AUSTRALIAN INSTITUTE
of COMPANY DIRECTORS

Royal Commission
Interim Report

Summary for Directors

Tuesday 2 October 2018

Misconduct in the Banking, Superannuation and Financial Services Industry

1. Overview

Commissioner Hayne's Interim Report was released publicly on 28 September 2018. It addresses the case studies highlighted in the first four rounds of Royal Commission hearings (consumer lending, financial advice, loans to small and medium enterprises and issues affecting Australians who live in remote and regional communities), makes a number of observations about the conduct examined, and questions how and why it was so widespread.

Hayne's view appears to be that entities and individuals have been motivated by financial gain or short term profit at the expense of basic standards of honesty. He does not make adverse findings in relation to breaches of the law (on the basis that is the role of a court), but does identify conduct that may have amounted to misconduct or fell below community standards and expectations. He comments that entities appear to have treated the law as applying only when and if they choose to obey it.

To move forward, Hayne asks 'why did it happen?' and 'what can be done to avoid it happening again?' He expresses a preference for simplification of the legal framework rather than additional regulation, noting that complexity can promote a 'tick the box' approach to compliance and obscure the simple principles that should govern behaviour in the financial services industry.

While Hayne states that each financial services entity is responsible for its own conduct, he also addresses the failings of the regulators. He is particularly critical of ASIC as the conduct regulator and notes that its approach so far has been insufficient to achieve deterrence. He acknowledges the prudential focus of APRA and accepts its approach to regulation needs to be viewed through the lens of its core objective to promote financial system stability, but still comments on its relative lack of enforcement action.

Finally, the report raises a number of policy questions, many of which go to core governance issues such as remuneration, culture, accountability, and risk management.

The structure of this paper is as follows:

- **Section 2:** Implications for directors and the regulators;
- **Section 3:** Regulation and the regulators; culture, governance and remuneration;
- **Section 4:** Potential areas of policy focus for the AICD; and
- **Section 5:** Conclusions and commentary on institutions

2. Implications for directors and the regulators

The interim report's implications for directors, particularly in the financial services sector, are potentially wide-reaching. At a minimum, the report will prompt questions such as:

- Whether existing remuneration structures are appropriate, particularly variable incentives, including for senior executives?
- What governance and risk management practices do we have in place to prevent misconduct?
- How do we engage with the regulators, and is that appropriate?
- How much visibility does the board have of misconduct and poor customer outcomes?

Given the significant criticism levelled at the regulators – particularly ASIC – the report is likely to force some introspection. For ASIC, the report will raise expectations from government and the community more broadly that it will take a more litigious approach to enforcement, rather than favouring negotiated outcomes (such as enforceable undertakings). Such a shift was already underway with the recent appointment of a new Deputy Chair, Dan Crennan QC.

While for APRA, there will be pressure to adopt a stronger focus on the link between misconduct and remuneration, and to ensure that it has a clear view of governance and risk culture in financial institutions, especially the four major banks and AMP (following on from the APRA prudential inquiry into CBA).

3. Regulation and the regulators; culture, governance and remuneration

In Chapter 8, Hayne focuses on the issues of regulation and the regulators. Key points are as follows (with the most significant bolded for emphasis):

Additional regulation not the answer

- **The conduct that is at the heart of the Commission's work is inextricably connected with remuneration practices; deficiencies in governance and risk management; and the culture of the relevant entities.**
- Most of the conduct identified and criticised in the report contravened existing norms of conduct (i.e. either existing laws or regulation, or promises made in industry codes or more directly to consumers).
- Hayne appears reluctant to go down a path of additional regulation, noting that **breaches of existing laws are not prevented by passing new laws**. Indeed, he expressed a preference for simplification rather than additional regulation, suggesting that the more complicated the law, the more likely compliance will become a 'tick the box' matter. Further, new laws would only increase the complexity and breadth of existing regulation. This can increase pressure on the regulator's resources and allow entities to develop cultures and practices unfavourable to compliance.
- Given the conduct addressed in the report was contrary to existing financial services laws, two questions arise (1) why were the breaches as widespread as they were? (2) Why would changing the law make any difference?
- **The principles that should be followed by financial services are simple: obey the law; do not mislead or deceive; be fair; provide services that are fit for purpose; deliver services with reasonable care and skill; and when acting for another, act in the best interests of that other.**
- Hayne emphasised the importance of financial services laws, which regulate the conduct of central actors in the Australian economy. He stated that **neither ASIC nor APRA has marked or enforced the bounds of permissible behaviour set by the law in a way that has prevented the conduct that has come to light during the hearings.**
- While Hayne is critical of the approach of the regulators (particularly ASIC), he specifically notes that criticisms of the regulators must not be understood as diminishing the culpability of entities that engaged in the relevant conduct.

