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Shaping the future with confidence

Your business post-Financial Services Royal Commission

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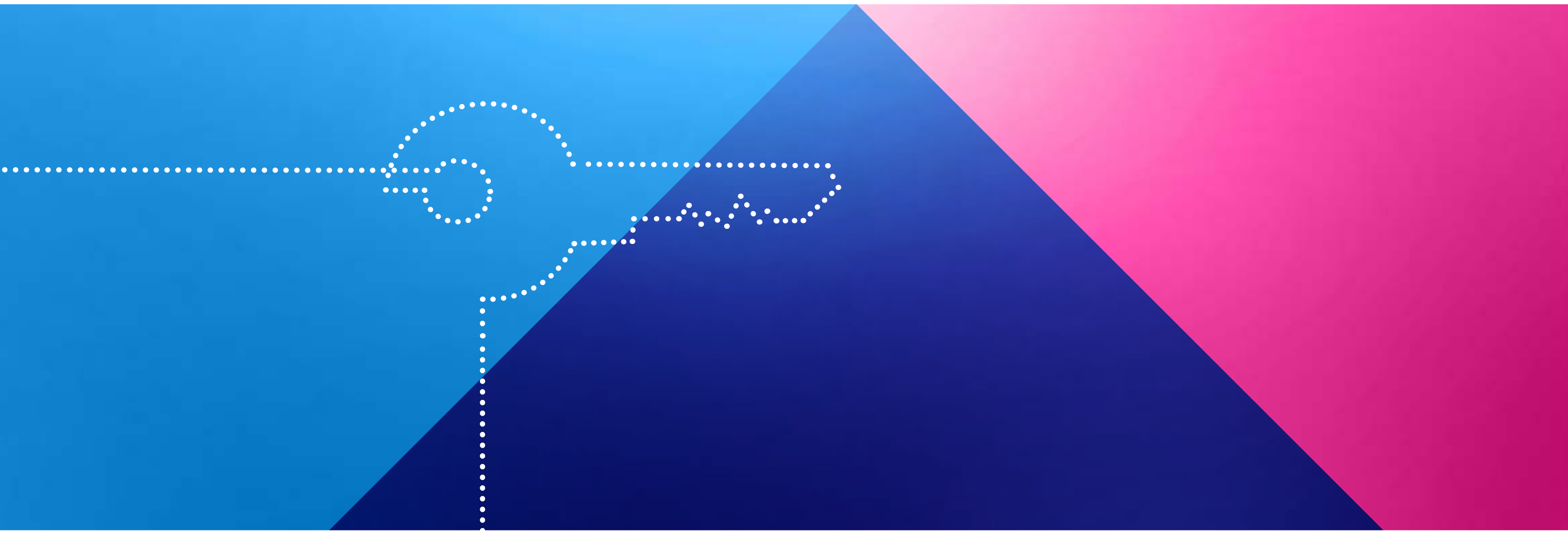

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ROUND 1: EXPERIENCES WITH CONSUMER LENDING PRACTICES

In the Final Report, the Commissioner has found that, for the most part, whilst the legislative tools necessary to protect borrowers are already available, there have been significant shortcomings in their application and enforcement.

As a result, the actual legislative changes proposed in the Final Report in relation to consumer lending are generally more limited than some might have anticipated or worried – the only significant exception being the regulation of brokers (although whether the recommendation that brokers be remunerated directly by borrowers will be introduced remains uncertain in light of the different positions adopted by the Government and the Opposition).

The key changes that the Commissioner did recommend were:

- The abolition of broker commissions and an eventual move towards a borrower pays model;
- The introduction of a best interests duty for brokers followed, in time, by brokers being subject to all laws that apply to financial advisers;
- The abolition of the point of the sale exemption; and
- The enforceability of financial industry codes.

Each of the above recommendations are discussed in more detail below.

In addition, there are several important changes that the Final Report recommends *not* be made. Most notably:

- That the current responsible lending standard (ie that a loan is 'not unsuitable') should be retained; and
- that the *National Consumer Credit Protection Act 2009 (Cth)* should not be extended to apply to the provision of credit to small businesses.

BROKERS

In both the Interim Report and now in the Final Report, the Commissioner gave significant consideration to the important role of mortgage brokers in the consumer lending industry. He finds that brokers are in a position of trust with their customers, and that customers rely on them for advice and assume they will act in their best interests. The recommendations contained in the Final Report are intended to ensure there is a legislative framework in place that requires brokers to meet the expectations that, in the Commissioner's view, their customers already have of them.

Broker commissions

As the Commissioner raised in the Interim Report, he considers that the current structures around the remediation of mortgage brokers, which typically involve the payment of upfront and trail commissions by lenders, create an inherent conflict between the interests of the broker and the interests of the customer.

Considering the Commissioner's strong criticism of any form of conflicted remuneration in the Interim Report, it was inevitable the Final Report would include recommendations for amendments to the way brokers are paid. However, the Commissioner has recommended not just an amendment to the current model, but its complete overhaul, recommending that borrowers, not banks, should pay brokers for their services.

The Commissioner has justified this recommendation on the basis that the payment of commissions by lenders to brokers is a form of conflicted remuneration. He questions why, if financial advisors are banned from accepting conflicted remuneration, any exception should be made for mortgage brokers, who are providing an equally important service to customers.

The Commissioner has largely dismissed concerns raised in some responses to the Interim Report that such a change would weaken the broking industry (as fewer customers would use brokers) and have a negative impact on competition among lenders. He does, however, suggest the changes might be accompanied by a requirement that banks be obliged to charge a service fee when issuing a loan to borrowers in order to reduce any competitive advantage they might gain as a result of brokers charging customers directly.

Importantly, however, this recommendation by the Commissioner is the only one among the 76 specific recommendations contained in the report that the Government has not committed to implementing, citing concerns about the reduction of competition among lenders (including inhibiting access to the smaller lenders). Instead, the Government has agreed to ban trail commissions from July 2020, but has reserved its position on phasing out upfront commissions.

The Opposition's position on this recommendation is not yet clear. Before the release of the Final Report, the Opposition committed in principle to adopt every one of the Commission's recommendations. However, such sweeping reform to the broker market might not have been fully anticipated when that commitment was made.

This will be an area of ongoing interest, especially in light of public sensitivity over house prices and interest rate rises. It is unlikely to be resolved until after the Federal election.

