government may not need to mandate rules with respect to boards in order to achieve that outcome.

Extend the BEAR

62. The BEAR currently only applies to ADIs, reflecting a view when it was introduced that banking was the priority sector in which to address poor customer outcomes and accountability. While the effectiveness of the regime in achieving its objectives cannot yet be assessed, consideration could be given to extending the BEAR to other entities. Extension of the regime would be consistent with evidence to the Commission that indicates that governance and accountability issues extend beyond the banking sector into areas such as general and life insurance, financial advice and wealth management.

63. Extending the BEAR, or a like regime, to a wider range of entities may be one way to lift standards of behaviour and conduct across the financial sector. This would impose heightened obligations on both entities and the senior individuals within them who influence the culture of the firm, provide regulators with greater visibility over who is accountable for each area of an entity’s business, better align senior executive remuneration with long-term outcomes and provide for enhanced consequences where senior executives and directors do not meet their obligations.

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40 ASX Listing Rules, Listing Rule 14.4.

41 Organisation for Economic Co-operation and Development 2017, *Governance Factbook 2017*, pages 106–107, <http://www.oecd.org/daf/ca/Corporate-Governance-Factbook.pdf>.

42 Financial Reporting Council (United Kingdom) 2017, *Proposed Revisions to the UK Corporate Governance Code*, pages 11–12.

64. Extending the BEAR would also be consistent with the United Kingdom's Senior Manager and Certification Regime (SMCR). The SMCR has been in place since March 2016 and is being extended to all sectors of the financial services industry by mid-to-late 2019.[43] The BEAR has a number of similarities to the SMCR, including preparation of accountability statements and maps and the imposition of behavioural standards.[44] Initial evidence from the United Kingdom is that such an accountability regime can be expected to improve clarity of responsibilities and internal governance and controls.[45]

65. One option would be to extend the BEAR to all prudentially regulated firms – general, life and health insurance and superannuation. This would be consistent with the current design of the BEAR, which focusses on conduct adversely affecting the prudential standing or reputation of a firm including non-financial risks (such as risk management and governance) as well as financial risks. Extension to superannuation may bring additional complexities, given its trust structure and the substantial differences in its regulatory framework compared to other prudentially regulated sectors.

66. An additional option would be to consider the scope of behaviour that is covered by the BEAR – that is, as in the United Kingdom, the regime could be extended to cover conduct or behaviour that is of a systemic nature beyond those that impact the prudential reputation or standing of a firm. Consideration would be needed as to the types of conduct to be regulated under an extended scope. Such an extension could also require that both APRA and ASIC jointly administer the regime – similar to the approach in the United Kingdom – and would require effective coordination between the regulators. Adopting this option would also allow the BEAR to extend beyond APRA-regulated firms. There could be merit in extending BEAR to other large firms involved in wealth and asset management, financial advice and the provision of credit, given their role in the financial system. Taken together with a change in the scope of behaviour, such an option would be significantly more complex to implement.

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43 Financial Conduct Authority (United Kingdom) 2018, Extending the Senior Managers & Certification Regime to FCA Firms, pages 74 and 81.

44 Note that under the SMCR, behavioural standards are imposed on all employees undertaking financial services in a regulated firm, with specific additional rules applying to senior management.

45 Carney, M 2017, *Worthy of trust? Law, ethics and culture in banking*, speech to the Banking Standards Board, 21 March, page 5.

67. Any extension in this manner would need to be well-targeted. There is a much greater diversity in the size, activities and structures of non-prudentially regulated companies. The ASIC Enforcement Review considered that an accountability regime similar to BEAR should not be applied to non-prudentially regulated firms, given the likely regulatory burden on small businesses and the reforms already recommended by the Taskforce. However, as noted by ASIC in its submission to the hearings on financial advice, an extension of aspects of BEAR-type arrangements to additional entities could enable ASIC to gain clarity on where responsibility for conduct lies and enhance ASIC's ability to hold those responsible to account for significant conduct failures.[46] The Government has accepted recommendations of the ASIC Enforcement Review to expand the scope of banning powers of ASIC, for example, by extending it to officers and senior managers who are not fit and proper to perform such roles in a financial services business.

Enhance remuneration disclosure requirements

68. Improved disclosure of remuneration arrangements could improve the ability of shareholders and other stakeholders to hold firms to account for their remuneration policies and the behaviours they incentivise. This could address criticisms that remuneration reports are too long, difficult to read, repetitive and overly detailed.[47]

69. Consideration could also be given to improving the disclosure of the remuneration policies of the whole firm (not just key management personnel) to provide greater insights into the incentives of middle management, who set the tone for day-to-day conduct, and frontline staff, who deal directly with individual consumers.

70. The fundamental limitation of such reform is that it relies on shareholders to agitate when remuneration policies do not serve consumer interests — and they may not do so. However, if such reform is to be considered, it would need to be carefully designed to avoid being overly prescriptive, which would not aid transparency and comparability. Stripping out much of the existing detail that is currently mandatory may also create further gaps in the disclosure regime or undermine transparency around executive remuneration.

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46 ASIC 2018, Round 2 hearings submission to the Financial Services Royal Commission, page 18.

47 PricewaterhouseCoopers 2017, 'Remuneration Reporting – Streamlined', PricewaterhouseCoopers, pages 2- 3, <https://www.pwc.com.au/assurance/ifrs/assets/remuneration-reporting-streamlined.pdf>.

CAPABILITY AND EFFECTIVENESS OF THE FINANCIAL SYSTEM REGULATORS

71. Responsibility for compliance fundamentally rests with those to whom the obligations apply. Government and regulators cannot ultimately set the culture within firms. As the Financial System Inquiry noted, to expect regulators to create the 'right' culture in firms by using prescriptive rules is likely to lead to over-regulation, unnecessary compliance cost and a lessening of competition.[48] Firms and industry more broadly play an important role in designing and shaping aspects of the regulatory environment, including what is considered to be 'normal' industry practice, and self-regulatory frameworks and industry codes like the Australian Banking Association's Code of Banking Practice.[49]

72. Regulators, however, have a crucial role to play in ensuring compliance with the regulatory framework, and ultimately have the power to enforce compliance by sanction. For there to be trust in the financial system it is essential that all market participants have confidence that regulators are actively ensuring that the regulatory regime is adhered to and can be relied on. Regulators that are respected and willing to enforce the regulatory framework provide a strong deterrent against misconduct.

73. Effective regulation is not one dimensional, and effective regulators have in their toolkit a range of powers and tools, including enforcement powers, surveillance and information gathering powers, the ability to set industry standards, licensing powers, a capacity to publish industry information and research to inform the market. Effective regulators have not only the powers afforded to them under the law but also the power of moral suasion – the ability to influence and affect change in conduct through non-formal means. Conversely, a perception that regulators are unable or unwilling to deter misconduct, and act on it when it occurs, makes markets more susceptible to misconduct.

74. To be effective, regulators also need to be independent and accountable as well as having access to the appropriate regulatory tools and resources.[50] However, assessing the effectiveness of regulators is difficult, and what makes for effective regulation can change over time in response to changing market, economic conditions and expectations of governments and the community. Rapid technological change will continue to present a challenge for the regulatory system and innovation creates new regulatory risks along with improved efficiency and system outcomes.[51]

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48 Commonwealth of Australia 2014, *Financial System Inquiry: Final Report*, page 7.

49 Office of Best Practice Regulation 2014, *Australian Government Guide to Regulation*, page 28.

50 Commonwealth of Australia 2014, *Financial System Inquiry: Final Report*, page 7.

51 Commonwealth of Australia 2014, *Financial System Inquiry: Final Report*, page xix.

75. At a structural level, Australia's 'twin peaks' model of financial regulation – where responsibility for conduct and disclosure regulation lies with ASIC and responsibility for prudential regulation with APRA – has clearly served the financial system and economy well and remains appropriate.[52] Similar architecture has been adopted in other jurisdictions and ASIC and APRA are well-regarded by peer-regulators in other countries and by international standard setting bodies and organisations.[53]

76. There is, however, scope for improvement in financial system regulation, and in particular how misconduct is identified and ASIC's ability to deter or address it.[54] Consideration of the regulators' remits and their capabilities – including leadership, powers and resourcing – and the appropriateness of their regulatory culture in changing market circumstances may identify areas where changes could be made to improve effectiveness.

77. The Commission's hearings, particularly those into financial advice and lending to small and medium enterprises, have led Counsel Assisting and the Commissioner to raise questions about regulatory culture; the appropriateness of ASIC's approach to enforcement, achieving compliance and other matters, and ASIC's general effectiveness.[55] The practical constraints for ASIC arising from its level of resourcing have also been raised. We note that ASIC, in its witness statements and submissions, has provided considerable data and commentary on these issues.[56]

78. ASIC, with its remit across conduct and disclosure, is the regulator with primary responsibility for addressing the types of misconduct that the Royal Commission has brought to light. APRA can also assist through its focus on and enforcement of the obligations that apply to its regulated entities in relation to governance and risk culture. Given this division of regulatory responsibilities, this section focuses primarily on ASIC and turns to APRA only where relevant.

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52 The same observation was made by the 2014 Financial System Inquiry, see Commonwealth of Australia 2014, *Financial System Inquiry: Final Report*, page 234.

53 International Monetary Fund 2012, *Australia: Financial System Stability Assessment*, page 1. Following its introduction in Australia, 'twin peaks' regulatory architecture has been adopted also by New Zealand, the United Kingdom and others.

54 Commonwealth of Australia 2017, *ASIC Enforcement Review Taskforce Report*, pages x-xii.

55 See Royal Commission transcript, 1 June 2018, page 3059.

56 See for example: ASIC 2018, Round 2 hearings submission to the Financial Services Royal Commission; Royal Commission 2018, 16 April 2018, Exhibit 2.1, Witness Statement of Kell, P., pages 50-51.

79. ASIC's effectiveness has been under close scrutiny in recent years and the reviews outlined below have led to a number of reforms to enhance its capability and refine its remit.

- The 2014 Financial System Inquiry considered the role, objectives, funding and performance of financial regulators, including an international comparison.[57] It made a number of recommendations aimed at making the regulators more effective, adaptable and accountable by: improving the accountability frameworks for financial regulators; ensuring regulators have the funding, skills and tools to deliver their mandates effectively; rebalancing the regulatory focus towards competition; and improving the process for implementing new financial regulations.[58]
- In 2015 and 2016, ASIC was the subject of a Capability Review conducted by an independent panel. The Capability Review was asked to examine and make recommendations on how efficiently and effectively ASIC operates to achieve its strategic objectives, including how ASIC uses its current resources and powers, and to assess ASIC's ability to perform as a capable and transparent regulator. The Capability Review concluded that the effectiveness and efficiency of ASIC's capabilities varied across the range of areas assessed from best practice (market supervision and consumer education) to areas where improvement was immediately required (IT and data infrastructure, governance, and stakeholder management). It found that ASIC's culture needed to become more open and strategic and less defensive, reactive, risk-averse and inward looking to ensure ASIC's future effectiveness.[59] ASIC has undertaken considerable work to implement many of the recommendations of the Capability Review and has reported publicly on this work.[60]
- In 2016, the Government commissioned a taskforce to review the enforcement regime of ASIC. The ASIC Enforcement Review Taskforce's Final Report was provided to Government in December 2017 and the Government has agreed or agreed in principle to all 50 recommendations regarding ASIC's penalty regime and enhancements to a range of powers.[61]

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57 Commonwealth of Australia 2014, *Financial System Inquiry: Final Report*, page viii.

58 Commonwealth of Australia 2014, *Financial System Inquiry: Final Report*, page xxi.

59 Commonwealth of Australia 2015, *Fit for the future: A capability review of the Australian Securities and Investments Commission*, pages 1, 10, 11 and 19.

60 ASIC 2016, *ASIC Capability Review – ASIC's implementation plan*, https://download.asic.gov.au/media/3826160/asic-capability-review-asics-public-response-and-implementation-plan-20-4-2016.pdf

61 Morrison, S (Treasurer) and O'Dwyer, K (Minister for Revenue and Financial Services) 2018, Boosting penalties to protect Australian consumers from corporate and financial misconduct, media release, 20 April, viewed 10 May 2018, <http://sjm.ministers.treasury.gov.au/media-release/boosting-penalties-to-protect-australian-consumers-from-corporate-and-financial-misconduct/>.

80. Specifically, these reviews have led to a number of recent or proposed reforms including: significant changes to ASIC's powers and penalties that apply to breaches of its administered laws; rule making powers in a number of areas; removal of ASIC from the Public Service Act to provide greater flexibility in attracting and retaining suitably skilled and experienced staff; explicitly including competition in the mandate of ASIC; and changes to ASIC's remit to remove its registry functions. In addition, the Government has made changes to ASIC's leadership team, including a new Chair and a second Deputy Chair with a focus on enforcement.

81. While some of these reforms are still being implemented, taken together they reflect a substantial change to ASIC's capabilities. If utilised effectively, these enhanced powers and penalties, improvements to flexibility and additional resources could have a material impact on how ASIC delivers on its mandate.

82. Nevertheless, there may still be a need to consider whether these reforms to ASIC's capabilities and remit will fully address the concerns raised by the Commission. For example, considering whether the breadth of its remit is too wide or whether ASIC needs greater flexibility to determine the regulatory framework with rule-making powers or the appropriateness of its resourcing in light of any further reforms to its remit, powers or changing circumstances. However, in considering further reform options there are trade-offs, discussed below, to be weighed up.