Role of ASIC: failure to achieve deterrence and reluctance towards strategic litigation

- Hayne acknowledges that ASIC's focus is on conduct regulation, and that attention must first be directed at whether and how ASIC might have better regulated conduct in the industry.
- **Hayne criticises ASIC's approach to regulation, noting that in responding to misconduct, the starting point for a conduct regulator should not be to ask "How can this be resolved by agreement?"** When considering contravening conduct, the regulator must always ask whether it can make a case that there has been a breach and, if it can, then ask why it would not be in the public interest to bring proceedings.

- **ASIC approach to enforcement to date has not been effective to achieve deterrence. Hayne also appears to suggest that ASIC has disregarded the need for strategically important litigation.** ASIC rarely went to court to seek publication denunciation of and punishment for misconduct. More often than not, when misconduct was revealed little happened beyond an apology, a drawn out remediation program and protracted negotiation with ASIC of a media release, an infringement notice or an enforceable undertaking.
- **While ASIC's powers are limited (all regulatory and enforcement powers are limited), ASIC has greater enforcement powers than it has used.**
- Hayne notes the proposal to implement recommendations from the ASIC Enforcement Review Taskforce, but expresses reservations about their effectiveness. In particular, he notes that increased penalties for misconduct will only have limited deterrent or punitive effect unless there is greater willingness to seek their application.
- Hayne also points to the following issues: (1) the size of ASIC's remit; (2) an entrenched culture of negotiating outcomes rather than insisting on public denunciation and punishment; (3) while remediation of consumers is vitally important it is not the only consideration; (4) failure to appreciate that an amount outlaid to remedy a default may be much less than the advantage an entity has gained; and (5) no effective mechanism to keep ASIC's enforcement policies and practices congruent with the needs of the economy more generally.

Role of APRA: lack of action and compromised by financial stability mandate

- APRA's chief focus is on governance and risk culture, and it has a core objective of promoting financial system stability. Its central task is to prevent failure of the financial system and to prevent failure of entities within the system.
- **APRA is obliged to look at issues of governance and risk culture through the lens of financial system stability. Understood in that light, APRA's lack of action in response to the conduct may, perhaps, be more readily understood.**
- Until the APRA report into CBA, APRA had taken no public step pointing to any deficiency in the governance and risk culture of any of the major banks or any of the other large financial services entities falling within APRA's remit.
- There is a question as to whether other financial services entities have the same or similar deficiencies of governance and risk culture identified in relation to CBA. It is clear that other entities have engaged in conduct of the kinds that led APRA to conduct its inquiry into CBA. This suggests that there has been insufficient attention given within those entities to regulatory and compliance risk. It suggests a lack of attention to reputational risk, and some of the conduct suggests a lack of proper governance.

In Chapter 9, Commissioner Hayne makes a number of observations regarding the causes of misconduct by entities, in particular at the intersection of **culture, governance and remuneration**. Key points as follows (with the most significant bolded for emphasis):

- All the conduct identified and criticised in the report was conduct that provided a financial benefit to the individuals and entities concerned.
- **The culture and conduct of the banks was driven by, and was reflected in, their remuneration practices and policies.**
- **Every piece of conduct that has been contrary to law is a case where the existing governance structures and practices of the entity and its risk management practices have not prevented that unlawful conduct.**
- There can be no doubt that remuneration practices can drive, and in Australia have driven, conduct of staff and conduct of intermediaries that is not consistent with the interests of the customer.
- The APRA Prudential Practice Guide on remuneration, issued in 2009, said nothing about conduct risk, compliance or regulatory risk, or reputational risk, suggesting to regulated entities a sole focus on management of financial risk-taking.
- Eliminating incentive based payments for front-line staff will not necessarily affect the ways in which they are managed if their managers are rewarded by reference to sales or revenue and profit.
- Despite the Sedgwick review of bank remuneration, banks continue to remunerate in ways that emphasise sales (this was contrasted with the UK where banks had severed, or at least loosened, the connection between individual conduct and entity profit).
- The unstated premise that staff and intermediaries will not do their job properly and to the best of their ability without incentive payments must be challenged.
- Hayne appeared to discount the notion (suggested by Treasury in its earlier policy submission) that better disclosure of remuneration would make a difference, noting potentially conflicting interests of shareholders and customers.
- Criticised APRA for having insufficient regard to the link between remuneration and conduct risk.
- **Good culture and proper governance cannot be implemented by passing a law. Culture and governance are affected by rules, systems and practices but in the end they depend upon people applying the right standards and doing their jobs properly.**
- If more junior bank employees should not be remunerated with variable incentives, why should managers or more senior executives?