Best interests duty and brokers as financial advisers

The Commissioner observes in the Final Report that brokers not only advise customers about one of the most significant financial decisions they are likely to make in their lives, but also that customers expect brokers to act on their behalf and in their best interests when providing that advice. In those circumstances, the Commissioner can see no reason that the law should treat them differently to financial advisers.

To bring the law in line with both consumers' expectations and the realities of a broker's role, the Commissioner recommends that brokers initially be subject to a 'best interests' duty, obliging brokers to act in the best interests of their customers, which would be enforceable by way of a civil penalty. The Commissioner also recommends that, after a sufficient transition period, mortgage brokers be subject to, and regulated by, the same law that applies to financial advisors under Part 7.7A of the *Corporations Act 2001* (Cth). This would likely mean that brokers are subject to obligations such as the need to provided appropriate advice (s961G) and to give priority to clients' interests (s961J).

Mortgage brokers are currently subject to the obligations of a credit assistance provider under the NCCP Act. The report does not deal with how these additional proposed obligations to act in the customer's best interests would sit with the current responsible lending obligation of only recommending a loan that is 'not unsuitable'.

The adoption of these recommendations is likely to have a material impact on how brokers operate. For example, it is foreseeable that a broker will need to refuse to recommend a loan to a borrower in circumstances where they are aware that the borrower could obtain a cheaper rate by approaching the same lender directly, or the broker is not accredited by the particular lender. If the Government does not adopt a 'borrower pays' remuneration structure, but does adopt the best interest duty, then this scenario would result in the broker receiving no payment for the work they have undertaken for the customer.

Finally, there are also a number of obligations currently placed on financial advisers beyond the best interests duty which brokers are likely to feel the burden of, including the proviso of statements of advice, as well as additional educational and disclosure requirements.

However, while the Final Report offers the sweeping recommendation of making brokers subject to the same laws as financial advisers, it offers very little detail of what this will look like and whether any allowance will be made for some of the legitimate differences between the industries. As a result, we will have to wait and see.

OTHER THINGS TO NOTE

'Not unsuitable'

At present, lenders can only offer a loan to a borrower if they have made an assessment that the loan is not 'unsuitable' for the borrower.

As mentioned above, the Commissioner has not recommended changing the 'not unsuitable' test to a 'suitable' test, despite the urges of some consumer advocacy groups. The Commissioner noted that requiring a lender to test if a loan were 'suitable' for a borrower would require the lender to assess not only an absence of harm, but that the loan would actually provide a benefit to the borrower. However, the Commissioner ultimately concluded that lenders are not in a proper position to make such an assessment.

This is likely to come as a relief to the banks, as a requirement to assess suitability would have placed a heavy and somewhat unrealistic burden on them.

The use of benchmarks

In the Interim Report, the Commissioner had strongly criticised the over-reliance of banks on general statistical benchmarks (such as the *Household Expenditure Measure* (***HEM***)) and the customer's own declarations about affordability.

In the Final Report, he echoes this criticism and reiterates that, while benchmarks like the HEM do have some value in determining whether a consumer will be able to repay the loan (ie whether the loan is 'not unsuitable'), they should not be used as a substitute for inquiries about, and verification of, a customer's actual financial position (as required under s130 of the NCCP Act). The Commissioner does not go so far as to suggest that the use of such benchmarks should be banned, but he does note with some approval that the banks are already starting to reduce their reliance on them.

Abolition of the point of sale exception

At present, suppliers of goods or services that arrange credit for their customers from a lender at their own premises in order to assist those customers in buying the suppliers' products are exempt from the requirement to hold a credit license (one common example being car dealerships).

Consistent with the Commissioner's general preference throughout the Final Report for removing exceptions in order to simplify the laws that will apply, the Final Report recommends the removal of the point of sale exception.

Enforceable codes

At present, many banks have voluntarily signed up to industry codes, like the 2019 Banking Code of Practice (which has been approved by ASIC and is due to come into operation on 1 July 2019). Those codes have been held, in some circumstances, to create contractual obligations between customers and the relevant bank, although this is generally subject to a case by case analysis.

The Commissioner has recommended that:

- the ABA and ASIC should take steps to identify those provisions of the 2019 Banking Code that should be enforceable; and then
- that the law be amended so that a breach of those provisions will be a breach of the law, with remedies available that are equivalent to those now set out in Part VI of the *Competition and Consumer Act 2010* (Cth).

This will mean that customers face no uncertainty about their ability to bring a claim for a breach of such an enforceable provision before the Court. Presumably, ASIC will also be able to bring a claim of this sort, seeking damages on behalf of a customer.

In the case of the 2019 Banking Code, the Commissioner anticipates that such 'enforceable provisions' will include obligations like the need to engage with customers in a fair, reasonable and ethical manner (clause 10), and the obligation to exercise the care and skill of a diligent and prudent banker when extending credit (clause 49) (although there will undoubtedly be many more obligations included).

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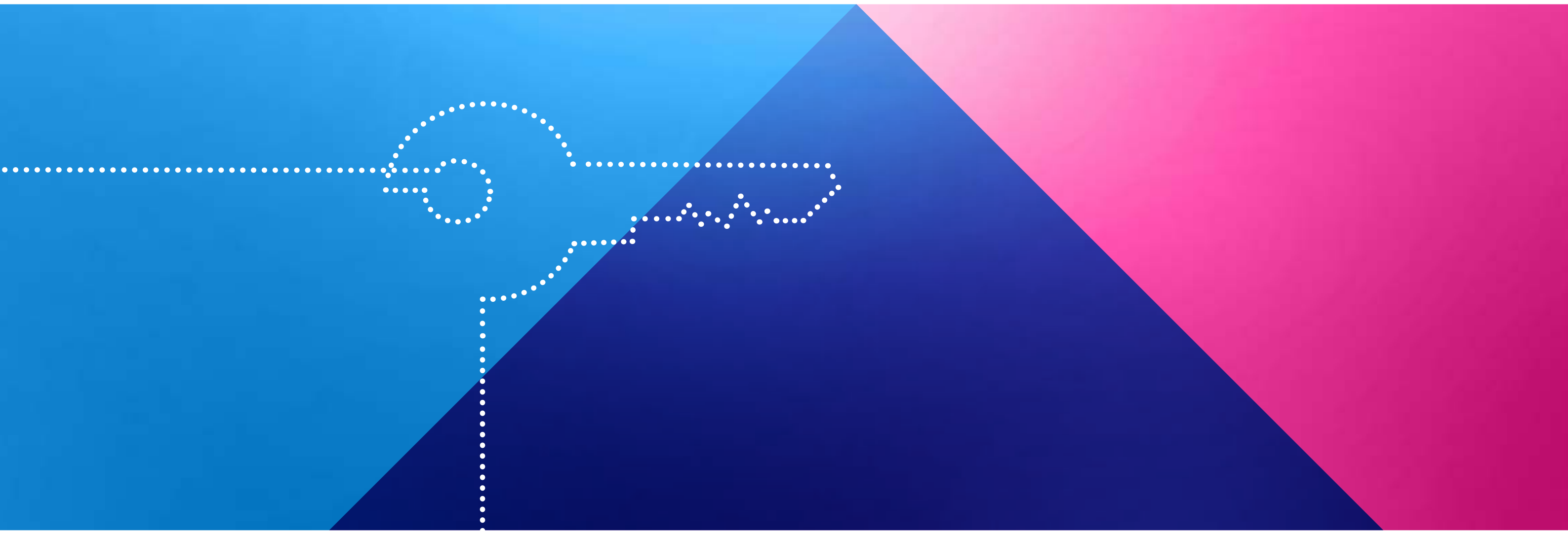

