

Financial Services Insights

Six axioms emerging from the Hayne report

A preliminary analysis of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

As foreshadowed in our previous Financial Services Insight, which deals with the Interim Report, the period of public hearings has been completed and Commissioner Hayne released the Commission's Final Report on 4 February 2019.

The Final Report includes 76 Recommendations which overall, if implemented by legislative amendment, will involve sweeping changes to the financial services sector.

It is yet to be seen whether all the recommendations will have the backing of parliament and retain their original intent when ultimately translated into enacted legislation.

However, it is apparent that there is political will within the Parliament to at least enact a substantial number of the recommendations given the level of misconduct particularly prevalent in the banking sector which was highlighted in the public hearings.

Meridian anticipates that reforms are likely to impact on a number of financial services industry sectors including banks, superannuation funds, mortgage brokers, insurers, claims handlers and insurance brokers.

Six Axioms

The Final Report is extensive and it is not possible in a short summary to cover all the Recommendations and their potential impact, however we have identified the following headline issues which result from our first impressions of the Final Report.

1. There was misconduct and it was pervasive

Based on the evidence adduced at the public hearings there was patent misconduct in a number of areas in the financial services sector at varying levels and which, in some circumstances, was pervasive.

The seeds of such misconduct arose as a result of a confluence of factors including the pursuit of profit, inherent conflicts of interest, a failure by institutional culture to act in the interest of the

customer, failure by relevant Boards to 'root out' conflicting behaviour and failure by regulators to prosecute those failures by establishing and enacting effective deterrence.

2. There was inadequate regulation and enforcement by regulators in addition to ineffective implementation of tools of deterrence

Commissioner Hayne articulated this concept as follows:

"When misconduct was revealed, it either went unpunished or the consequences did not meet the seriousness of what had been done."

"Misconduct will be deterred only if entities believe that misconduct will be detected, denounced and justly punished,"

"Misconduct, especially misconduct that yields profit, is not deterred by requiring those who are found to have done wrong to do no more than pay compensation."

Supervision and implementation of the suite of regulatory remedies available to the regulator weighed in favour of managing risk by way of regulatory compliance measures, remediation and enforceable undertakings rather than enlisting more severe public enforcement tools such as prosecution and litigation in circumstances where appropriate deterrence was needed.

3. At times there was insufficient clarity and understanding of regulatory norms by regulators, financial services entities and their boards and market participants

A resultant confusion and lack of clarity about the fundamental regulatory norms arose as a result of a regulatory system which was managed and implemented utilising complex regulatory 'carve outs' and which undermined the simplicity of the law and fundamental legal principles which underlies that framework.

The Final Report raises the fundamental question as to *"how can the law be simplified so that its intent is met?"*

The Recommendations favour a return to simplification of the law and as far as possible, exceptions and qualifications to generally applicable norms of conduct in legislation governing financial services entities should be eliminated, particularly in the case of hawking of superannuation products and insurance products.

4. Remuneration structures materially contributed to the underlying institutional behaviours which resulted in misconduct

Conflicts in certain sectors was endemic and pervasive.

Middle management and intermediary remuneration structures has focussed on profit over the interests of the client and has resulted in substantial and damaging conflicts with consumer and client interests.

The Recommendations suggest a targeted approach and further reform to the management of conflicts of interest and conflicts between duty and interest.

5. Boards must ultimately take responsibility and be accountable for systemic misconduct

While to some extent a Board is dependent on information which it receives from management, operational executives and staff and governance committees, it must ultimately take responsibility and be accountable for systemic misconduct and corporate culture that may foster it.

Remuneration structures within Boards should be revised to counter conflicts and behaviour which is inconsistent with regulatory norms and to refocus remuneration on the customer's interests rather than profit. In particular, sound compensation principles and practices should be further implemented and APRA should determine a new responsibility under the BEAR for bank products and the BEAR be extended to other APRA-regulated institutions.

Further detailed assessment needs to be undertaken in order to determine what more can be done to achieve effective leadership, good governance and appropriate culture so that financial services entities obey the basic norms of behaviour that underpin the proper regulation of the financial services industry.

6. Consideration should be given as to whether an independent mechanism should be implemented to supervise the Regulators to assess their effectiveness in implementing regulatory norms

There was no adequate mechanism within the regulatory framework and no overriding assessment by regulators to determine if regulatory norms were ultimately being promoted or implemented.

The Commissioner has recommended the establishment, by legislation, of a new oversight authority for APRA and ASIC, independent of Government, assess the effectiveness of each regulator in discharging its functions and meeting its statutory objects and in particular to extend to assessing ASIC and APRA's adoption of the BEAR.

Retail level response

It is important to appreciate that the Recommendations are a response to the accumulated evidence arising from the public hearings. That scope concentrated on specific sectors such as banking, superannuation, insurance and financial advisory however the focus was on consumer lending practices within the context of credit products and consumer outcomes in the financial planning and wealth management industries.

That is, the Recommendations reflect the following context:

- (a) they are a product of the terms of reference under which the Commission was tasked with identifying if misconduct occurred;

- (b) they have assessed conduct, practices, behaviour or business activities against a benchmark of regulatory norms and community standards and expectations;
- (c) they are consumer focussed and targeted at retail sector outcomes;
- (d) while the terms of reference required the Commission to consider the ongoing stability of the finance sector in Australia and economic implications, the driver of that consideration emphasised an assessment of the availability and cost of financial services for the Australian community, being dealt with in a retail context;
- (e) it follows that the response is not intended nor does it deal with or make recommendations at a wholesale market, wholesale client or sophisticated client level.

What to expect

Even though the Recommendations are subject to passage through and implementation by Parliament and the terms of any final legislation, by virtue of the damning evidence arising out of the public hearings and the expansive nature of the Recommendations, we anticipate that the Report will be likely to have a broad regulatory and behavioural impact on the financial services sector including:

- More regulatory activity and surveillance by regulators especially in the banking and superannuation sectors
- More prosecutorial action across the target sectors
- Potentially 24 referrals for misconduct by institutions in which regulators may initiate civil or criminal proceedings
- Product intervention by ASIC
- Bans and caps on some commission arrangements
- Legislative reform to simplify the law and to reduce the number and the area of operation of special rules, exceptions and carve outs
- Increased accountability of Boards and intermediaries
- Close regulatory supervision of conflict management and the elimination of exceptions to the ban on conflicted remuneration
- Review and enforcement of limitations on executive and board remuneration structures

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Meridian will separately deal with the potential implications of the Recommendations in specific financial industry sectors including insurance, superannuation, insurance broking, banking and finance as well as regulatory reform and governance implications in subsequent Insight publications.

This Financial Services Insight was written by Principal, **Michael Bracken**. For further advice or information in relation to implications of the Final Report and Recommendations of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry and its potential regulatory, governance or industry impact, please contact **Michael Bracken – Principal – Financial Services, Corporate Governance and Corporate Advisory**.



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