83. Steps have also been taken to enhance APRA's effectiveness. Most relevantly, these include the introduction of the BEAR and the announcement of a second Deputy Chair. APRA was also provided with additional funding in the 2016–17 Budget to improve its data collection and analytics capabilities.

84. In discussing the effectiveness of ASIC and APRA, this section responds to the case-studies considered by the Royal Commission to date: consumer lending, financial advice, small to medium enterprise lending, and remote and regional issues. It does not consider issues that may arise in relation to superannuation (where APRA has a greater role in addressing misconduct), or insurance which are expected to be the subject of a future hearing.

CONSIDERING REGULATOR EFFECTIVENESS

Regulator remit

85. A key driver of regulator effectiveness is having a clear and coherent mandate that is manageable in size and creates valuable synergies between the component parts.

86. Over the past twenty years the remit of ASIC has expanded considerably, as has ASIC's regulated population. ASIC now has a wider regulatory remit than comparable market conduct regulators in overseas jurisdictions, such as the United Kingdom, the United States and Germany. The breadth of this regulatory remit increases the complexity of ASIC's operations and places demands on its leadership, internal communications and governance, and resourcing.

Figure 1: Comparison regulatory remits of market conduct regulators

This chart is a visual aid and has been simplified for clarity. Areas of responsibility are based on Australia's regulatory framework and may not precisely align with frameworks adopted in other jurisdictions. The Reserve Bank of Australia has responsibility for payment systems and APRA for prudential regulation. In Australia the ACCC is the primary competition regulator, but ASIC's revised Statement of Expectations requires ASIC to have regard to competition issues.

87. In 1998, ASIC's then responsibilities as the corporate, securities and futures regulator were expanded to include responsibility for consumer protection in superannuation, insurance and deposit-taking. In 2002, responsibility for financial services conduct and disclosure was added, and in 2010 ASIC's responsibilities were again expanded to include consumer credit and finance broking as well as taking over market supervision of domestic licensed equity, derivatives and futures markets (including the ASX). In addition to these regulatory functions, ASIC also leads the National Financial Literacy Strategy.[62]

88. One recently announced change that will reduce ASIC's remit is the decision by the Government to modernise ASIC registers and the Australian Business Register on a platform that will be administered by the Australian Business Register within the Australian Taxation Office. Once this happens, ASIC will no longer have any registry functions. ASIC is currently in the unique position amongst regulators globally in having a major business registration function as part of its responsibilities.

89. The remit of APRA has been subject to much less change and is broadly consistent with that of other international prudential regulators. Since its establishment in 1998 to prudentially regulate ADIs, insurers and superannuation funds (other than self-managed funds), it has assumed responsibility for the Financial Claims Scheme in 2008 (closely related to its prudential concerns in respect of deposits and insurance policies) and the prudential supervision of private health insurers in 2015. From 2018 it was also given reserve (but not prudential) powers in respect of non-ADI lenders where they pose a systemic risk to financial stability.

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62 ASIC, The National Financial Literacy Strategy, web page, viewed 3 July 2018, < http://www.financialliteracy.gov.au/>.

90. While APRA's remit is relatively unchanged since its inception, in recent years APRA has had to do more in certain areas reflecting changes in international standards for prudential supervision, legislative changes and in response to changing market conditions. This includes the BEAR, a greater focus on the risk culture of its regulated entities and on considering and addressing macro-prudential risks, as well as taking more active steps, where consistent with its mandate, to support competition in the financial system.

Regulator powers

91. If a regulator does not have the appropriate powers – that is, regulatory tools available to it – to undertake its functions, its effectiveness will be hampered.

92. The ASIC Enforcement Review recommended substantial increases in penalties for the offences administered by ASIC and a range of reforms to strengthen ASIC's regulatory toolkit. The reforms recognise that the existing penalties available to ASIC and the courts have not acted as a credible deterrent or met community expectations as to the seriousness of misconduct in these sectors, and that deficiencies in ASIC's regulatory toolkit may have potentially hampered ASIC's ability to effectively and/or efficiently undertake its functions.[63]

93. As outlined above, the Government agreed, or agreed in principle, to all 50 of the Enforcement Review recommendations and will prioritise the implementation of 30 of the recommendations. The remaining 20 recommendations – those that relate to self-reporting of breaches, industry codes and ASIC's directions powers – are to be considered alongside the final report of the Royal Commission. [64]

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63 Commonwealth of Australia 2017, *ASIC Enforcement Review Taskforce Report*, pages 49 and 58; Commonwealth of Australia 2014, *Financial System Inquiry: Final Report*, page 218. ASIC, itself, has made this argument.

64 Morrison, S (Treasurer) and O'Dwyer, K (Minister for Revenue and Financial Services) 2018, Boosting penalties to protect Australian consumers from corporate and financial misconduct, media release, 20 April, viewed 10 May 2018, <http://sjm.ministers.treasury.gov.au/media-release/boosting-penalties-to-protect-australian-consumers-from-corporate-and-financial-misconduct/>.

94. Additionally, as part of the response to the Financial System Inquiry, the Government committed to introducing a Product Intervention Power for ASIC, as well as Design and Distribution Obligations on product manufacturers and distributors. The Product Intervention Power will enable ASIC to temporarily intervene in the distribution of a product (or class of products) where it perceives a risk of significant consumer detriment and take a range of actions including requiring the amendment of product marketing and disclosure materials; imposing consumer warnings and labelling changes; restricting how a product is distributed; and banning products.[65] The Product Intervention Power is significant, because it will provide ASIC with the capacity to intervene in relation to a product issued by multiple entities, and because ASIC is empowered to intervene when it has a basis for anticipating significant consumer detriment, not just when such detriment has manifested. Consultation has been undertaken on draft legislation with additional consultation to be undertaken prior to its introduction.[66]

95. APRA by contrast has generally been seen as having sufficient powers in respect of ADIs and insurers, deriving essentially from its supervisory function and broad powers. For example, under the *Banking Act 1959* (Banking Act), APRA has the power to determine prudential standards in relation to a wide range of matters and has broad directions powers. The introduction of the BEAR has provided APRA with a new set of tools, and was also accompanied by additional examination powers under the Banking Act (such as the ability to examine witnesses and compel the production of documents and accounts).

Regulatory culture

96. The effectiveness of a regulator will also be influenced by its overall regulatory culture. Regulatory culture includes how a regulator chooses to fulfil its mandate within the relevant legal and political framework. For example, the weight given to collaboration to pre-emptively improve industry practices over investigation of breaches and legal action.

97. A regulator's regulatory culture is influenced by:
   - the powers available to a regulator;
   - how it chooses to use its regulatory and enforcement tools, such as court based sanctions, administrative actions such as bannings, consumer remediation or industry guidance; and
   - the timeliness of such actions; and

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65 Exposure drafts of legislation to implement these two measures were released in December 2017: see O'Dwyer, K (Minister for Revenue and Financial Services) 2017, Improving outcomes for financial consumers: Design and Distribution Obligations and Product Intervention Power, media release, 21 December, viewed 10 May 2018, <http://kmo.ministers.treasury.gov.au/media-release/125-2017/>.

66 O'Dwyer, K (Minister for Revenue and Financial Services) 2018, Address to the ASIC Annual Forum 2018, Sydney, speech, 19 March 2018, viewed 10 May 2018, < http://kmo.ministers.treasury.gov.au/speech/006-2018/>

- its multiple goals, such as delivering on its mandate, meeting community expectations, prioritising resources and maintaining effective relationships with its regulated population.

98. While a co-operative approach is necessary, a regulator must also be willing and able to take action to address, prevent or deter misconduct when necessary~~.~~

99. The ASIC Corporate Plan covering the period 2015–16 to 2018–19 sets out the high priority that ASIC places on enforcement activity with the 'Detect-Understand-Respond' approach where there is wrongdoing or the risk of wrongdoing in the market. The Plan outlines that ASIC typically uses 70 per cent of regulatory resources on surveillance and enforcement.[67]

100. ASIC considers a range of factors when deciding whether to take enforcement action and which action to take.[68] ASIC's strategy in making these decisions is based on the availability of enforcement tools, and factors including the severity and scale of the breach, its impact on consumers and what it indicates about a licensee's compliance controls and systems.[69] This regulatory strategy may also point to the use of tools other than enforcement as being most likely to achieve the desired consumer protection outcome.

101. ASIC's use of its enforcement tools varies across the sectors it regulates, in part due to the different availability and appropriateness of these tools across sectors. For example, ASIC's enforcement activity in the small business and corporate governance sectors is directed at persons who are not licensed by ASIC, and the breaches relate to matters such as failure to provide books and records; as such, the most appropriate remedies are primarily court-based ones. By comparison, ASIC licences entities in the financial services segment; correspondingly its enforcement activities have focused on keeping non-compliant persons out of the industry (for example via bannings) and on obtaining remediation for affected investors. For ASIC's work in the financial services sector, a key consideration is how best to meet the objectives of improving industry conduct and also fostering consumer confidence in the financial system.

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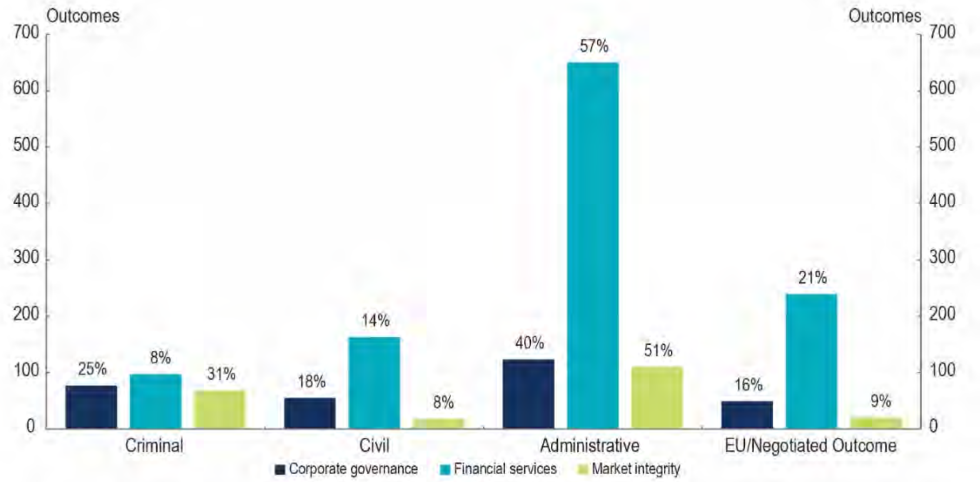
67 ASIC 2015, *ASIC's Corporate Plan 2015-16 to 2018-19*, page 5.

68 ASIC 2013, *Information Sheet 151: ASIC's approach to enforcement*, page 3.

69 Royal Commission 2018, 16 April 2018, Exhibit 2.1, Witness Statement of Kell, P, page 33.

Figure 2: ASIC's use of regulatory tools across market segments, July 2011 – June 2018[70]



*Percentages reflect the proportion of different enforcement outcomes by sector. Percentages may not add to 100 due to rounding.

102. Where ASIC pursues criminal or civil penalties, ASIC's success rate for litigation across its market segments has averaged higher than 90% since 2011–12.[71] This has led some to the assumption that ASIC's regulatory approach reflects a more risk-averse culture that has led ASIC to rely more on administrative actions and enforceable undertakings than pursuing civil and criminal penalties in circumstances where there was less certainty that ASIC would win in court.

103. Successful litigation can have a strong demonstrative effect. The Capability Review found that only 41 per cent of external stakeholders agreed that 'ASIC deters individuals or organisations from engaging in misconduct' and that only 23 per cent of external stakeholders and 37 per cent of ASIC senior executive leaders and Commissioners thought that 'ASIC acts quickly to investigate potential breaches of the law'.[72] The Review suggested that ASIC could more strategically use litigation as a way of communicating key messages to the regulated population to have the desired deterrence effect.[73]

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70 Data provided by ASIC July 2018.

71 Excludes administrative actions and summary prosecutions for strict liability offences: see ASIC 2017, *Annual Report 2016-17*, page 182. The lowest success rate was 85% in 2014-15 and the highest 96% in 2015–16.

72 Commonwealth of Australia 2015, *Fit for the future: A capability review of the Australian Securities and Investments Commission*, page 8.

73 Commonwealth of Australia 2015, *Fit for the future: A capability review of the Australian Securities and Investments Commission*, page 120.

104. It is important that ASIC is a strong and respected regulator and that this view is widely held by financial firms and the community. ASIC has already developed a more forthright communication strategy on its enforcement in recent years, including the publication of Enforcement Reports. More effective communication of its enforcement strategy and more generally, may also assist consumers to better understand the necessary prioritisation decisions made by ASIC, and, in that context, why ASIC does not (and cannot) take action in response to every consumer complaint. A lack of understanding by consumers of ASIC's approach can risk undermining the perception of ASIC's effectiveness in the community.

105. In addition to the communication of its regulatory approach, stronger powers and penalties being available to ASIC will be central to the regulatory strategy it adopts in identifying, weeding-out and taking strong action against misconduct in future. The ASIC Enforcement Review, which involved a Taskforce working intensively with ASIC to identify gaps or deficiencies in the regulatory framework, has recently considered the enhancements needed to deliver more effective enforcement of the regulatory regime. Implementation of these recommendations is expected to have a material impact on ASIC's regulatory culture with regard to enforcement.