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ROUND 2: EXPERIENCES WITH FINANCIAL ADVICE

In her summary my colleague, Michelle Levy, said her initial reaction was that the recommendations in the Final Report were modest but, on a second reading, some would set a cat among the pigeons. We think the recommendations concerning mortgage brokers are in the 'cat and pigeon' category, while the recommendations concerning financial advisers are firmly in the 'modest' category. In this article, we explain why.

COMMISSIONS

The Commissioner's dislike for grandfathered trail commissions paid to financial advisers is well-known, and he recommended that they cease as soon as reasonably practicable. He did not specify a date but the Government did, settling on 1 January 2021. This will, obviously enough, be a little while after the Ripoll Inquiry recommended (in 2009) that all value-based payments from product issuers to financial advisers should cease. The Government says it expects the benefits of ending grandfathered commissions to be passed on to customers and that ASIC will monitor whether they are.

The Commissioner has doubts about claims that abolishing commissions on life insurance could result in underinsurance. He says most life insurance is opt-out insurance held through superannuation and that if someone is not prepared to pay for something it gives a fair indication of the value they attach to it. Even so, he does not recommend abolishing commissions immediately or at all. Instead, he says that when ASIC conducts its post-implementation review of the Life Insurance Framework in 2021, it should consider the results and then consider reducing the caps on commissions to zero at that time. It is notable that the caps only apply to hybrid commissions that need to fit within the benefit ratio and clawback requirements under ASIC's LIF Instrument. There is nothing in the Final Report about level commissions, and the Government's response tends to indicate that level commissions, which are uncapped, would remain even if hybrid commissions were phased out.

Again, the Commissioner has taken a surprisingly cautious approach to commissions on general insurance and consumer credit insurance. He simply says ASIC should consider, in 2021, whether the exceptions to conflicted remuneration for such products should be removed.

ONGOING FEE ARRANGEMENTS

The Commissioner's views on the phenomenon referred to as 'fees for no service' were made perfectly clear in the Interim Report, and they are no more benign in the Final Report, going so far as to suggest the conduct might amount to 'dishonest conduct' under s1041G of the *Corporations Act 2001* (Cth) – a provision that can be prosecuted as a criminal offence. This makes it a little surprising that the Commissioner did not recommend banning ongoing adviser fees outright, or at least the deduction of ongoing adviser fees from superannuation.

Instead, the Commissioner recommended that the opt-in requirement that applies to ongoing fee arrangements be expanded and upgraded. Specifically, he recommends that the opt-in requirement:

- apply to all ongoing fee arrangements (irrespective of when they were first entered into);
- apply more frequently (every year rather than every two years);
- apply not just to the advice licensee but also to the product issuer who will deduct and pay the fee; and
- require that the opt-in notice specify the services that are to be provided over the year ahead.

And while advice fees will not be able to be deducted from MySuper products, they will be able to be deducted from Choice superannuation products if the annual opt-in requirement is satisfied.

For those who remember, the requirement that an opt-in notice specify the service that will be provided was included when the Future of Financial Advice (***FoFA***) was being formulated, but had been removed by the time FoFA was legislated.

DUTIES, CONFLICTS AND VERTICAL INTEGRATION

The remaining recommendations are undeniably modest. Indeed, what the Commissioner did not recommend is arguably more interesting than what he did.

He recommended that where a financial adviser would not be independent within section 923A of the Corporations Act, they will need to give the client a concise explanation of why they are not independent. He also recommended that if the quality of advice has not improved by the end of 2022, the safe harbour should be removed from the legislative best interests duty. This stands in contrast to the criticism that the Commissioner poured onto the safe harbour in the Interim Report.

The Commissioner did not recommend that there be a requirement to eliminate conflicts. This is despite his finding that the *management* of conflicts has not prevented the problems that have occurred. Therefore, it appears there will be no change to the conflicts-priority duty for financial advisers or, for AFS licensees, the obligation to have adequate arrangements for the management of conflicts.

Finally (almost) – vertical integration. As you already know, the Commissioner did not recommend that it be abolished. He noted the cost and disruption that such a recommendation would cause and was not persuaded that they would be outweighed by any benefit. And so, vertical integration survives, although given how difficult it will likely be to sell superannuation products and life insurance in the future, significant challenges will remain. (We will cover selling superannuation products and life insurance in a separate article.)

REGISTRATION AND DISCIPLINARY ARRANGEMENTS

Although the Commissioner was hesitant to make specific recommendations directed at improving the quality of advice, he was less reserved in his criticism of the industry's 'aspiring' professionalism. The cause? At least in part, a fragmented yet overlapping system of professional discipline that is hindered by its gaps.

In the last two years, the Government, ASIC and the industry have each introduced measures directed at increasing professionalism in the industry. The most recent of these involves phasing out RG146 and education standards in favour of new requirements, including a code of ethics to be overseen by the Financial Adviser Standards and Ethics Authority.