4. Potential questions arising from the report

Chapter 10 of the Interim Report highlights a number of governance-related policy questions which are grouped by theme below.

Causes of misconduct

- What should either or both of banks and regulators be doing to the meet the danger of conduct risk?
- Should any customer facing employee be paid variable remuneration? If the answer is either no or some should not, what follows about incentive remuneration for managers or more senior executives?
- Should other changes be made to the remuneration practices of banks?
- Is the BEAR regime relevant to the intersection between remuneration and culture more generally than its application to particular senior executives? Should the BEAR be altered or extended in application?

Regulation and the regulators

- Should there be annual reviews of the regulators' performance against their mandates? Is ASIC's remit too large?
- Are ASIC's enforcement practices satisfactory? If not, how should they be changed?
- If the recommendations of the ASIC Enforcement Review are implemented, will ASIC have enough and appropriate regulatory tools?
- Should ASIC's enforcement priorities change? In particular, if there is a reasonable prospect of proving contravention, should ASIC institute proceedings unless it determines that is in the public interest not to do so?
- Are APRA's regulatory practices satisfactory? If not, how should they be changed?
- Does the conduct identified and criticised in the report call for reconsideration of APRA's prudential standards on governance?
- Having examined the governance, culture and accountability within the CBA group, what steps (if any) can APRA take in relation to those issues in other financial services entities?

We have not included technical policy questions that relate to a single sub-sector of financial services, for example the provision of financial advice or responsible lending in this document.

Further, we note that separate policy questions have been released by the Royal Commission following the insurance round of hearings, which relate to governance in the financial services sector more broadly. These include questions regarding the role of law and regulators in shaping culture, and whether there should be greater consequences for financial services entities that fail to maintain effective compliance systems.

5. Conclusions and commentary on institutions

In the report, Hayne stressed that he was only required to inquire into whether conduct might have amounted to misconduct, and not whether conduct did constitute an offence, or other contravention of the law. For this reason, a number of Hayne's findings are framed as findings which "might" have amounted to misconduct of a particular kind.

However, in some cases, where the entity in question acknowledged through its submissions that its conduct amounted to misconduct, Hayne went further and found that particular conduct had amounted to misconduct. Apart from these cases, Hayne only expressed conclusions that conduct might have amounted to misconduct of a particular kind.

Hayne has made a significant number of conclusions, including that some of Australia's largest financial institutions may have breached the law, failed to meet community standards and expectations, and potentially breached various iterations of the Code of Banking Practice (Banking Code).

In relation to the consumer lending case studies, findings were made that certain matters may have amounted to misconduct, including breaches of legal obligations and conduct which fell below community standards and expectations, by National Australia Bank (NAB), Commonwealth Bank of Australia (CBA), Aussie Home Loans, ANZ, Westpac and Citibank (Citi).

In relation to financial advice case studies, Commissioner Hayne concluded there may have been a number of breaches of the law, and several instances of conduct which fell below community standards and expectations, along with breaches of the Banking Code, in relation to AMP, CBA, Westpac, ANZ, NAB, Henderson Maxwell, and Dover.

In relation to case studies relating to small and medium-sized enterprises, Hayne concluded that misconduct may have occurred in relation to Westpac, CBA, Suncorp, ANZ, Bank of Queensland, NAB, Bankwest, and Bank of Melbourne.

In relation to case studies concerning agricultural lending, Hayne concluded that ANZ, Rabobank Bankwest, NAB, Rural Bank and CBA may have engaged in conduct which failed to meet community expectations and standards, and in some cases, may have breached the law or the Banking Code.

In relation to case studies concerning remote communities, Hayne observed that it was open to find that the Aboriginal Community Benefit Fund and Select had may have breached several laws and fallen below community standards and expectations. In addition, according to Hayne, ANZ may have failed to meet community expectations, and possibly breached the Banking Code.

Member feedback

The AICD is currently preparing a submission for the Commissioner to consider on the issues raised by the Interim Report. Interested members can contact us at **policy@aicd.com.au** with their feedback.

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