106. APRA's regulatory posture is also important for addressing poor risk culture within prudentially regulated entities. In discussing APRA's regulatory posture there are two relevant factors: APRA's approach to ensuring that its requirements are adhered to; and APRA's increasing supervisory focus on governance, risk culture and remuneration practices within its prudential framework.

107. APRA's regulatory approach is that of consultative risk-based supervision.[74] The goal is to identify and evaluate potential risks at an early stage and ensure that they are addressed before they pose a threat to a regulated firm or its beneficiaries. The vast majority of actions taken by APRA do not involve any formal exercise of APRA's enforcement powers. Rather, APRA works with the boards of the relevant firms as they take appropriate steps to address issues.[75]

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74 APRA 2015, *The APRA Supervision Blueprint*, viewed 3 July 2018, <https://www.apra.gov.au/sites/default/files/APRA-Supervision-Blueprint-FINAL.pdf>.

75 APRA 2014, Second round submission to the Financial System Inquiry.

108. This regulatory approach is broadly consistent with the approach adopted by prudential regulators in comparable jurisdictions and with that advocated by international regulatory standard setting bodies (the Basel Committee on Banking Supervision) and organisations (the Financial Stability Board).[76] There are, however, prudential regulators that are taking an increasingly active approach to enforcement; for example, the Prudential Regulation Authority in the United Kingdom.[77]

109. APRA's identification of significant risks and allocation of its resources against them is also an important part of its posture. Following the financial crisis, and consistent with the recommendations of the Financial System Inquiry, there has been a focus by APRA on capital adequacy and resilience. Reflecting domestic exposures to the housing market, improving residential lending standards has been another priority.

110. APRA is increasingly considering practices in relation to risk culture and remuneration. While most matters of conduct primarily lie within ASIC's remit, poor customer experiences can be a significant indicator of poor risk culture which, in turn, can have significant prudential impacts.[78] The APRA Chairman recently noted that "traditional prudential requirements for adequate financial resources may not be sufficient when an institution suffers from poor governance, weak culture, or ineffective risk management. These deficiencies can, if severe and persistent enough, threaten the financial soundness that is at the heart of prudential safety."[79]

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76 Financial Stability Board 2013, *Principles for An Effective Risk Appetite Framework*.

77 For example, since its establishment in 2013 PRA has opened 25 cases against individuals and ten against firms with fines arising from Prudential Regulation Authority's enforcement action exceeding £40m. The topics covered by these enforcement cases have been varied, ranging from outsourcing to IT system failures to risk management. See Prudential Regulation Authority 2018, *Prudential Regulation Authority Annual Report*, < https://www.bankofengland.co.uk/-/media/boe/files/annual-report/2018/pra-2018.pdf?la=en&hash=929BC2A486101460E1A371FF96F0DC73B424BF0F>.

78 APRA 2016, Submission to Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the life insurance industry*, page 21.

79 Byres, W 2018, *Beyond the BEAR Necessities*, speech at the UNSW Centre for Law Markets and Regulation Seminar, 2 May.

111. Changes by APRA to its standards relating to governance and risk management have progressively demonstrated an increasing concern by APRA with the non-financial risk aspects of its prudential framework.[80] In 2010, APRA introduced requirements in relation to remuneration to require boards of APRA-regulated firms to ensure that remuneration practices were aligned to prudent risk taking.[81] In 2014, APRA introduced a requirement for boards of ADIs and insurers to form a view on the appropriateness of the risk culture of the firm.[82] The effective applications of these standards have only recently been thematically reviewed. For example, in 2018, APRA published the findings of its review of remuneration policies and practices across a sample of large APRA-regulated entities. APRA's report indicated a poor application of relevant prudential standards and guidance by entities reviewed (see paragraph 41).

112. While APRA maintains its cooperative approach to pre-emptively work with its regulated firms to address concerns, APRA has noted that it "will apply a greater supervisory intensity to institutions that are unwilling or unable to address behaviours that are inconsistent with prudent risk management practices".[83] APRA has noted that at the same time, it will "continue to work to identify practices that are associated with sound, and less sound, risk cultures, and share these observations with institutions and other stakeholders".[84]

113. This approach has been demonstrated in APRA's action in relation to its prudential inquiry into the CBA to examine the frameworks and practices in relation to the governance, culture and accountability within the CBA group.[85] In publishing its Final Report on the inquiry, APRA also recommended that other financial firms should review their internal practices to guard against similar failings.

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80 These standards include Prudential Standard *CPS 510: Governance* (minimum foundations for good governance of an firm), Prudential Standard *CPS 520: Fit and Proper* (fitness and propriety of individuals to hold positions of responsibility) and Prudential Standard *CPS 220: Risk Management* (requirement for firms to have a risk management framework).

81 For example, APRA's Prudential Standard on Governance was amended in 2010 to reflect the Financial Stability Board's release of Principles for Sound Compensation Practices in 2009: see APRA 2009, APRA finalises position on remuneration, media release, 30 November, viewed 3 July 2018, < https://www.apra.gov.au/media-centre/media-releases/apra-finalises-position-remuneration>.

82 APRA 2016, *Information Paper: Risk culture*, page 5.

83 APRA 2016, Submission to Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the life insurance industry*, page 21.

84 APRA 2016, Submission to Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the life insurance industry*, page 21.

85 APRA 2018, Prudential Inquiry into the Commonwealth Bank of Australia (CBA) Final Report, media release, 1 May, viewed 3 July 2018, <https://www.apra.gov.au/media-centre/media-releases/apra-releases-cba-prudential-inquiry-final-report-accepts-eu>.

114. In light of the evidence emerging from the Commission, APRA's inquiry into CBA and its review of remuneration practices, APRA may need to continue to strengthen its work in relation to governance and risk culture.[86] As implementation of the BEAR progresses, this also may require a shift in APRA's stance towards enforcement to hold firms and individuals within those firms to account. APRA's willingness to take enforcement action, as is the case for ASIC, has the potential to play a role in addressing conduct issues within prudentially regulated sectors. An increased focus on enforcement could, however, require consideration of APRA's resourcing, both staff capability and funding.

Regulator resources

115. Allocation of resourcing to all government agencies requires careful consideration and this is no different in the case of ASIC and APRA where the majority of funding approved by the Government is now cost recovered from industry. There is no formula for determining the optimal level of funding for a regulator and funding, in and of itself, cannot drive effectiveness.

116. In recent years, both ASIC and APRA have received operational and capital funding to improve their capabilities. The 2016–17 Budget provided $121 million for ASIC to improve data analytics, enable increased surveillance and enforcement, and implement law and regulatory reform.[87] APRA was also provided $20.9 million to modernise its data collection and dissemination system and support its ongoing operations; APRA is overhauling the way its collects, stores, interprets and shares data about the financial sector firms it regulates. These programs are not yet complete and the extent to which they will improve capabilities cannot yet be determined.

117. In an aggregate sense, ASIC's annual appropriations (in real terms) and staffing levels are broadly the same as they were a decade ago. When taxpayers previously funded all of ASIC's budget, this funding had to be weighed against broader federal budget priorities. However, with establishment of the ASIC Industry Funding Model from 1 July 2017, the trade-off in determining ASIC's funding envelope primarily involves weighing the need for sufficient resourcing with the fact that the impost will ultimately be borne by customers or shareholders of regulated entities.

118. Over the past 10 years, APRA's annual funding has also remained broadly constant in real terms. Unlike ASIC, until recently there have not been significant changes to APRA's remit, although the scope and intensity of APRA's work within that remit has increased, as discussed in paragraph 90. The exceptions to this were following the GFC where APRA was given additional temporary funding to deal with the GFC.[88]

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86 See for example, Royal Commission transcript, 23 March 2018, pages 970 and 979-80.

87 Morrison, S (Treasurer) and O'Dwyer, K (Minister for Revenue and Financial Services) 2016, Turnbull Government bolsters ASIC to protect Australian consumers, media release, 20 April, viewed 10 May 2018, <http://sjm.ministers.treasury.gov.au/media-release/042-2016/>.

88 APRA 2010, Annual Report 2010, page 66

119. Appropriate funding is undoubtedly an important determinant to having the right resources – but it is not the only one. Leadership and staff with the right capabilities, as well as the right systems and processes to direct these resources to the right issues are also needed.

120. The Government has appointed a new ASIC Chair, Mr James Shipton, who has brought extensive financial market and regulatory experience to ASIC. Mr Daniel Crennan QC will soon join ASIC as an additional Deputy Chair focused on enforcement.[89] The Treasurer has also indicated an intention to nominate Mr John Lonsdale as the second Deputy Chair of APRA.[90]

Accountability, co-operation and information sharing

121. A key aspect of determining regulator effectiveness is considering the regulators' accountability and performance reporting. Australia's regulators are accountable to Parliament and the public through Treasury Ministers and the Parliamentary Committee process. Regulators are required to meet the transparency and accountability requirements under the *Public Governance, Performance and Accountability Act 2013* (PGPA), table annual reports and appear at Senate Estimates Hearings. Governments also provide regulators with Statements of Expectations, which set out the Government's expectations of the regulator within its broader agenda. The financial regulators are not subject to oversight by a dedicated, standalone body.

122. At an operational level, the decisions of regulators may be bound by the requirements of procedural fairness and/or subject to internal or external review, for example by the Administrative Appeals Tribunal or a court.

123. Australia's financial system regulators co-ordinate their work in a number of ways, including through the Council of Financial Regulators (CFR). The CFR was established in 1998 following the recommendations of the Wallis Inquiry, and is made up of of ASIC, the Reserve Bank of Australia, APRA and Treasury. It is a non-statutory body whose role is to contribute to the efficiency and effectiveness of financial regulation, to promote stability of the Australian financial system, and to advise the Government on the adequacy of Australia's financial regulatory arrangements. Although the CFR's arrangements are informal, they were considered with approval by the International Monetary Fund's 2012 Financial Stability Assessment Program and more recently by the Financial System Inquiry, which recommended only that there would be benefit in increasing the transparency of the CFR's deliberations.[91]

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89 O'Dwyer, K (Minister for Revenue and Financial Services) 2018, Strengthening ASIC's leadership, media release, 28 March, viewed 10 May 2018, <http://kmo.ministers.treasury.gov.au/media-release/028-2018/>.

90 Morrison, S (Treasurer) 2018, Strengthening our financial regulator, media release, 30 May 2018, viewed 30 May 2018, < http://sjm.ministers.treasury.gov.au/media-release/056-2018/>

91 Commonwealth of Australia 2014, *Financial System Inquiry: Final Report*, page 234.

124. The regulators have access to valuable information on their regulated populations, and these populations often overlap. While each regulator may assess information for different purposes, there are common interests between the regulators that mean effective information sharing is an important contributor to their effectiveness.[92] The ability to effectively share information is affected by any legislative restrictions to maintain confidentiality,[93] systems to make sharing information simple and accessible, and the capabilities of regulators' staff to identify information of common interest. ASIC and APRA have established mechanisms to share information at various levels across each of the organisations. It is important these mechanisms for co-operation continue to evolve as regulatory tools and remits evolve.

OPTIONS TO ENHANCE REGULATOR EFFECTIVENESS

125. Fundamental to considering options for reform to enhance the effectiveness of regulators is the assessment of the long-term benefits against the long term costs of different options.

126. Regulatory costs – the cost of meeting regulatory requirements, including funding of the regulators – are borne by financial firms and, in turn, by consumers either directly through higher costs for financial products and services, or indirectly through the impact of such costs on competition or innovation in the choice and quality of products and services that consumers can access.

127. Regulatory costs impact all firms but can have a disproportionate impact on smaller firms and new entrants.

128. Over time, a financial system that is overburdened by regulation will fail to deliver on its objectives of meeting the financial needs of the community and facilitating a dynamic, stable and growing economy. Thus reforms to ensure consumer confidence through strong respected regulators must balance the efficiency and ability of the financial system as a whole to succeed.

129. The Government has taken a number of steps to address many of the challenges the regulators, both ASIC and APRA, have historically faced. This section outlines some further options and other matters to be considered in determining any further changes. This section focuses on ASIC reflecting the primacy of its role in regulating conduct.

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92 See, for example, Byres, W 2018, *Beyond the BEAR Necessities*, speech at the UNSW Centre for Law Markets and Regulation Seminar, 2 May.

93 Commonwealth of Australia 2015, *Fit for the future: A capability review of the Australian Securities and Investments Commission*, page 138. For example, the ASIC Capability Review Panel identified limitations on accessing evidential material obtained by the Australia Federal Police under its search warrant powers.

ASIC’s remit

130. If ASIC’s regulation of financial services to protect consumers is hampered by the breadth of ASIC’s remit then it would be appropriate to consider options such as narrowing the scope of its responsibilities.

131. A structural separation of ASIC – that is, removing significant regulatory responsibilities from ASIC and placing them with another (new or existing) regulator to narrow and sharpen the focus of ASIC’s activities and reduce organisational complexity – could be a major shift in Australia’s regulatory architecture and, in turn, could also be complex, disruptive and have unintended consequences. Given this, the case would also need to be clear that a change in remit – as opposed to a boost to capabilities – was the key to enhancing ASIC’s effectiveness in delivering its mandate.