The Commissioner, however, cautioned against conflating the purposes and importance of codes of ethics with laws. As was a theme throughout the final report, in the Commissioner's view, any disciplinary system should give 'proper weight' to denunciation and punishment. To this end, the Commissioner has recommended that a single, central disciplinary body be introduced which can impose a wide range of sanctions. All financial advisers must register with that body and their registration will be on the line as a disciplinary tool.

To further strengthen reporting and disciplinary arrangements, the Commissioner has also recommended new licence conditions requiring compliance with the Australian Banking Association's reference checking and information sharing protocol, reporting of serious compliance concerns to ASIC on a quarterly basis and, where financial adviser misconduct is identified, obligations on Australian Financial Services Licence (***AFSL***) holders to undertake inquiries as are reasonably necessary to determine the nature of misconduct and to inform and remediate affected clients.

It remains to be seen whether this new world of adviser discipline will improve standards and discipline in the industry. As the Commissioner himself acknowledged, primary responsibility for discipline will still be retained by AFSL holders. Even though he doubted the appropriateness of a 'one-size fits all' approach to consequence management, ASIC has been encouraged to consider providing 'best practice' guidance in this area – watch this space.

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ROUND 3: LENDING PRACTICES TO SMALL AND MEDIUM ENTERPRISES

*Throughout the Royal Commission, Commissioner Hayne grappled with the difficulties of striking an appropriate balance between ensuring that small and medium enterprises (**SMEs**) have access to credit, and imposing standards on the provision of that credit to protect SME borrowers and third-party guarantors.*

After hearing from many stakeholders of the difficulties likely to arise from increased regulation in this area, Commissioner Hayne ultimately determined the issue called for no substantive legislative change.

BUSINESS AS USUAL

1. Extension of the NCCP

One of the key issues the Commissioner examined was whether lending to SMEs should fall within the reach of the *National Consumer Credit Protection Act 2009* (Cth) (***NCCP***). Currently, the NCCP does not apply to lending for business purposes.

Following the Interim Report's conclusion that there was no substantial support for changing the legal framework regulating SME lending, in particular by extending the NCCP to cover SME lending, it is unsurprising the Final Report recommends the NCCP not be extended to cover this form of lending. Instead, Commissioner Hayne tells us to 'apply the law as it stands'.

This means the prohibitions contained in the NCCP will not apply to SME lending, including the requirement not to enter a credit contract:

(a) unless the prescribed inquiries and verification have been made; or

(b) if the contract is unsuitable.

Commissioner Hayne decided not to extend the NCCP to SMEs in recognition of the need to ensure that small businesses have access to reasonably affordable and available credit.

2. Guarantors

The Commissioner also considered making amendments to the existing guarantor framework, since third-party guarantees are commonly taken in support of loans to SMEs.

However, the Final Report concluded no changes need to be made to the existing law in relation to guarantees. In so doing, Commissioner Hayne tipped his cap to the diligent work already completed by his fellow High Court judges in ensuring appropriate protections for voluntary guarantors, referencing two leading High Court decisions (one of which he presided over).

The Final Report noted that the 2019 Banking Code of Practice (the ***Code***) had also introduced new protections in this area relating to both enforceability and the bank's requirement to assess the principal debtor's ability to service the loan. Commissioner Hayne concluded these developments were desirable and sufficient.

CHANGES MADE TO SME LENDING

Despite the Final Report making very few substantive changes to the SME lending framework, it did make two recommendations in this area.

1. Definition of 'small business'

Commissioner Hayne concluded that the definition of 'small business' in the Code is 'too complicated and too confined in its reach'.

As a result, the Final Report recommended the Australian Banking Association (***ABA***) amend the definition of 'small business' to apply to any business or group employing fewer than 100 full-time equivalent employees, where the loan applied for is less than $5 million.

This definition was first put forward in the 2017 Khoury Review as an alternative to the three-part test currently set out in the Code.

2. Enforceable codes

As outlined in our detailed analysis of Round 1, the Commissioner recommends:

- that the ABA and ASIC take steps to identify those provisions of the Code that should be enforceable; and
- that the law be amended so that a breach of those provisions will be a breach of the law, with remedies available equivalent to those now set out in Part VI of the *Competition and Consumer Act 2010* (Cth).

The effects of these changes on lending to SMEs can include:

- **Dealings with AFCA (formerly FOS)**: The Commissioner observes that if breaches of enforceable code provisions result in contraventions of statute, this will help reduce systemic issues identified in entities' dealings with FOS. This may mean that SMEs may elect to enforce any breach through the courts rather than through external dispute resolution mechanisms. The Commissioner notes it would be for the customer (or guarantor) to elect which path was to be taken in seeking redress.
- **Industry engagement and dealings with ASIC**: The Commissioner observes that ASIC's role in reviewing the proposed enforceable code provisions must go beyond being the 'passive recipient' of industry proposals. Key industry players, such as the ABA, may need to substantiate the basis for identifying those provisions that govern, or are intended to govern, the terms of the contract made between the financial services institution and SMEs.

The Commissioner states that while it is time to give certainty and enforceability to key code provisions that govern the terms of the contract between the financial services entity and the customer or a guarantor, he does not intend to interfere with the broader development or operation of industry codes.

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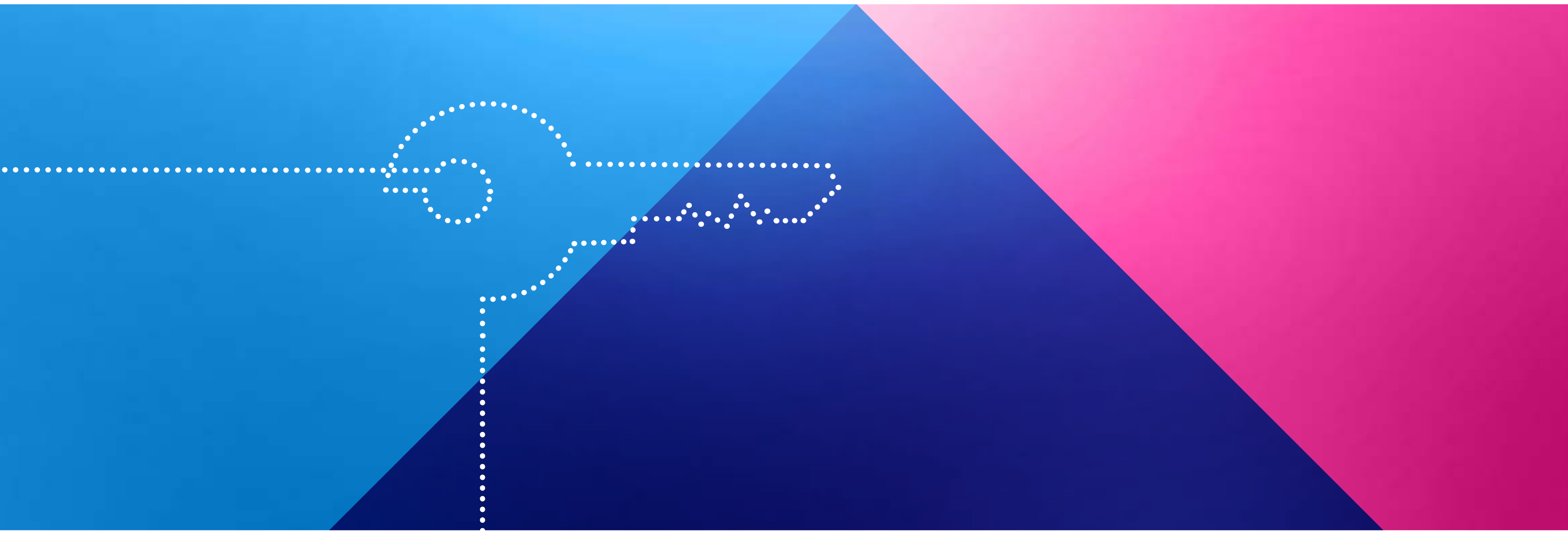

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ROUND 4: EXPERIENCES WITH FINANCIAL SERVICE ENTITIES IN REGIONAL AND REMOTE COMMUNITIES

During the agricultural round of hearings, and in his Interim Report, the Commissioner asked if there should be special rules for farmers to address the particular challenges of the sector, and if so, who should bear the added cost? The Commissioner weighed various proposals, some of which had the potential to significantly affect the sector. For example, Counsel Assisting asked whether there should be a moratorium on banks taking enforcement action when a property is affected by natural disaster.

In his Final Report, the Commissioner has not, for the most part, recommended special rules for farmers. Rather, he takes a measured approach addressing particular concerns. The Commissioner makes four recommendations relating to the valuation of farming assets, charging of default interest, and enforcement of loans.

In relation to the enforcement of loans, the Commissioner recommends that banks adopt various procedural measures. It is unclear how this recommendation is to be enacted. No changes to the law (or Banking Code) are recommended, and the Government has only indicated that it supports banks acting on the recommendation. However, even if no formal obligations are imposed, this recommendation may ultimately inform the standard of conduct expected of banks under other obligations.

In relation to agricultural lending, the Commissioner recommends that:

(a) APRA update its prudential standard (APS 220) to:

  i. require that internal appraisals be independent of loan origination, processing and decision processing; and

  ii. provide for valuations of agricultural land that recognise, to the extent possible, the likelihood of external events affecting its realisable value and the time that may be taken to realise the land at a reasonable price.

(b) the ABA should amend the Banking Code to provide that banks will not charge default interest on loans secured by agricultural land in an area declared to be affected by drought or other natural disaster;

(c) a national scheme of farm debt mediation should be enacted;

(d) when dealing with distressed agricultural loans, banks should:

  i. ensure loans are managed by experienced agricultural bankers;

  ii. offer farm debt mediation as soon as a loan is classified as distressed;

  iii. manage loans on the footing that working out will be the best outcome for bank and borrower, and enforcement the worst;

  iv. recognise that appointing receivers or administrators is a remedy of last resort; and

  v. cease charging default interest when there is no realistic prospect of recovering the amount charged.

VALUATIONS

In his Interim Report, the Commissioner observed that there is a conflict of interest where an employee engaged in loan origination is also responsible for conducting an appraisal of the property offered as security, and urged the prompt implementation of a suggestion by APRA that valuations should be made independently of staff engaged in loan origination. The Commissioner formally recommends that change in the Final Report. This is despite concerns raised during the hearings that in rural areas, often the local banker responsible for loan origination will also be best-placed to conduct an appraisal, because they are familiar with the area.

The Commissioner has also recommended that APRA amend its prudential standard to provide for valuations that recognise the likelihood of external events (including fire, drought and flood) affecting an agricultural property's realisable value and the time that may be taken to realise the land at a reasonable price.

This recommendation appears to respond to the Commissioner's earlier question as to whether banks should be required to take account of the fact that in seasonal downturns there may be no market for land, or that even if there is a market, a better value would be achieved when the good times return. The Commissioner does not provide any detail in the Final Report as to *how* APRA should provide for valuations that recognise this likelihood.

The Government has indicated its support of these recommendations.

DEFAULT INTEREST

Two of the Commissioner's recommendations relating to agricultural finance address the charging of default interest.

First, the Commissioner recommends that the ABA amend the Banking Code to provide that banks will not charge default interest on loans secured by agricultural land in an area declared to be affected by drought or other natural disaster. Many banks have already implemented such a policy in relation to declarations of drought. Questions may arise as to the manner and extent of declarations applicable to other forms of natural disaster.

Second, the Commissioner has recommended that banks cease charging default interest when there is no realistic prospect of recovering the amount charged, though no change to the law (or Banking Code) is proposed. In this regard, the Commissioner observes that '[p]roviding for the payment of default interest is, and should remain, a matter for any lender to proffer [...] as a term of the loan contract', '[b]ut there comes a time [...] when charging default interest serves no larger commercial purpose than providing a bargaining chip'. While the sentiment appears reasonable, we query how banks will practically determine when there is 'no realistic prospect' of recovery.

The Government has indicated its support of these recommendations.

NATIONAL FARM DEBT MEDIATION SCHEME

The Commissioner observes that, properly used, farm debt mediation may allow the lender and the borrower to agree upon practical measures that will, or may, lead to the borrower working out of the financial difficulties that have caused the lender to treat the loan as distressed.

The Commissioner recommends that banks should offer farm debt mediation as soon as a loan is classified as distressed, though again no change to the law (or Banking Code) is proposed, so it is unclear how this recommendation is intended to be enacted. It seems to us that it may not always be practical for banks to mediate as soon as a loan is classified as distressed. This may be when the loan is only 90 days in arrears, in an industry where seasonal factors often cause lengthy delays.