132. Consideration of the appropriateness of ASIC’s remit is not new. It was considered in the Wallis Inquiry in 1997. It concluded that there were significant synergies in a single regulator having responsibility for market conduct, consumer protection and the regulation of companies.[94] The issue of the remit was further examined in the Financial System Inquiry. Despite the growth in ASIC’s responsibilities, it did not support any major changes to the responsibilities of the regulators. It accepted “the view that there are synergies between functions—such as market supervision, insolvency and consumer protection—that would be lost if these functions were moved to other agencies”.[95]

133. The Financial System Inquiry also specifically considered and did not recommend divesting responsibility for consumer protection in financial products to another regulator. It determined that these powers were an important part of ASIC’s toolkit and that there was value in having an integrated consumer regulator for financial services.[96]

Improving ASIC’s powers

134. Consideration of the need for further reforms to ASIC’s powers requires regard to the significant reforms already underway.

135. One further option for reform that could be considered is whether ASIC has sufficient flexibility in determining the regulatory framework it administers. Changes to ASIC’s regulatory framework typically require new laws to be approved by Parliament, which can take time and limit ASIC’s ability to respond to emerging risks.

136. ASIC currently has certain rule-making powers through its exemption and modification powers and through class orders. For example, ASIC’s exemptions and modification power in relation to the financial services industry allows ASIC to exempt certain classes of financial services providers from the requirement to hold a financial services licence.

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94 Commonwealth of Australia 1997, *Financial System Inquiry: Final Report*, page 19.

95 Commonwealth of Australia 2014, *Financial System Inquiry: Final Report*, page 235.

96 Commonwealth of Australia 2014, *Financial System Inquiry: Final Report*, page 235.

137. As in the financial services example, ASIC's existing rule-making powers are often limited in two respects:

- ASIC's power is limited to specific segments of ASIC's regulated population; and/or
- the kinds of rules that ASIC can make are limited to exempting or modifying existing provisions in the law.

138. More recent reforms have sought to provide ASIC with greater flexibility in its ability to make rules. For example, in the reforms to life insurance remuneration, the *Corporations Amendment (Life Insurance Remuneration Arrangements) Act 2017* provides ASIC with the ability to set the cap that applies through determining a legislative instrument.[97] Similarly, the Product Intervention Power, currently being developed, seeks to provide ASIC with a degree of flexibility in setting its regulatory approach.

139. Rule-making powers give regulators discretion to add and vary requirements under a statutory framework without requiring new laws to be made by Parliament. This allows regulators to take a more responsive approach to regulation as rules and requirements can be modified to meet a changing regulatory environment. As legislative instruments, these rules are disallowable and therefore enable Parliamentary scrutiny. They can also be subject to ministerial oversight, as is the case for some ASIC rule-making powers.

140. There may be other specific areas where further rule-making power could enhance ASIC's ability to address misconduct (for example, see paragraphs 193 and 275). One such option would be to give ASIC further targeted rule-making power that is limited to a segment of the financial services industry or in respect of a particular function. This approach would narrow the areas in which ASIC can establish rules, mitigating concerns around reduced Parliamentary oversight. A targeted rule-making power may, however, exacerbate issues around regulatory coherence. ASIC's ability to make rules already varies depending on the sector or issue involved, and further targeted rule-making powers could perpetuate this fragmentation.

141. Alternatively, this option could take the form of a broad rule-making power (scope of power based on part or all of ASIC's mandate) cast in similar terms as APRA's rule-making power under section 11AF of the Banking Act which gives APRA the power to make standards in relation to 'prudential matters'.

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97 For example, see s 963BA2 of the *Corporations Act* 2001 inserted by s 13 of the *Corporations Amendment (Life Insurance Remuneration Arrangements) Act 2017*. ASIC may, by legislative instrument, determine an acceptable benefit ratio, for a benefit for a year or determine the amount that is an acceptable repayment.

142. The advantage of a broadly-cast power is that ASIC would be consistently empowered to establish rules across its entire regulated population. However, with the greater variability in ASIC's regulated population relative to that of APRA, careful consideration would need to be exercised by ASIC to ensure the benefits are weighed against the costs of any additional regulation imposed through new rules.[98] A more fragmented stakeholder base may be less effective in raising concerns during consultation processes or being able to navigate parliamentary processes for disallowance. Greater flexibility for ASIC can also mean less certainty around obligations placed on the regulated population, which can compound compliance costs whenever obligations change.

143. A broadly-cast rule-making power is not without international precedent. For example, the Financial Conduct Authority (FCA) in the United Kingdom has a broad statutory power to make general rules as appear necessary or expedient for the purpose of advancing one or more of its operational objectives.[99]

144. While there may be a case for giving ASIC further rule-making powers, doing so would require a trust, now and into the future, that ASIC's leadership would use such powers responsibly and judiciously — particularly for broadly-cast rule-making powers.

ASIC's regulatory culture

145. Responsibility for deciding which regulatory tools to use in a particular case, and more generally what regulatory approach is most appropriate for each industry, rests with ASIC as an independent regulator. ASIC's capacity to change this approach rests on the capabilities available to it (including powers, leadership and resourcing), and is influenced by the Government's Statement of Expectations and community expectations more broadly.[100]

146. The trade-off that requires careful consideration is to what extent a regulatory culture with enhanced and accelerated enforcement can, in the longer term, instil change in the conduct of financial firms, and whether the scale of such a change would mean that consumers are better off in the long run. The costs can involve a higher level of resourcing of enforcement activity – funded by industry – and risk tolerance for failed court cases. Higher volumes of court actions would also have flow on resourcing consequences for the court system and the Commonwealth Director of Public Prosecutions.

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98 Where rule making powers apply through determination of legislative instruments, the *Australian Government Guide to Regulation* sets out expectations for consultation and cost benefit analysis. Further, as subordinate legislation these instruments remain subject to disallowance by Parliament.

99 *Financial Services and Markets Act 2000* (United Kingdom), s 137A.

100 ASIC, 2014,Statement of expectations and intent, viewed 10 May, <https://asic.gov.au/about-asic/what-we-do/our-role/statements-of-expectations-and-intent/>

Regulator resources

147. As discussed above, regulator resourcing should contemplate more than just funding, but also capabilities. The appointments made to a regulator and the policies of regulators to attract or develop staff with the right capabilities and appropriate systems to support operations are pivotal to effective regulators.[101]

148. The regulators are now largely funded through industry levies and fees. However, the total quantum of funding (that is then cost recovered) remains a decision of government. The Commission may consider the adequacy of the regulators' current resources in assessing their ability to carry out their mandates.

149. However, as has been noted above, under existing arrangements any additional funding comes at an increased cost to industry, which in the long run is borne directly by consumers through higher costs of products and indirectly though the impacts on competition. Having the cost borne by industry in the first instance makes transparent the regulatory effort required in relation to a particular sector and can encourage the sector to improve its practices in order to reduce costs.

150. As the Treasurer and the Minister for Revenue and Financial Services have noted, ASIC is currently in discussions with the Government on whether additional funding is required for ASIC to be able to deliver its regulatory responsibilities, including whether ASIC's Enforcement Special Account is sufficient to support multiple large-scale investigations.

151. In addition to the quantum of funding, the Commission may also consider the model for funding the regulators.[102] The Financial System Inquiry recommended that regulators be provided with stable funding by adopting a three-year funding model based on periodic funding reviews. While a three year funding model may provide additional stability in funding, the current funding model allows regulators to request additional funding on an annual basis (through submitting new policy proposals) and provides a level of stability in terms of funding through the forward estimates.

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101 The ASIC Capability Review made recommendations aimed at realigning ASIC's internal governance, ensuring best-practice merit-based recruitment of senior staff, implementing a forward looking skills gap assessment of the Commission, increasing the scale and diversity of secondments, improving workforce planning and improving ASIC's ability to attract talent by removing ASIC from the *Public Service Act 1999* (Cth).

102 Commonwealth of Australia 2014, *Financial System Inquiry: Final Report*, page xxvi.

ADVICE AND CONFLICTS OF INTEREST

152. The Commission's hearings have brought out conflicts of interest that exist in two significant parts of the financial system — financial advice and residential mortgage broking — and the poor customer outcomes that can result from the failure of firms to appropriately manage such conflicts. Conflicts involving product or sales incentives for employees have also featured. Those conflicts appear, in turn, to have had a corrosive effect on the culture and governance of some of the firms involved.

153. Advice and intermediary services, such as those provided by mortgage brokers and financial advisers, play an important role to bridge the information gaps and lower the search costs consumers face, and assist in dealing with complex choices. The 2015 Harper review concluded that such services play an important role in providing services that allowed consumers to foster competition, but only where the incentives of these intermediaries align with those of consumers.[103]

154. In light of the evidence of misconduct and conduct falling below community standards and expectations, Counsel Assisting the Commission have asked what more could or should be done to ensure that the interests of consumers and the incentives of advisers or brokers align, and that the legal obligations relating to conflicts of interest are complied with.[104]

155. The preceding sections of this paper looked at two broad responses: improved governance and culture in the industry; and more capable and effective regulators. This section focuses on what more may also be required of the regulatory framework, as it applies specifically to financial advice and mortgage broking as well as employee incentive arrangements, to address the issues the Commission has identified.

103 Commonwealth of Australia 2015, *Competition Policy Review: Final Report*, page 301.

104 See, for example, evidence relating to NAB (Royal Commission transcript, 23 March 2018, pages 976-77), CBA (Royal Commission transcript, 23 March 2018, page 982) and ANZ (Royal Commission transcript, 23 March 2018, page 987).

156. Treasury's background papers to the Commission on consumer lending and financial advice set out the current regulatory regime and how the regime has evolved in recent years. For financial advice in particular, the regulatory framework has moved away from relying on appropriate disclosures to consumers to imposing higher professional standards on financial advisers and requiring greater alignment of interests between advisers and their clients. Professional standards have been increased by requiring advisers to reach higher levels of education, pass an exam, undertake continuing professional development and comply with a code of ethics. There has been greater alignment of interests by the introduction of a 'best interests duty' (requiring financial advisers to act in the best interests of their clients when giving personal advice) and related obligations, and banning advisers from receiving conflicted remuneration (with some exceptions).

157. The hearings have, however, raised questions about the merits of the exceptions to the conflicted remuneration ban, particularly the grandfathering of arrangements in place prior to 1 July 2013, and the efficacy of the best interests duty.[105] There appears some potential for reform in these areas to achieve better consumer outcomes.

158. The possibility of a major structural reform, of breaking up integrated financial services firms, has also been raised. Counsel Assisting have asked whether it is possible for integrated financial firms that provide advice to manage appropriately the conflicts of interests arising from their inherent misaligned incentives. Due to the significance of such a reform, this submission provides a more in-depth consideration of its merits than initially provided in our submission responding to the financial advice hearings.

159. Our judgment — subject to evidence in future hearings — is that recent structural changes in the industry, recently introduced or soon to be introduced reforms, other potential reforms the Commission could recommend, and heightened attention by firms and ASIC, should be sufficient to mitigate the systemic risks involved — subject to further ongoing scrutiny by regulators. Structural separation would also be complex and disruptive, and could have unintended consequences.

160. For mortgage broking, the regulatory framework is less interventionist, with no direct regulatory restrictions on conflicted remuneration or positive duty on brokers to act in consumers' interests. In part, this reflects the fact that the broker's role is a narrower and well-defined one, and that mortgage broking represents a distribution channel for a specific financial product.

161. As a key distribution channel for mortgages, and by assisting consumers' search for a better deal, mortgage broking also has a vital role in facilitating effective competition and better outcomes for consumers that needs to be taken into account in assessing reform options.

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105 See for example, ASIC (Royal Commission transcript, 16 April 2018, pages 1041-44) and AMP (Royal Commission transcript, 27 April 2018, pages 1936–43 and 1948–53)

162. Following a comprehensive report by ASIC in 2017 on mortgage broker remuneration, the industry is progressing reforms that could address the most significant misconduct with the current remuneration model, and ASIC is to obtain powers to intervene when satisfied that there has been, or is likely to be, significant consumer detriment. The adoption of a positive duty on brokers to act in consumers' interests may also merit consideration if it can be achieved without adding undue compliance costs.

CONFLICTS OF INTEREST IN FINANCIAL ADVICE

163. Individuals engage financial advisers because they consider the financial system, together with their own circumstances, too complex for them to make unaided choices. Reflecting this role, financial advisers need to be trustworthy, competent, honest and act fairly towards their clients. First and foremost, they should be focused on promoting their clients' financial interests.

164. Conflicts of interest undermine these basic requirements where the adviser puts their interests ahead of their client.

165. All remuneration structures and business models can, however, give rise to conflicts of interest, even if its form differs or the parties concerned vary. When markets function well, commercial practices evolve to best manage the multiplicity of interests and potential conflicts. Hence, overly prescriptive interventions —not taking account of all the trade-offs involved — can give rise to costs and unintended consequences.

166. The Commission's second round of hearings, along with the work of ASIC, has identified conflicts of interest resulting in poor consumer outcomes arising from:[106]

- the remuneration structures of financial advisers and remaining conflicted remuneration;
- financial advice business models, and incentives to create ongoing advice relationships with customers; and
- integrated business models that combine financial advice with other financial products and services.