Noting that there was little or no disagreement in submissions to the Royal Commission as to the instigation of a single national legislated farm debt mediation scheme, the Commissioner has recommended that one be enacted.

ENFORCEMENT OF LOANS

The Commissioner's final recommendation relating to agricultural lending is that banks should ensure loans are managed by experienced agricultural bankers, and adopt various procedural measures when taking steps to enforce the loan, including referring a matter for farm debt mediation as soon as it is classified as distressed, managing loans on the footing that working out will be the best for both bank and borrower.

As stated above, it is unclear how this recommendation is to be enacted, as no changes to the law (or Banking Code) are recommended. The Government has indicated only that it supports banks acting on the recommendation. However even if no formal obligations are imposed, this recommendation may ultimately inform the standard of conduct expected of banks under other obligations: for example, clause 10 of the Banking Code, which provides that banks will engage with customers in a fair, reasonable and ethical manner.

INTERIM REPORT – ABORIGINAL AND TORRES STRAIT ISLANDER CUSTOMERS

The Final Report makes various recommendations relating to the access of financial services by Aboriginal and Torres Strait Islander customers in remote communities, including recommending that the Banking Code be amended to provide that:

(a) banks will work with customers who live in remote areas, or who are not adept in using English, to identify a suitable way for those customers to access and undertake their banking;

(b) banks will not allow informal overdrafts on basic accounts without prior express agreement with the customer;

(c) banks will not charge dishonour fees on basic accounts; and

(d) if a customer is having difficulty proving his or her identity, and tells the bank that he or she identifies as an Aboriginal or Torres Strait Islander person, the bank will follow Australian Transaction Reports and Analysis Centre's guidance about the identification and verification of persons of Aboriginal or Torres Strait Islander heritage.

The case studies in the fourth round of hearings also considered issues arising out of the conduct by funeral insurance providers. In the Final Report, the Commissioner recommends that the law should be amended to prohibit the hawking of insurance products, to remove the exclusion of funeral expenses policies from the definition of 'financial product' and put beyond doubt that the consumer protection provisions of the ASIC Act apply to funeral expenses policies.

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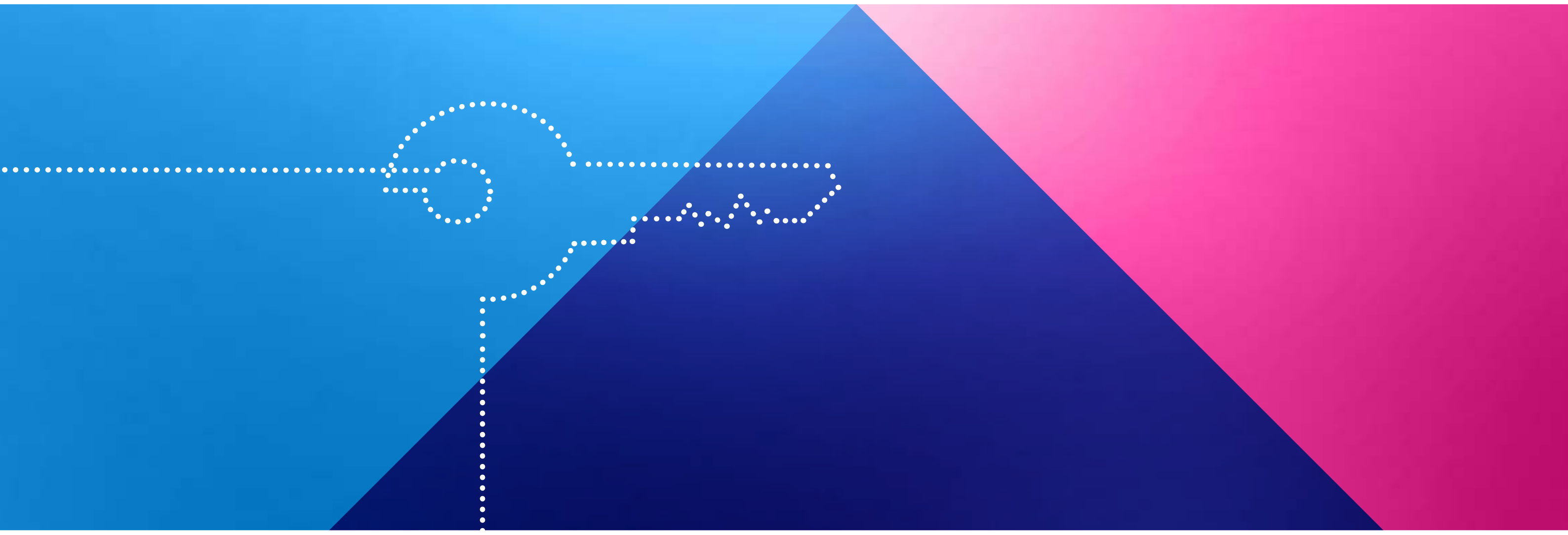

Shaping the future with confidence

Your business post-Financial Services Royal Commission

Detailed analysis

ROUND 5: SUPERANNUATION

Perhaps the biggest issue dealt with in the superannuation hearings is how various forms of conflicts create perverse incentives for trustees to not comply with their duties.

Although the Commissioner seemed to be of the view that a trustee could not 'manage' conflicts between its duties to members and its own financial interests, in the end the Commissioner did not recommend prohibiting for-profit funds or breaking up vertically integrated business models. In the double-negative that is perhaps more familiar to criminal lawyers, the Commissioner says that he is not satisfied that for-profit funds cannot comply with their best interests duties and the duty to give members' interests priority. He has, however, recommended a number of measures and provided analysis of trustee's duties which may affect the way trustees go about 'managing' conflicts in future.

RECOMMENDATION 3.1 – NO OTHER ROLE OR OFFICE

First, the Commissioner suggests that superannuation trustees should not be able to have another '**role or office**' – specifically, they should be prohibited from assuming any obligations that do not arise from or in the course of its performance of the duties of trustee of a superannuation fund. Some superannuation trustees currently also act as responsible entities of managed investment schemes. This would no longer be possible if this recommendation were implemented.

Trustees also commonly assume other obligations which do not arise from their role as trustee of a super fund, such as obligations as a financial adviser. In future, advice may need to be provided by a separate entity.

DEALING WITH RELATED ENTITIES

The Commissioner also has quite a bit to say about trustees dealing with related entities. He does not favour requiring structural separation of super trustees from other entities, particularly service providers. Trustees can deal with related party administrators, investment managers and life insurers. But this needs to be done carefully.

The Commissioner does not recommend changes to the legal obligations of trustees in this area. Trustees should comply with the existing best interests covenant (which he thinks is a fairly simple concept – a surprise perhaps to those who have had to advise trustees on what it means) and prudential standards. But he thinks more scrutiny is required of related party arrangements and how they are entered into.

He draws attention to the fact that the information provided to trustees may be influenced by the interests of other parties within the group. Trustees need to think about who from management is advising them and what conflicts may exist. Related party administrators and life company may have different interests to those of members.

Trustees need to apply additional scrutiny and be clear about the reasons for selecting a related party as a service provider. In the Commissioner's view, the existing requirements in SPS 231 (Outsourcing) has not led to sufficient rigour. But he does not favour extending trustees' duties to other entities such as administrators.

Policy and reality

While trustees rely on their conflicts management policies to satisfy themselves that they are managing conflicts appropriately, APRA comes in for criticism for reviewing conflicts frameworks by looking only at policy, and not looking closely enough at the way frameworks are in fact implemented in practice. So expect more scrutiny about how conflicts are dealt with in specific cases.

Additional assurance for related-party insurance

In the insurance section, the Commissioner also recommends that **SPS 250** (Insurance in super) be amended to require RSE licensees to obtain independent certification that arrangements and policies entered into with a related party life insurer are in the best interests of members and otherwise satisfy legal and regulatory requirements. It is not clear why this is required in the insurance context and not in relation to other outsourcing arrangements.

GOVERNANCE

While the Commissioner says that governance in superannuation is a matter for APRA to supervise, he has some views about how it could be improved. He thinks boards need to have directors with the right skills. Who they represent and how they are appointed is irrelevant. All directors in his view have the same duties.

He thinks **term limits are critical** to allow for board renewal. He does not recommend changes to the law in this area – this is a matter for the trustee, and ultimately for APRA as the prudential regulator if trustees fail to put in place appropriate term limits and ensure board renewal.

In relation to **fund mergers**, the Commissioner makes the point that merger decisions must be made based on consideration of the interests of members, certainly not of directors or shareholder organisations. He thinks a stalled merger might be an appropriate situation for APRA to use the proposed **directions power** currently before parliament.

SELLING SUPERANNUATION (AND INSURANCE): *RECOMMENDATION 3.4 – NO HAWKING*

The report recommends that all forms of unsolicited selling (**hawking**) of superannuation should be prohibited. The same recommendation is made in relation to insurance products. He says the prohibition should not prevent trustees or related entities advertising generally the availability of the product. But cross-selling of products in branches or over the phone would be difficult.

His proposed definition of '**unsolicited**' would be more restrictive than the current understanding of the existing anti-hawking provisions and may be difficult to apply. Contact would be unsolicited unless the customer initiates contact for the *express purpose* of inquiring about, discussing or entering into negotiation about that kind of product. Banking, insurance and superannuation products would each be different kinds of products. So a customer who asks about banking products in a branch will not have initiated contact for the express purpose of discussing superannuation and could not be sold a superannuation product.

FEES

He recommends prohibiting the taking of advice fees from MySuper products. While ongoing advice fees from other types of products could continue, they should be subject to annual renewal, prior written identification of services, and the client's express written authority before being deducted. He also recommends that the grandfathering arrangements made in the FOFA reforms for superannuation now end.

DEFAULT SUPERANNUATION

The Commissioner agrees with the Productivity Commission that employees should have one default fund which is opened when they start employment and which follows them through jobs.

The Commissioner also clearly thinks the entertainment provided by super trustees to employers is not appropriate. The existing restriction on benefits given to employers in section 68A of the SIS Act is quite narrow. The Commissioner recommends that it be broadened to prevent any sort of 'treating' of employers where it may be reasonably understood by those employers to have the substantial purpose of influencing decisions about default funds or choice of fund by employees. So employers can expect fewer invitations to the tennis!

REGULATORY

Finally, the Commissioner recommends that both the trustee and director duties be civil penalty provisions, and that both ASIC and APRA have jurisdiction in their respective roles. He also says that a version of BEAR should be extended to super trustees.

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ROUND 4: EXPERIENCES WITH FINANCIAL SERVICE ENTITIES IN REGIONAL AND REMOTE COMMUNITIES

ROUND 5: SUPERANNUATION

ROUND 6: INSURANCE

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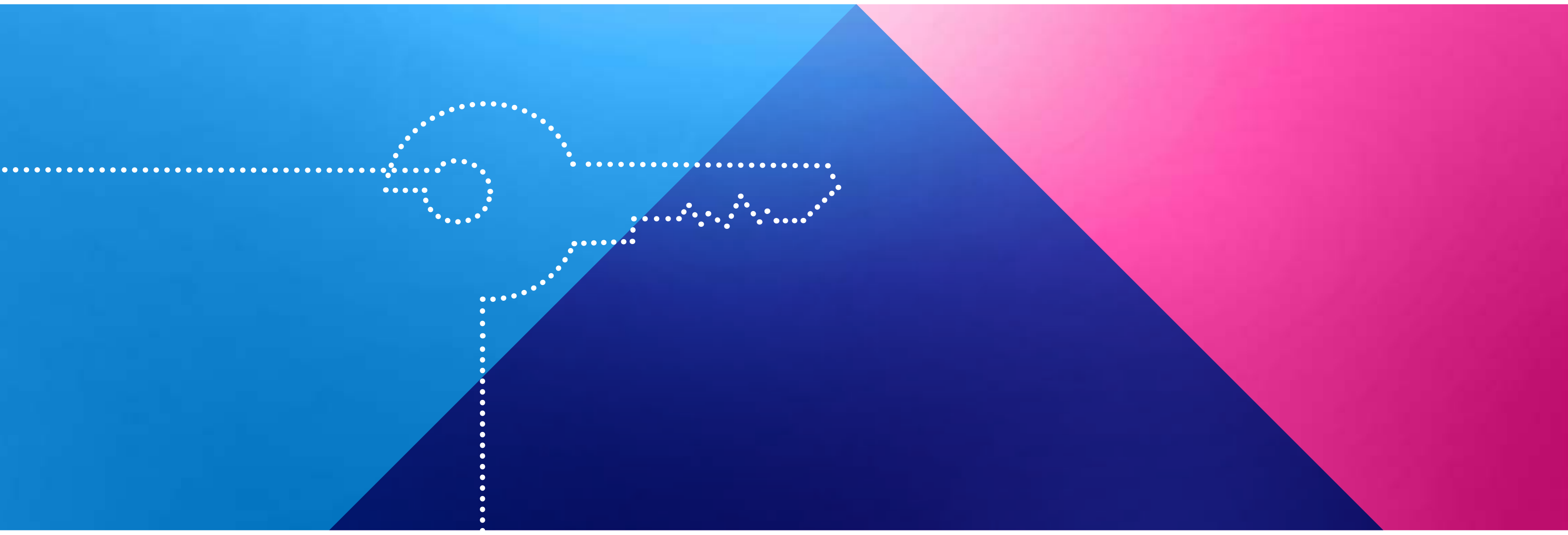