106 ASIC 2018, *Report 562: Financial advice: Vertically integrated institutions and conflicts of interest*; ASIC 2018, *Report 575 SMSFs: Improving the quality of advice and member experiences*; ASIC 2014, *Report 413: Review of retail life insurance advice*.

Conflicts of interest arising from remuneration structures

167. The Future of Financial Advice (FOFA) reforms banned financial advisers from accepting conflicted remuneration. FOFA also banned product issuers and employers paying conflicted remuneration to a financial adviser. These reforms have removed some of the worst conflicted remuneration practices from the industry, improved industry professionalism and improved the practices of advice licensees and their advisers.[107]

168. The Commission has heard evidence outlining the continuing potential for grandfathered conflicted remuneration to bias advice.[108] Counsel Assisting have questioned the continuation of the statutory carve-outs to the ban on conflicted remuneration, including in relation to insurance commissions, and the grandfathering of pre-FOFA remuneration arrangements.

Removing exemptions from the ban on conflicted remuneration

169. Those exemptions to the ban on conflicted remuneration for which concerns have been raised over poor consumer outcomes relate to life insurance, elements of general insurance (consumer credit insurance), basic banking products, stamping and brokerage fees and time-share arrangements.[109] Given the varied nature of the exemptions, removal of these exemptions is best considered on a case-by-case basis following a thorough analysis of the impacts and trade-offs involved.

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107 ASIC 2018, Round 2 hearings submission to the Financial Services Royal Commission, pages 11 and 13; ASIC 2018, *Report 562: Financial advice: Vertically integrated institutions and conflicts of interest*, page 9; Royal Commission 2018, 16 April 2018, Exhibit 2.1, Witness Statement of Kell, P, paragraph 88.

108 The Commission heard evidence about the treatment of grandfathered payments by Commonwealth Financial Planning (Royal Commission transcript, 27 April 2018, pages 1946-47), AMP (Royal Commission transcript, 27 April 2018, pages 1940-41) and CBA (Royal Commission transcript, 27 April 2018, page 1951), and their influence on the culture and practices of those firms. The Commission also heard evidence of advisers not transitioning clients off uncompetitive platforms, which could also be attributed to biases resulting from grandfathering (but this was not specifically identified by the Commission): see Royal Commission transcript, 27 April 2018, pages 1948–49.

109 Other exceptions concern fees paid by the client, training and education, information technology and support and non-monetary benefits less than $300.

170. The life insurance exemption is one of the more significant,[110] and an area where ASIC has clearly identified poor consumer outcomes.[111] Reforms to life insurance remuneration were legislated in 2017 following extensive consultation and consideration by Parliament, and have only been in effect since 1 January 2018. Continuing to allow (capped) commissions was considered justified given concerns over under-insurance, affordability of advice and the viability of some adviser practices.[112] The reforms also empowered ASIC to vary the level of permissible commissions in the future. ASIC will review the impact of these reforms in 2021.

171. For time-share arrangements, ASIC has expressed concern over the potential for consumer harm arising from the current exemption,[113] and is reviewing its guidance to industry.[114] Given that removal of the exemption would likely have a substantial effect on the sector and relevant consumers, more in-depth analysis of the issues involved in removing the exemption would be worthwhile. In respect of stamping and brokerage fees, the Government has agreed to a Financial System Inquiry recommendation to review remuneration practices in the stockbroking industry which would cover aspects of these.[115]

172. Other exemptions, such as for basic banking products and consumer credit insurance, are also relevant to the broader issue of product sales incentives in retail banking that have arisen in the Commission's hearings to date (see below).

173. While there is also an exemption provided for buyer of last resort (BOLR) arrangements, which featured in the second round of the hearings, its purpose is to clarify the application of the ban in respect of BOLR arrangements. Removing the exemption, by itself, would not prohibit BOLR arrangements. However, such arrangements would then need to be assessed against the general principle underpinning FOFA, which prohibits benefits that could reasonably be expected to influence recommendations around choice of financial products or advice provided to clients.

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110 Industry estimates place commissions from life insurance products at 24 per cent of adviser revenue: see Taylor, M 2018, 'Losing life/risk commissions would hurt the most', *Money Management*, 22 May, viewed 3 July 2018, <https://www.moneymanagement.com.au/news/financial-planning/losing-liferisk-commissions-would-hurt-most>. This share is likely to be significantly higher for specialist risk advisers.

111 ASIC 2014, *Report 413: Review of retail life insurance advice*.

112 Treasury 2018, *Background Paper: Key reforms in the regulation of financial advice*, pages 11 and 12, which outlines the rationale for the reforms and why it was decided to allow capped commissions to continue.

113 Royal Commission 2018, 16 April 2018, Exhibit 2.1, Witness Statement of Kell, P, paragraph 100.

114 ASIC 2017, *CP 272: Time-sharing schemes: Update on the status of our review of the policy settings*.

115 Commonwealth of Australia 2014, *Financial System Inquiry: Final Report*, Recommendation 24, page 217.

Removing grandfathered conflicted remuneration

174. At the time FOFA was introduced, it was believed that grandfathered commissions concerning arrangements in place prior to 1 July 2013 would have a short natural life, and that grandfathering would give firms and the industry the opportunity to adjust their business models. Grandfathered payments have, however, persisted for longer than expected.

175. Concerns about grandfathered payments have centred on their potential to bias advisers towards recommending a customer stay with an existing grandfathered product or arrangement where there is a superior alternative available.[116]

176. Precise estimates of the remaining extent of grandfathering are not available. One estimate is that grandfathered conflicted remuneration makes up between 9 and 19 per cent of adviser total revenue mix.[117] The Productivity Commission has estimated that grandfathered trail commissions in relation to superannuation accounts total around $214 million per annum.[118]

177. Beyond removing a driver for potentially poor quality advice, removing grandfathering has the potential to benefit consumers by lowering product fees. Whether this would happen would depend on the behaviour of the entity that is currently required to pay the conflicted remuneration:

- scenario one: if the entity currently required (by contract) to pay the grandfathered conflicted remuneration (most likely, a product issuer) retains the payments, the issuer, and not clients, would benefit from the removal of grandfathering.
- scenario two: alternatively, if the entity paying the grandfathered conflicted remuneration decided to pass to consumers the benefits of no longer making payments to advisers (for example, through lower product fees or rebates), consumers would directly benefit.

178. In both cases, advisers may seek to recover any lost revenue by imposing additional advice fees directly on their customers. They may also stop servicing certain customers or exit the industry if no longer financially worthwhile to remain.

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116 This risk was identified by CHOICE and ASIC in their Round 2 hearing submissions to the Financial Services Royal Commission.

117 Taylor, M 2018, ‘Losing life/risk commissions would hurt the most’, *Money Management*, 22 May, viewed 3 July 2018, <https://www.moneymanagement.com.au/news/financial-planning/losing-liferisk-commissions-would-hurt-most>; Morgan Stanley 2018, AMP Limited Report, *Asia Pacific Insight*, page 16.

118 Productivity Commission 2018, *Superannuation: Assessing Efficiency and Competitiveness,* Draft Report, page 51.

179. BT's announcement in June 2018 to remove grandfathered payments in relation to BT products for customers of BT Financial Advice (BT salaried advisers) from 1 October 2018, and to pass the benefits through to clients, is an example of clients benefitting from the removal of grandfathered payments (scenario two).[119] BT chose to bear the cost of the new arrangements, with their advisers left no worse off.[120]

180. Legislative action to end grandfathering and replicate the BT example would be complicated.[121] Legislative action could possibly replicate scenario one, where the product manufacturer would benefit at the expense of the adviser. Any decision about benefits to customers and/or compensation for advisers (scenario two) would then be up to the product manufacturer and would be difficult to legislate for given the wide variety of circumstances and commercial arrangements that would need to be covered.

181. Therefore, while the continued conflicts of interest and degree of potential harm make for an in-principle case for removing grandfathered payments, doing so is not straightforward. An abrupt end could also impact on the viability of some financial advice practices, with implications for their owners, employees and customers.

182. One way forward could be to encourage firms to take more active steps to phase out grandfathered arrangements, while setting a clear end date for legislative action to be taken if significant grandfathering still persists. Consideration could also be given to introducing disclosure requirements to ensure consumers are informed when they are holding a product associated with a grandfathered conflicted remuneration payment.[122] Increased transparency could lead clients to put pressure on advisers to move them to alternative arrangements where appropriate or to pass through the benefits of the commissions.

Conflicts of interest arising from adviser business models

183. There are significant costs involved in providing financial advice. Typically, costs to the adviser are upfront, occurring when the adviser needs to gather information about the client's circumstances and develop and implement a financial advice strategy.

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119 BT Financial Group 2018, BT Financial Advice announces removal of grandfathered payments, media release, 20 June, viewed 3 July 2018, <https://www.bt.com.au/about-bt/media-centre/media-releases/archives/2018/media-release.html>.

120 There are reports of moves by other major financial advice providers taking steps to prohibit their in-house advisers from receiving grandfathered conflicted remuneration, but the details of these measures are less clear: see Uribe, A 2018, 'IOOF, ANZ Stick with Commissions', *Australian Financial Review*, 5 July 2018, page 18.

121 As noted by ASIC's submission to the financial advice hearings (p3), when grandfathering of commissions was discussed in the context of the proposed FOFA reforms concerns were raised that the abolition of commissions might breach s 51(xxxi) of the Constitution.

122 Productivity Commission 2018, *Superannuation: Assessing Efficiency and Competitiveness,* Draft Report, page 477.

184. When the adviser is unable to recoup the costs upfront, they have an incentive to establish an ongoing advice relationship. Advice recommending that a client invest in more complex financial products, such as a platform to enable active management of the assets that may be difficult and/or costly to exit, can then be seen as a means by which an adviser can justify an ongoing advice relationship.

185. This can directly give rise to consumer harm: for example, if advisers switch clients into products with unnecessary or inappropriate features even though the client's interest would have been better served by remaining with their existing product, such as an existing life insurance policy.[123]

186. The client can also end up paying multiple tiers of fees – for the product, platform and the advice on an ongoing basis.[124] This can prove costly where a client's interests would have been better served by alternative strategies (for example, paying down debt or investing in products directly rather than through a platform). Asset based fees can similarly bias advisers towards recommending investments in financial products over other strategies. [125]

187. These incentives are inherent to the adviser business model and will exist regardless of whether the adviser works as part of an integrated firm or is independently owned. Similar incentives to establish an ongoing advice relationship can also be observed in relation to self-managed superannuation funds (SMSFs) where advisers may be inclined to advise a client to establish a SMSF to create an ongoing fee paying relationship (through the provision of auditing, administration and investment services).[126]

Options to address conflicts arising from adviser business models

More prescription around the application of the best interests duty

188. One way the regulatory framework seeks to deal with the conflicts inherent in the adviser relationship, beyond the general requirements to manage conflicts of interest, is the best interests duty. However, the duty does not require advisers to compare their recommended product against specific products or types of products when constructing their advice, recognising that it is not feasible for advisers to benchmark against every product in the market.[127]

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123 Royal Commission transcript, 16 April 2018, pages 1038-39.

124 CHOICE 2018, Round 2 hearings submission to the Financial Services Royal Commission, page 11.

125 CHOICE 2018, Round 2 hearings submission to the Financial Services Royal Commission, page 12.

126 ASIC 2018, *Report 575 SMSFs: Improving the quality of advice and member experiences*, page 69; Royal Commission 2018, 16 April 2018, Exhibit 2.1, Witness Statement of Kell, P, paragraphs 46 – 48.

127 Other than the client's existing product: see ASIC, Regulatory Guide 175 *Licensing: Financial product advisers—Conduct and disclosure.*

189. Additionally, the operation of the best interests duty is subject to a 'safe-harbour' provision which most advisers rely on given what they see as the inherently uncertain nature of the requirement.[128] The widespread use of the safe harbour means that satisfaction of the best interests duty has become more a matter of process than substance. Even then, the extent of compliance with the safe harbour appears low.[129]

190. Where there is evidence of significant and systemic client detriment arising from conflicts of interest in particular areas, consideration could be given to strengthening the best interests duty, for example by providing more prescription about the requirements that must be met for an adviser to discharge the duty.

191. One option may be to establish a presumption that switching from or into certain products would be considered to not meet the best interests duty unless an adviser can positively demonstrate that the customer will be better off.

192. Such an approach would not be without its downsides. Where an adviser seeks to satisfy a presumption they are likely to incur additional costs in doing so, and in time these would be passed on to clients in higher fees. Adviser caution may also mean that advisers do not recommend a course of action different to the presumption even when it would be in the client's best interests for this to occur. Other advisers may seek to avoid the costs associated with the best interests duty and move into general or no advice models (where the duty does not apply).

193. The requirements would need to be carefully calibrated to ensure the right balance between not being excessively restrictive whilst also ensuring that the presumption is not rendered largely ineffective. To obtain the right balance would be challenging, particularly as circumstances and practices evolve over time. One option to address this would be to give ASIC a degree of rule-making power in this area (an example of a general approach discussed at paragraphs 135 to 144). Such an approach would give more flexibility over the design of any presumption, including flexibility to make adjustments as required.

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128 The safe harbour allows an adviser to demonstrate they have complied with the best interests duty by taking steps outlined in the legislation, including identifying the objectives, financial situation and needs of the client and making reasonable enquiries to obtain complete and accurate information.