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ROUND 6: INSURANCE

The sixth round of public hearings considered issues associated with the sale and design of life insurance and general insurance products, the handling of claims under life insurance and general insurance policies, and the administration of life insurance by superannuation trustees.

The hearings also considered the appropriateness of various aspects of the current regulatory regime for the insurance industry.

Evidence was taken in respect of case studies involving ten insurers. The Commissioner identified the issues he considers to have arisen from those case studies under the following broad headings:

- issues relating to the manner of selling some insurance products (which were sometimes compounded by issues relating to the low value of particular insurance products);
- issues relating to the avoidance of insurance policies as a result of pre-contractual non-disclosure or misrepresentations;
- issues relating to the use of, and reliance upon, potentially unfair contract terms;
- issues relating to claims handling;
- issues relating to the lack of enforceability of code obligations; and
- issues relating to external dispute resolution.

In keeping with the themes developed elsewhere in his report, the Commissioner pointed to aspects of the interrelated areas of culture, governance, remuneration and accountability as underpinning or contributing to many of the areas of concern that were identified. In a number of instances he attributed poor conduct to a focus on profit and sales ahead of customer outcomes. In this regard, the Commissioner has obviously seen merit in consistency of regulation and has proposed winding back various of the exceptions that have been afforded to insurers in respect of aspects of the financial services laws.

KEY INSURANCE TAKEAWAYS

The impact of the insurance recommendations:

- The individual recommendations of the Commission for general and life insurance were not unexpected. If they are fully implemented we may see significant changes in the way in which insurance products are created and distributed. However, full implementation may take until 2022.
- The more important recommendations can be grouped into two broad categories.

Contract formation, contract terms and claims

The first category concerns the formation of contracts, their terms and the way claims are to be dealt with. In this area there are a number of important recommendations which, when accumulated, are likely to have a real impact on insurance provided to consumers.

Firstly, there are recommendations that disclosure and misrepresentation laws contained in the Insurance Contracts Act 1984 should be refocused so that the insured's duty will be determined by the standard of negligent misrepresentation. This will mean that insurers will need to be much more focused on identifying to consumers the matters on which information is required. They will not be able to place great reliance on the existing general duty of disclosure. Although there have already been changes in this area in relation to certain eligible insurance contracts, under the proposed new arrangements those provisions would have little further work to do. The interesting questions in this area that are left to be worked out are how a 'consumer contract' will be defined and where the burden of proof will lie. Moreover, will the definition of 'consumer' be determined by reference to particular types of contract, such as a home and contents policy or will it be by reference to the type of insured (ie an individual or certain small businesses) regardless of the type of contract which is being purchased? Will the insurer have to prove negligence or will the insured have to show the misrepresentation was without fault?

Secondly, the proposal that certain provisions of codes of practice will be subject to regulatory enforcement will have an impact on the terms of the contract of insurance itself and the way in which it is administered. It will be interesting to see how this issue and the approval process develops.

Thirdly the application of unfair contract terms as set out in the ASIC Act to insurance contracts regulated by the Insurance Contracts Act will require a review of contract terms to identify any that are potentially unfair to consumers. It is recommended that the unfair contracts provision will operate alongside of the continuing duty of good faith found in section 13 of the Insurance Contracts Act and so s14 will continue to disallow reliance on terms that would involve a breach of this duty.

Finally, the recommendation that claims handling be no longer excluded from the definition of financial service means, amongst other things, that claims handling must be undertaken in line with the principles of efficiency, honesty and fairness. Presumably the content of those principles would be sought to be addressed in Codes of Practice.

These changes, together with the passing of legislation for ASIC to be able to intervene in respect of products, have the potential to generate significant differences to the terms of insurance contracts sold to consumers and their administration through any claims process.

Distribution and marketing

The second group of changes relate to distribution and marketing.

These changes include:

- the prohibition against hawking, that is unsolicited telephone sales,
- a deferred sales model for the sale of add-on insurance (other than Comprehensive Motor Insurance),
- a cap on commissions that can be paid to motor vehicle dealers,
- the proposal that exemptions for general insurance should be removed in respect of the various existing provisions relating to conflicted remuneration; and
- the limitations on commission were risk-based life insurance may ultimately be reduced to zero.

All of these provisions are put forward by the Commission without any real discussion about structural issues within the insurance industry where some companies are much better placed to operate by direct sales and others are very dependent on sales through intermediary channels. Those firms with existing large customer bases may be advantaged over new players or those with an existing smaller business.

So hard rules on benefits paid to intermediaries may severely disadvantage intermediated businesses compared to those that are integrated and selling by direct means (particularly off the back of existing customer bases) unless the remuneration arrangements in the integrated businesses prohibit value or volume benefits in a similar way.

There has been little direct discussion about the need for intermediation in a competitive economy. If the new rules make it next to impossible to remunerate intermediaries then competition may be adversely impacted. Is it preferable to better regulate and supervise intermediaries and their activities rather than to severely constrain their use? It may be that further debate of this issue is needed before these recommendations are implemented.

MORE GENERALLY

The broader findings of the Commission as to governance, risk and compliance matters, together with the recalibration of relationships with regulators and the way in which regulators may approach questions of enforcement, are all issues which are also of significant relevance to the boards and senior management of insurers. The extension of the BEAR regime to insurers is also on the horizon. If it comes to pass it will more formally require a very significant focus on issues surrounding remuneration and accountabilities.

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