129 Several ASIC reports into the quality of financial advice prepared post-FOFA found significant levels of non-compliance with the best interests duty: see ASIC 2018, *Report 562: Financial advice: Vertically integrated institutions and conflicts of interest*; ASIC 2014, *Report 413: Review of retail life insurance advice*; ASIC 2018, *Report 575 SMSFs: Improving the quality of advice and member experiences*.

Banning asset-based fees and mandating separate invoice

194. Submissions to the Commission have also suggested that some of the existing conflicts of interest could be addressed through banning asset-based fees or requiring invoicing of adviser fees to clients.[130] These proposals essentially seek to make the costs of advice clearer to customers, particularly under ongoing advice arrangements. Both proposals will create additional pressure on advisers to demonstrate value to the customer to justify their charges.

195. Banning asset based fees and requiring separate invoicing to clients would require substantial changes to some industry practices, and would not entirely mitigate against the conflicts of interest inherent in for-profit business models (for example, time-based billing could encourage advisers to over-service).

Conflicts of interest arising from integrated business models

196. The Commission's hearings have highlighted the inherent misalignment of incentives within firms that integrate personal financial advice along with product manufacture, and the challenges firms have had in adequately managing those conflicts.[131] These conflicts arise for both vertically and horizontally integrated firms.

197. Firms across the economy adopt various business models in supplying goods or services to consumers, and with varying degrees of integration of products and supply chains. Competition and innovation in business models is integral to a market economy, and can enhance firm productivity. In general, integrated business models are therefore not a concern, though they can raise particular policy issues as for financial advice or given their potential to restrict competition.

Issues arising from the integration of financial advisers with product manufacture and other services

198. The ban on conflicted remuneration applies equally to all financial advisers – be they 'in-house' (salaried), 'affiliated' or non-affiliated.[132] The incentive for in-house or affiliated advisers to recommend in-house products is likely to be more deeply rooted than remuneration incentives alone and include factors like career progression, greater visibility of and access to information/training on in-house products and a tendency for advisers to identify with a firm and its products.

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130 CHOICE 2018, Round 2 hearings submission to the Financial Services Royal Commission, page 4; ASIC 2018, Round 2 hearings submission to the Financial Services Royal Commission, page 2.

131 See for example, CFPL (Royal Commission transcript, 27 April 2018, pages 1949-51) and CBA (Royal Commission transcript, 27 April 2018, pages 1951-53).

132 An affiliated financial adviser is one that is working under the Australian Financial Services Licence of a financial firm, but is not an employee of that firm.

199. There is clear evidence from the hearings and ASIC that vertically integrated firms have often not appropriately managed these conflicts, despite general legal obligations to do so.

200. In-house product bias has been found in ASIC 'shadow shopping' surveillances in 1998, 2003, 2006 and 2011, especially in relation to platforms. More recently, ASIC's Report 562 looked at the quality of superannuation switching advice provided by the major vertically integrated firms (AMP, ANZ, CBA, NAB and Westpac) and found a strong bias towards in-house products, involving widespread non-compliance with the best interests duty and, in 10 per cent of cases, demonstrable harm to consumers.[133] ASIC is expanding the scope of this work more broadly across the sector.[134]

201. The problems arising from a conflict of interest can also manifest in other ways. Consumer detriment can come from failure by one part of a financial firm to respond adequately to evidence of poor conduct by another part. In evidence to the Commission, a representative of Colonial First State conceded that it would be unlikely that Colonial would deny a CBA-affiliated licensee access to their platform because of a breach of the dealer terms of trade.[135]

202. As well as potentially giving rise to direct detriment to individual clients, the misaligned incentives of financial advisers connected with large vertically integrated firms may reduce competitive pressures on the product manufacturing side of these firms. It can also affect competition in related markets. For example, in-house advisers may be required to use an in-house platform even when superior platforms may be available .[136]

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133 It is likely that ASIC Report 562 understates the number of cases where consumers are significantly worse off as a result of switching. To be included in the 10 per cent of files where consumers where significantly worse off, there needed to be enough information about the client's existing product included on the client's file to enable ASIC to make a conclusion about the relative position of the client as a result of the switch.

134 Shipton, 2018, Senate Economics Legislation Committee: Opening statement by ASIC Chair, James Shipton, media release, Accessed 30 May 2018, < https://asic.gov.au/about-asic/media-centre/speeches/senate-economics-legislation-committee-opening-statement-by-asic-chair-james-shipton-30-may-2018/>.

135 Royal Commission transcript, 18 April 2018, pages 1255–56.

136 Adviser Ratings Research 2018, *2018 Australian Financial Advice Landscape,* Adviser Ratings, page 35.

203. Issues have also arisen with respect to 'one-stop shops' — horizontally integrated firms that provide a range of services and products, including financial advice.[137] One area of concern relates to one-stop shops for SMSFs.[138] These firms have incentives to recommend a customer establish an SMSF in order to provide other related services to the client, even in circumstances where the establishment of the SMSF is not in the client's best interests. Enhancing the best interests duty, discussed above, could be one way to address the issues associated with one-stop shops.[139]

Options to address issues arising from vertical integration — structural separation

204. Counsel Assisting questioned whether financial firms and advisers are able to appropriately manage the conflicts of interest arising from vertical integration, and whether it is necessary to enforce the separation of products and advice.[140]

205. Our judgment — subject to evidence in future hearings — is that structural changes in the industry (reflecting decisions both by firms and the recent shift of advisers away from the largest vertically integrated firms),[141] recently introduced or soon to be introduced reforms and other potential reforms the Commission could recommend, and heightened attention by firms and ASIC to the problems that have been identified, should be sufficient to mitigate the misconduct risks involved — subject to further ongoing scrutiny by regulators. Structural separation would also be complex and disruptive, and could have unintended consequences.

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137 Royal Commission 2018, 16 April 2018, Exhibit 2.1, Witness Statement of Kell, P, paragraphs 46 – 48 and 51(b).

138 Royal Commission 2018, 16 April 2018, Exhibit 2.1, Witness Statement of Kell, P, paragraphs 46 – 48 and 51(b); ASIC 2018, Round 2 hearings submission to the Financial Services Royal Commission; ASIC 2018, *Report 575 SMSFs: Improving the quality of advice and member experiences*.

139 The myriad of possible business arrangements, and ability of businesses to restructure (including to establish informal referrals), mean that the option of structural separation discussed in respect of vertically integrated firms would be even more difficult to apply to one-stop shops.

140 See for example, CFPL (Royal Commission transcript, 27 April 2018, pages 1949-51) and CBA (Royal Commission transcript, 27 April 2018, pages 1951-53).

141 Financial advisers have been exiting the large vertically integrated financial firms to work for privately-owned firms, while approximately two-thirds of new advisers to the industry are joining privately owned groups (Adviser Ratings Research 2018, *2018 Australian Financial Advice Landscape*, Adviser Ratings, page 28). Most of the horizontally integrated banking groups are also in the process of being unwound, though wealth management arms are typically being sold as vertically integrated businesses, even if no longer bank owned.

Design issues involved in requiring structural separation

206. Structural separation would require separating the provision of financial products (including platforms) from the provision of retail personal financial advice.[142] Product manufacturers and platform operators would not be able to employ financial advisers, nor have any significant ownership or financial interest in financial advice practices or dealer groups.

207. There would be a number of design choices to make as part of such an option that would require detailed consideration, including:

- the degree of ownership or interest that would be prohibited, and how it would be measured;
- whether all financial products should be excluded or certain non-complex products allowed (for example, basic banking products);
- whether other arrangements that possibly give rise to similar outcomes as vertical integration should be covered (for example, exclusive distribution agreements, financial advisers offering 'managed accounts' to clients and white-labelling arrangements); and
- transitional arrangements.

208. As discussed below, in-house advice in the superannuation sector would also need specific consideration given the provision of advice by superannuation funds can play a beneficial role.

209. While choices on these design features are relevant in assessing the advantages and disadvantages of requiring structural separation, and reaching a judgment on whether the net benefits are likely to be significantly positive, a general outline of the merits follows.

Implications of structurally separating vertically integrated personal finance advice

210. There would be advantages as well as disadvantages from requiring personal financial advice to be separated from product manufacture and platforms.

211. The potential advantages are clear. For consumers who receive personal financial advice a material source of conflict of interest concerning that advice would be removed. In addition, structural separation could strengthen competition in platform and product markets based on which products are lower cost and/or better able to meet customers' needs.

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142 A client is taken to be a retail client for the purposes of the *Corporations Act 2001* unless an exemption applies. There are a range of exemptions that apply, but the most common exemptions relate to: the acquisition of a financial product over $500,000; the financial product or service is in connection with a business that is not a small business; having personal wealth of $2.5 million in net assets or income of at least $250,000; or the person is a professional investor (see *Corporations Act 2001*, s761G).

212. A review of submissions provided to the Royal Commission has identified the following claims as being the most significant drawbacks of structural separation:

- vertically integrated firms benefit from economies of scale, allowing for cheaper advice for a given quality;
- there is a convenience for the client of dealing with a single firm as well as brand assurance that comes from large, familiar firms;
- vertically integrated firms provide better access to redress if things go wrong as they have 'deep pockets' and a broader reputation to protect; and
- the risk of unintended consequences from individuals switching to rely on general advice or other (lower quality) advisers.

213. Some of these claims are more convincing than others.

Economies of scale from vertical integration

214. There are clearly economies of scale at different points in the wealth management supply chain, most notably in the operation of a platform and in the services provided by dealer groups.

215. Platforms by their nature can involve major financial commitments – due to significant IT infrastructure investments and regulatory and licensing costs. The significant fixed costs of platforms, but low marginal costs from their use, give rise to economies of scale. Despite this, independent third parties have been able to enter the market and there are other sources of competition.

216. There are also economies of scale operating at the adviser level. This is one reason why the industry is structured around 'dealer groups', where the dealer group provides a range of services to support financial advisers, including training and professional development, risk management and compliance, advice documentation (for example advice templates), research and software solutions, and marketing.

217. The key question, however, is whether there are additional economies of scale from the integration of advisers, dealer groups, platforms and product manufacturers into the same group. The current structure of the financial advice industry, which is not particularly concentrated, suggests that these economies are not significant.[143] That there is currently a significant movement of advisers to non-institutionally aligned firms supports this conclusion.[144]

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143 Whereas the four major banks hold very substantial assets, accounting for nearly 80 per cent of the entire banking system (see Productivity Commission 2018, *Competition in the Australian Financial System,* Draft Report, page 107), the five largest firms in financial advice (AMP, IOOF, Westpac, CBA and NAB) have a combined market share of just over 50 per cent: see IBISWorld 2018, *Industry Report: Financial Planning and Investment Advice in Australia*.

144 Adviser Ratings Research 2018, *2018 Australian Financial Advice Landscape*, Adviser Ratings, page 28.

The convenience of dealing with a single firm

218. ASIC Report 562 noted that customers who obtain financial services from a vertically integrated advice business are attracted to the convenience of a relationship with a single financial firm.[145] For example, customers of a bank may benefit from having access, when required, to financial advisers who are employees of the bank.

219. Convenience may not, however, be significant for other forms of vertical integration. Customers are often not aware that they are dealing with an adviser practice affiliated with a major firm at the time a service is provided. In part, this was the basis for Recommendation 40 of the Financial System Inquiry that the ownership of financial advisers and mortgage brokers be disclosed. Where advisers separate from a financial firm, their clients will also often follow the adviser to the new licensee — suggesting that consumers value their relationship with the adviser over the firm.

'Deep pockets' and reputation

220. There is clear evidence that prudentially regulated firms are more capable of remediating consumers. This can be seen in the case of unpaid external dispute resolution (EDR) arrangements. The amount of outstanding EDR determinations at May 2018 was around $15 million, and approximately 55 per cent of outstanding determinations were related to financial advice.[146] However, none of the outstanding determinations were related to APRA-regulated entities.

221. A potential systemic response to problems of uncompensated consumer losses, arising in respect of smaller, non-prudentially regulated firms, would be to establish a limited and carefully targeted forward-looking compensation scheme of last resort (CSLR) restricted initially to financial advice, as recommended by the Ramsay Review in 2017. The potential need for such a scheme is reflective of the limitations of professional indemnity insurance in this regard.[147]

222. The design of that scheme would, however, depend on the kinds of entities that were required to become members. A CSLR that was not able to include large, vertically integrated prudentially regulated firms could be different from a scheme which did include such participants. Without such firms being included and effectively cross-subsidising other advice firms, a CSLR may be less viable; the policy case for requiring such cross-subsidies is, however, unclear, and doing so could be self-defeating if large firms exit and stop providing advice as a consequence.

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145 ASIC 2018, *Report 562: Financial advice: Vertically integrated institutions and conflicts of interest*.

146 Financial Ombudsman Service 2018, *Unpaid determinations update*, viewed 3 July 2018, <http://fos.org.au/fos-circular-33-home/fos-news/unpaid-determinations-update.jsp>.

147 Commonwealth of Australia 2017, *Review of the financial system external dispute resolution and complaints framework Supplementary Final Report*, page 36.

The risk of unintended consequences

223. Structural separation would likely see a move towards greater use of non-advised distribution channels (including those that rely on general advice). One consequence could be that consumers who purchase a product through a non-advised channel would have more limited protections relative to those that acquire a product through an advised distribution channel. Other benefits of personal advice may also be lost; for example, ASIC has found that consumers acquiring life insurance through a non-advised distribution channel had a higher proportion of claims rejected.[148]

224. The Government's proposed Design and Distribution Obligations, which would require product issuers to identify target markets for their products and to select appropriate distribution channels for their products, should, however, address some of the risks associated with non-advised distribution of financial products.[149] In addition, the Government is committed to re-labelling 'general advice' to address concerns that consumers may misinterpret or excessively rely on guidance, advertising and promotional material that is described as 'general advice'. [150]

225. Where customers continued to receive personal advice, it would be from an adviser not linked to a product issuer. While this would mean that the adviser would not have any conflicts resulting from ownership structures, non-affiliated owned advisers may not provide better quality advice overall than conflicted institutionally-owned or affiliated advisers — the case study involving Dover being an example.

226. ASIC's Report 562 only examined vertically integrated firms, and so does not provide a comparative assessment of the quality of advice provided in vertically integrated firms relative to independent advisers. In the case of life insurance advice, ASIC has noted that problems in this area were more pronounced among independently-owned advisers than for institutionally-owned or affiliated advisers.[151]

Superannuation funds and advice

227. The implications of structural separation for the superannuation sector would need specific consideration given the provision of advice by superannuation funds can play a beneficial role. Superannuation funds are set up as trusts with the trustees having a fiduciary duty to the beneficiaries. There is also the sole purpose test which requires that funds must be maintained solely for one or more of the core purposes.

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148 ASIC 2016, *Report 498: Life insurance claims: An industry review*, page 7.

149 Further information on the design and distribution obligations was in Treasury's submission to the Financial Services Royal Commission in response to the financial advice hearings.

150 Commonwealth of Australia 2014, *Financial System Inquiry: Final Report*, Recommendation 40, page 271.

151 ASIC 2017, Response to Questions on Notice from the Parliamentary Joint Committee on Corporations and Financial Services, page 6.

228. These arrangements provide a higher level of obligation compared with other financial firms that are not trusts. That said, financial advice provided by superannuation funds is subject to many of the same potential conflicts of interests as advice provided by any other product provider, even if the trust and sole purpose test arrangements go some way to mitigating these conflicts.

229. If structural separation was to be considered, exceptions to the general rule could be considered for the following areas:

- To allow superannuation funds to continue to provide ‘in-product’ and intra-fund advice (a limited form of personal advice).[152] This could cover personal financial advice which is about a product that a member already has. For example, it could include investment advice to members on increasing contributions and changing investment options within a product.
- To take account of the role of advice from superannuation funds when members reach retirement. As default ‘MySuper’ superannuation products are not permitted to include a default retirement income product, individuals (who are often disengaged from their superannuation) are forced to make a range of complex decisions at retirement in how to drawdown their superannuation savings. This is a key point when advice is likely to be required to help guide members into suitable retirement income products. The Government’s proposed Retirement Income Framework currently envisages a greater role for superannuation trustees to guide their members at retirement toward an appropriate product in the fund.[153]

230. More work would be needed to determine the nature and extent of conflicted advice provided by the superannuation sector and whether it exists in intra-fund advice. The Royal Commission hearings on superannuation may shed some light on this. ASIC will shortly undertake an examination of financial advice in the superannuation industry.

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152 The term ‘intra-fund advice’ refers to arrangements that allow superannuation funds to provide simple, non-ongoing personal advice to members and spread the cost of this advice across all members of the fund rather than charging individuals directly.

153 See Treasury 2018, *Retirement Income Covenant Position Paper*.

CONFLICTS OF INTEREST IN MORTGAGE BROKING

231. In Australia, residential mortgage lending is a key financial market — 3.3 million households have a mortgage over their primary residence, with around 659,000 new owner-occupier mortgage contracts entered into in the past year.[154] Mortgages make up the majority of household debt (80 per cent) and a large share of bank lending (66 per cent).[155] An efficient, competitive market that maintains high lending standards and lends responsibly is important for households and investors, the economy and financial stability.

232. With over 50 per cent of new residential home loans now arranged through a broker, mortgage broking is an important element of the home loan market.[156] The first round of hearings on consumer lending, however, raised questions over the potential of mortgage broker remuneration to lead to poor consumer outcomes and to breaches of existing legal obligations. The hearings also brought out issues as to how legal obligations, such as responsible lending, were managed by the mortgage broking industry.

The role of mortgage brokers

233. Mortgage brokers assist consumers to match their borrowing needs with suitable loan products. In doing so mortgage brokers primarily help consumers navigate a crowded and dynamic loan market where pricing – interest rates and fees – can be hard for consumers to identify, understand and negotiate. Brokers also assist consumers to understand features of different mortgage products and facilitate the loan application process and provide some subsequent support in relation to a loan.

234. In performing these roles, brokers also act as a distribution channel for lenders (particularly in regional areas) and facilitate competition, exerting downward pressure on home loan pricing more generally. They do this by providing a valuable distribution channel for lenders, reducing costs related to the direct loan channel such as marketing and operating branches.

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154 Australian Bureau of Statistics 2017, *Housing Occupancy and Costs 2015-16*, cat. no. 4130.0; Australian Bureau of Statistics 2018, *Housing Finance, Australia,* cat. no. 5609.0, April 2018.

155 Australian Bureau of Statistics 2018, *Australian National Accounts: Finance and Wealth*, cat. no. 5232.0, March 2018; APRA 2018, *Monthly Banking Statistics*, May 2018.

156 Mortgage & Finance Association of Australia 2017, Post-draft submission to Productivity Commission Inquiry into Competition in the Australian Financial System, page 7; APRA 2018, *Quarterly Property Exposures Survey March 2018*.

235. The broker channel is of particular benefit to smaller lenders (non-major banks) since the costs of broker distribution are mostly variable, in contrast to bank branches which represent a largely fixed cost. Brokers also allow smaller lenders to gain geographic diversification in their lending portfolio. The four major banks' share of third-party originated loans is only 72 per cent, compared with a 79 per cent share of direct channel loan flow.[157]

Mortgage brokers and lending standards

236. Brokers receive a commission for a successful loan application, creating an incentive for brokers to take steps to ensure the loan is approved, even where doing so would not meet responsible lending and other obligations. The first round of hearings raised a number of issues with the conduct of some brokers, the lenders' systems and oversight when lending through brokers,[158] and lending standards more generally (such as the use of the Household Expenditure Measure (HEM)).[159]

237. Compliance with responsible lending obligations and lending standards are important for households, the prudential soundness of banks and overall macro-financial and macro-economic stability. Responsible lending obligations provide an appropriate balance between protecting consumers who may misjudge or be tempted to take on more debt than they can afford, and enabling lenders to provide credit. Along with other steps to maintain lending standards, the resulting lower rate of non-performing loans and of highly indebted households supports the prudential strength of banks and financial system stability.

238. Importantly, ASIC and APRA have undertaken a range of actions since 2014 to ensure compliance with responsible lending obligations and improve lending standards, as well as address macro-financial risks more generally.[160] A number of these target issues raised in the hearings, such as those around the use of HEM. Lending standards have improved as a consequence of APRA's and ASIC's measures as well as independent moves by the banks, and as a result the quality of new mortgage lending is now better than it was prior to 2014.[161] The introduction of comprehensive credit reporting and open banking reforms should also assist. This is an area where continued effective action by regulators, rather than a further tightening of legal obligations, would generally appear to be appropriate.

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157 APRA 2018, *Quarterly Property Exposures Survey*, March 2018.

158 For example, the Aussie Home Loans case study identified alleged broker misconduct in the falsifying of documents including payslips and bank statements submitted to lenders in support of home loan applications (Royal Commission transcript, 23 March 2018, pages 983-87).

159 See the questions raised in Royal Commission transcript, 23 March 2018, page 977.

160 Reserve Bank of Australia 2018, *Financial Stability Review*.

161 APRA 2018, Round 1 hearings submission to the Financial Services Royal Commission.

Conflicts of interest arising from mortgage broker remuneration structures

239. Brokers are currently paid by lenders (via aggregators) using a standard commission model. This model includes upfront and trailing commissions which are proportional to the size of the loan, and subject to clawback arrangements which allow lenders to recover some or all of upfront commissions if a loan goes into significant arrears or is terminated within a specified period. These commissions have also been supplemented by volume and campaign-based bonuses, as well as non-monetary benefits that are predominately determined by volume targets.

240. As identified in ASIC's 2017 Review of Mortgage Broker Remuneration, these features of the standard model give rise to conflicts of interest for brokers that could lead directly to poor consumer outcomes and reduce competition.[162] Such conflicts of interest are not exclusive to the broker channel; as ASIC's report brings out, sales staff employed by lenders can also receive conflicted remuneration.[163]

Brokers have incentives to recommend larger loans that take longer to pay back

241. As remuneration is principally determined as a function of loan size, brokers have an incentive to arrange larger loans, irrespective of the borrowing capacity of a consumer and the suitability of the loan product for that consumer. The clawback arrangements and responsible lending obligations prohibiting unsuitable loans seek to temper the risks created by these incentives. Some lenders also pay smaller commissions for high loan-to-value ratio loans, providing an offsetting incentive in certain cases.

242. ASIC found that — for the sample of lenders it reviewed, which included the four major banks — home loans arranged through a broker were on average 7 per cent larger and (after statistically controlling for differences in borrower characteristics and loan features):[164]

- had a higher loan-to-valuation ratio (by 2.5 percentage points for the average lender);
- had higher 90-day arrears rates (9 per cent higher for the average lender);[165]
- were more likely to be interest-only loans (at least 50 per cent more likely); and
- had similar interest rates relative to home loans obtained directly from a lender.[166]

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162 ASIC 2017, *Report 516: Review of Mortgage Broker Remuneration*, pages 10 and 26.

163 ASIC 2017, *Report 516: Review of Mortgage Broker Remuneration*, pages 57-58.

164 Note that these statistics are not weighted by the relative market shares of loan flow of the lenders in the sample.

165 This difference means that an arrears rate of 1% in the direct channel would entail an arrears rate of 1.09% in the broker channel.

166 Although interest rates paid in the broker channel were found to be slightly lower, ASIC did not find these differences to be statistically significant.

243. These average differences are *prima facie* not so significant that they provide compelling evidence of major problems that require a wholesale change to the existing standard commission structure given the industry reforms currently underway (and discussed below); though it is possible that looking at averages masks a subset of consumers for whom there should be concern. The differences may also reflect the difficulties in statistically controlling for differences between brokered and direct channels, as well as brokers achieving outcomes actively sought by customers.

Brokers have incentives to recommend lenders that pay higher commissions

244. Brokers can also face incentives to arrange loans with lenders that pay higher commissions and bonuses, irrespective of the suitability of the loan products or the price of the loan — though an aggregator may choose to 'blend' commissions received from different lenders in passing on a share of commissions received to brokers.[167] These incentives could also have the effect of reducing competitive pressure in the home loan market if lenders compete for the attention of mortgage brokers (by higher commissions) and not of the customers (through lower interest rates or better products).

245. ASIC's 2017 Review showed that a lender offering increased upfront broker commissions gains in market share. The impact of higher upfront commissions on loan volume was also found to increase with market share, suggesting larger lenders are able to benefit the most from this effect. ASIC also found that volume-based bonuses and non-monetary benefits are generally provided by larger lenders, although campaign-based commissions were generally offered by non-major bank lenders. In the United Kingdom, however, a recent study by the Financial Conduct Authority did not find evidence that levels of commission paid by lenders to brokers gave rise to poor customer outcomes.[168]

Brokers have incentives to not switch customers to another lender

246. Clawback arrangements can discourage a broker from refinancing loans for existing customers (that is, switching to another loan or other lenders). Trailing commissions can also discourage switching, for example, where they increase over the life of the loan, or if they incentivise the broker to prioritise signing up additional customers (leading to additional upfront and trail commission payments) over switching existing customers (with only additional upfront commissions).

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167 Mortgage Choice, What makes us different, viewed 9 July 2018, <https://www.mortgagechoice.com.au/mortgage-brokers/what-makes-us-different/>.

168 Financial Conduct Authority (United Kingdom) 2018, *Mortgages Market Study: Interim Report*, Chapter 7.

Conflicts of interest arising from ownership structures

247. Vertical integration has been a significant feature of the mortgage broking industry in the years following the global financial crisis, with CBA, NAB and Macquarie each holding significant shareholdings in major aggregators. CBA has, however, recently announced that it will demerge its interests in Aussie Home Loans and Mortgage Choice, and Macquarie Group has reduced its interest in Yellow Brick Road and Vow.[169]

248. ASIC found that lenders' shares of the flow of loans from aggregators that they partly or fully owned were substantially higher than their overall share of brokered home loans.[170] For example, NAB's market share through NAB-owned aggregator FAST was 21.8 per cent, compared to NAB's overall market share of brokered home loans of 13.2 per cent. However, such results were only observed where there was also a white label arrangement (loans funded by a lender but branded by the aggregator) – an ownership relationship or white label arrangement alone was not sufficient.

249. These findings point to a risk that brokers working under vertically integrated aggregators may recommend specific in-house loan products that may not provide the best outcome for a consumer. Again, they are also suggestive of a potential negative effect on competition in the mortgage market at the expense of customers more generally.

Options to address conflicts of interest in mortgage broking

250. In December 2017, the Combined Industry Forum (CIF) — representing a broad set of lenders, mortgage brokers and aggregators, and with input from consumer organisations — outlined a reform package to address the proposals from ASIC's 2017 Review and the recommendations from the 2017 Sedgwick Review.[171] CIF members have individually committed to implement most of the proposals by the end of 2018.

251. The main change to remuneration practices likely to arise as a consequence of the CIF and the actions of its members is a move away from volume-based bonus commissions, campaign-based commissions and volume-based bonus payments. ASIC's view has been that it is these types of remuneration that are most likely to lead to adverse consumer outcomes. The CIF has also proposed adjustments to the standard commission model, including paying the upfront and trailing commission on the amount of funds drawn down (such as net of offset account balances) rather than total borrowing approved.

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169 Commonwealth Bank of Australia 2018, CBA announces intention to demerge wealth management and mortgage broking businesses, media release, 25 June; Yellow Brick Road 2018, Ceasing to be a substantial holder from MQG, ASX announcement, 22 May.

170 ASIC 2017, *Report 516: Review of Mortgage Broker Remuneration*, page 151.

171 Sedgwick, S 2017, *Retail Banking Remuneration Review Report*, Retail Banking Remuneration Review, pages 14-17.

252. The CIF proposals are positive developments which Treasury welcomes. Whether the adoption of these reforms by individual firms is sufficiently widespread and remains in place will need monitoring, as will the risk of other arrangements being developed to replicate the discarded elements under a different form or name. Also relevant in mitigating risks of poor consumer outcomes are APRA's and ASIC's general efforts in recent years to improve bank lending standards and lenders' compliance with responsible lending obligations, as discussed above.

253. Even with these changes, the standard commission model and lender ownership of aggregators still gives rise to conflicts of interest that have the potential to result in poor consumer outcomes, and Counsel Assisting asked at the conclusion of the first round of hearings whether the standard commission structure should be replaced by an upfront, flat fee payment.[172] Two approaches to doing this are discussed briefly below; but a range of other options could be developed that are variants or combinations of these and the CIF reforms.

Upfront, flat fees

254. Proposals for upfront, flat fees can involve up to three distinct changes to current industry practices:

- a move away from remuneration set by reference to loan size, to one of a fixed dollar amount per loan (possibly still varying with loan or lender type or characteristics);
- ending the practice of trail commissions; and
- requiring the payment to be made by the consumer and not the lender.

255. Combinations of one or more of these three elements can be seen in mortgage broker remuneration arrangements in other countries, such as in the Netherlands and the United Kingdom.

256. The first of these would directly target the incentive to encourage customers to take out larger loans, though in practice the consequence of this incentive may be quite limited. It would create some other misaligned incentives that would also need to be managed, such as the need to limit the splitting of a loan into multiple loans to generate additional broker fees.

257. The industry argues that a larger loan size correlates with greater complexity and hence effort on the part of the broker. If this is correct, brokers could have an incentive under a flat fee to service only those customers with straightforward needs, disadvantaging those with more complex needs such as first home buyers. The correlation between loan size and broker effort is, however, not obvious and commissions can already vary according to product and lender characteristics and flat fees could also do so.

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172 Royal Commission transcript, 23 March 2018, page 982.

258. The second change, of removing trail commissions, would have the potential advantage of removing incentives for brokers to inappropriately recommend larger loans that take longer to pay back (though, again, how significant this incentive is in practice is unclear), and brokers would have greater incentives to assist customers to refinance.

259. The removal of trails would, however, also reduce incentives for brokers to guard against arranging non-performing loans and to not unnecessarily switch consumers to alternative loans that do not provide for a better deal. Refinancing is not a costless exercise, with real costs for both lenders and borrowers. In the United Kingdom, where trails are not used, concern over churn has led lenders to pay retention fees to brokers to encourage consumers not to switch lenders but refinance at a different rate.[173] Services provided by brokers to customers after a loan has been arranged could also be affected if trailing commissions were removed.

260. The third change, of requiring consumers rather than lenders to pay the broker, would be the most radical. Without any significant remuneration from lenders, brokers' loan products and lender recommendations are more likely to align with the consumers' best interests or be more transparent if they do not. Some specific payments from lenders to brokers may, however, need to be retained if they were to continue to provide specific services to the lender.[174]

261. The risk with this option is if customers switch to obtain home loans from lenders directly rather than paying brokers an upfront fee, threatening the viability of the mortgage broker distribution channel. Estimates of what most consumers may be willing to pay a broker, of no more than $1000,[175] are well below the average value of commissions currently paid by lenders.[176] If mortgage broking activity contracted, this could have a significant detrimental impact on competition in the mortgage market.

262. A fee-for-service model has been introduced in the Netherlands. However, to maintain competitive neutrality between brokers and direct lending, and hence limit any negative effect on competition, policymakers also had to take the further step of mandating that lenders must charge an appropriately priced mortgage arrangement fee (without cross-subsidisation) when using non-broker distribution channels.

263. If a further change in the standard commission structure was supported by the Commission, consideration would also need to be given as to how best to achieve it. These changes, alone or in combination, have the potential to be disruptive to an industry already facing significant change in light of the CIF proposals and tighter lending standards, and involve significant costs in transitioning to and bedding down any changes.

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173 ASIC 2017, *Report 516: Review of Mortgage Broker Remuneration*, page 45.

174 For example, in assisting lenders to meet anti-money laundering/counter-terrorism financing (AML/CTF) obligations.

175 Deloitte 2016, *Customer Experiences of Using Mortgage Brokers*, market research report prepared for the Mortgage & Finance Association of Australia, page 5.

176 Productivity Commission 2018, *Competition in the Australian Financial System*, Draft Report, page 221, citing UBS research.

264. As the discussion above brings out, the standard commission structure represents a balancing of commercial interests and responsibilities between lenders, aggregators and brokers, as well as the interests of consumers. Too prescriptive and fixed a model risks being commercially inefficient, particularly as the market develops over time and technological and other innovations arise, and negatively affecting competition. While the online and technology based mortgage broker start-ups remain nascent, they are also innovating with remuneration structures (such as rebating commissions to customers) as a point of competitive advantage.

265. It would therefore, be worth considering flexible and less prescriptive approaches. The Product Intervention Power, once implemented, will enable ASIC to intervene in this area to target aspects of remuneration structures where ASIC is satisfied that there has been or is likely to be significant consumer detriment.

Introduction of a positive duty to act in the customer's interest

266. The Productivity Commission, in its Draft Report, proposed a best interests duty for lender-owned aggregators and brokers working under them, and various consumer advocacy groups have also endorsed a general best interests duty for all brokers as a means of aligning the incentives of brokers to customers rather than lenders.[177] A best interests duty for mortgage brokers applies in other jurisdictions, such as the United Kingdom, New Zealand, and the Netherlands.[178]

267. As brokers act as trusted advisers for customers with respect to housing finance, there is an in-principle case for introducing a positive duty on brokers to act in the interests of their customers. While responsible lending obligations provide protection against customers being recommended loans that are too large or otherwise not suitable for them, the purpose of a positive duty would be to counteract incentives to, for example, recommend a particular lender and loan type because the commission available to the broker is higher or because the loan is an in-house or white label product.

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177 Productivity Commission 2018, *Competition in the Australian Financial System,* Draft Report, page 35; Consumer Action Law Centre, Financial Counselling Australia, Financial Rights Legal Centre 2018, Post-draft submission to Productivity Commission Inquiry into Competition in the Australian Financial System, page 6; CHOICE 2018, Post-draft submission to Productivity Commission Inquiry into Competition in the Australian Financial System, page 8.

178 ASIC 2017, *Report 516: Review of Mortgage Broker Remuneration,* pages 44-47.

268. Applying a positive duty to brokers would not, however, necessarily be best achieved by attempting to replicate the financial advice best interests duty given differences between brokers and financial advisers, and the existence of responsible lending and other obligations. If it was to be introduced, careful consideration would again need to be given to an approach that mitigates conflicts of interest risks while avoiding unnecessary compliance costs, and to what extent it can rely on industry efforts or providing ASIC with some discretion or rule-making power.[179]

Disclosure of ownership structures (lender-owned aggregators)

269. As discussed above, there is a risk that brokers belonging to vertically integrated aggregators recommend to consumers less than optimal in-house loan products. ASIC's research is also suggestive of an overall negative effect on competition in the mortgage market that will have consequences for customers more generally, a view that the Productivity Commission shares.[180]

270. That said, with CBA and Macquarie Group in the process of divesting their interests in aggregators, and the lack of evidence of direct consumer harm from vertical integration of aggregators with lenders, the case for requiring aggregators to be independent of lenders does not appear strong.

271. One worthwhile step would be for ownership interests to be disclosed to consumers, though it should not be expected to have a significant impact on market share. This was recommended by the Financial System Inquiry (recommendation 40) and agreed to by the Government. The CIF has also committed to introducing ownership disclosure.[181] As part of this option, consideration could also be given to disclosing ownership in respect of white-label arrangements and separately branded banks operating under a single licence (for example, Bankwest, Bank of Melbourne and U bank).

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179 For example, ASIC's post-draft submission to the Productivity Commission notes it may be preferable to enhance the existing responsible lending obligations for mortgage brokers by focusing on obtaining specific positive outcomes for borrowers. Westpac's post-draft submission also endorses the adoption of 'good customer outcome' principles which complement existing responsible lending obligations.
See <https://www.pc.gov.au/inquiries/completed/financial-system/submissions>

180 Productivity Commission 2018, *Competition in the Australian Financial System,* Draft Report, page 30.

181 The CIF's proposed model would require disclosure of ownership structures in marketing material and at all distribution points, if 'significant influence' is deemed to be exerted over a participant in the industry.

EMPLOYEE PRODUCT SALES INCENTIVES

272. All rounds of the Commission's hearings so far have brought out the potential for incentive-based remuneration models of banks (both monetary and non-monetary) and other financial firms to encourage the mis-selling of credit and other products, both to individuals and to small and medium enterprises — particularly around farm lending. Incentive payments for frontline employees can be quite significant relative to an employee's base salary.[182] The hearings showed the effect on behaviour from such incentives can be significant, resulting at times in poor consumer outcomes, breaches of legal obligations and even fraud. ASIC has reached a similar view.[183]

273. Incentive-based remuneration can be used by businesses to ensure employees are acting in a manner consistent with the objectives of the business. A firm providing financial or credit services is required, through its licence obligations, to have in place adequate arrangements to manage conflicts of interest including those that arise from incentive-based remuneration.

274. The general ban on conflicted remuneration for financial advice also applies to employees of banks and other firms. However, not all bank employees would be providing advice when selling certain products. The ban on conflicted remuneration does not apply to credit products, and in respect of financial products there is an exemption for basic banking products and general insurance. So considerable room remains for product based commissions and other financial incentive structures.

275. The Product Intervention Power will provide ASIC with significant new powers in this area, and could help address first mover issues of the sort identified in hearings.[184] In its exposure draft form, ASIC would have the power to make interventions in relation to remuneration where that remuneration is conditional on the achievement of objectives directly related to financial products or consumer lending. In exercising this power, ASIC would need to show there is a risk of significant consumer detriment before it can make an intervention.

182 For example, a Bankwest manager was awarded a trip to Hayman Island for exceeding their sales target: Royal Commission transcript, 28 June 2018, pages 3463-64. See also ASIC 2017, *Review of Mortgage Broker Remuneration*, page 12.

183 ASIC 2018, Round 1 hearings submission to the Financial Services Royal Commission, page 2.

184 ASIC 2018, Round 1 hearings submission to the Financial Services Royal Commission, page 9.

276. The proposed Design and Distribution Obligations are also relevant. Under these obligations as currently drafted, distributors of financial products will need to take reasonable steps to ensure distribution occurs in a manner consistent with the target market the issuer has identified for the product. One of the steps the distributors may need to take to meet this obligation is to consider whether their remuneration practices are set in a manner that will result in the distribution conditions being met. These proposed obligations will apply to financial products but not credit products, because responsible lending obligations apply to credit products, which are designed to provide an individualised assessment of the suitability of a product for consumers.

277. Separately, the banking industry commissioned the Sedgwick Review to review issues associated with remuneration of bank employees. That Review concluded there was not sufficient evidence to ban all product based payments in retail banking, but that the risks were sufficient that significant changes were needed to existing practices.[185] This included banks reconsidering the use of recognition programs and campaigns (often connected with non-monetary forms of remuneration) and ensuring that any continuing role of these methods is consistent with the intention to de-emphasise sales. Banks have subsequently made some progress in implementing the Review's recommendations.[186] However, as highlighted in the hearings, further work is required before the recommendations are fully implemented.[187]

278. Given the impending introduction of new powers for ASIC and the efforts of the banking industry to undertake significant reform itself, it is not clear that further regulatory interventions are merited at this stage. While the policy focus has traditionally been around remuneration, it is also relatively easy for firms to reward staff that are high-sellers (or to penalise poor-sellers) without resorting to a direct link to remuneration. As general obligations already exist to manage such conflicts, the broader issue raised is that of firm culture and governance.

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185 Sedgwick, S 2017, *Retail Banking Remuneration Review Report*, Retail Banking Remuneration Review, page i.

186 McPhee, I 2018, *Independent Governance Expert Report – Australian Banking Industry: Package of Initiatives Report 8*, page 13.

187 See for example, BOQ (Royal Commission transcript, 24 May 2018, pages 2353-54).