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ROYAL COMMISSION INTERIM REPORT CRITICISES AUSTRALIAN BANKING INDUSTRY FOR CULTURE OF GREED

In an eagerly anticipated interim report, Australia's Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry has criticised the industry for bad conduct driven by the pursuit of short-term profit at the expense of customers' best interests. The Commission puts the industry on notice that some of the sector's methods and practices must change dramatically.

Key issues

- Australia's Royal Commission into misconduct in the banking industry has found serious failings which it blames on the industry's pursuit of short-term profit at the expense of customers.
- Much of the inquiry's focus has been on retail markets but the Commission's findings and recommendations are expected to have a wide impact across the entire sector.
- The interim report identifies issues including confusion as to the role of intermediaries and multiple conflicts of interest across the sector.
- A banking industry spokesperson said there were "no excuses" for the behaviour identified and promised to fix the problems without delay.

BACKGROUND

The Royal Commission was established in December 2017, after several years of campaigning from consumer groups, whistleblowers and lobbyists across the political spectrum and ultimately an acceptance by major domestic banks that their conduct had fallen short of community expectations. Public hearings have been conducted throughout 2018 with the final report due on 1 February 2019. The Commission has operated to a tight, fast moving schedule.

While the Commission's focus has been primarily on retail markets, its findings and recommendations are expected to have a wide impact across the financial services industry.

The Commission was tasked with investigating whether financial institutions might have engaged in misconduct, and whether any conduct, practices, behaviour or business activities by those entities fell below community standards and expectations. As far as possible, the Commission must seek to identify the underlying causes of any such conduct and how to best avoid a recurrence of such conduct in the future. The Commission is not a court; the most it can do is decide whether there *might* have been misconduct and, if so, to refer that question to the relevant regulatory agency.

The interim report raises questions which may bear on conclusions and recommendations that the Commission ultimately makes, including in relation to the adequacy of existing laws, policies, internal systems and industry self-regulation, the effectiveness and ability of regulators to identify and address misconduct, whether changes should be made to legal and regulatory frameworks and the effectiveness of existing mechanisms for consumer redress.

Evidence emerging at the public hearings included admissions of misconduct across various business lines, reports of mis-selling, failure to comply with responsible lending obligations and document forgery and bribery.

KEY MATTERS RAISED BY THE INTERIM REPORT

The report lays much of the blame on the pursuit of short term profit at the expense of honesty. The focus on selling too often *"became the sole focus of attention".* It says that *"products and services multiplied. Banks searched for their "share of the customer's wallet". "From the executive suite to the front line, staff were measured and rewarded by reference to profit and sales".*

Where misconduct was identified, it either went unpunished or the consequences did not meet the seriousness of what had been done. The report criticises both the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA) for rarely taking offenders to court and instead engaging in protracted negotiations with the institution involved that led to little more than media releases, or the noting by the institution that the regulator had "*concerns*" about its conduct. Penalties imposed were *"immaterial for the large banks"* and were seen as a cost of doing business rather than fundamentally shaping how the business should be conducted.

The report expresses concern that some banks could not readily identify how, and to what extent, it was failing to comply with the law. Indications were that some entities dealt with regulatory compliance in a disjointed, piecemeal way rather than comprehensively. Consequently, senior management and the board could not be given a coherent picture of the nature and extent of compliance failures.

Consumer Lending

The issues highlighted included those to do with:

- intermediaries and confusion of roles and responsibilities. The report noted the need to address the duties owed by intermediaries to customers and improving entities' systems to detect and prevent irresponsible lending;
- the notion of "consumer needs" which aligned with what the entity had to sell. Staff and intermediaries were rewarded for cross-selling products;
- responsible lending including an approach that lending was not unsuitable if the customer was unlikely to default; and
- processing errors including failure to deliver promised features of products sold and overcharging of interest and fees.

Evidence suggested that entities were doing as little as they thought necessary to meet their legal obligations. Remuneration policies had the effect of rewarding volume and amount of sales – this informed staff and others as to what the entity values and, in turn, was a critical element in forming culture. Similar arrangements with intermediaries encouraged those third parties to pursue their own profit interests. Doing the "right thing" and pursuing customers' interests was not rewarded.

Financial Advice

The Commission examined four topics: (i) fees for no service (a large and endemic problem in the industry); (ii) inappropriate financial advice (including due to self-interest of advisers as well as lack of skill and judgement);

(iii) improper conduct by financial advisers; and (iv) disciplinary matters. The report identified reoccurring themes of dishonesty and greed.

The report noted issues in connection with:

- culture and incentives. The response to scandals was often that misconduct was caused by a few "bad apples". This served to contain misconduct and distance the entity from responsibility. It ignored root causes which lay within systems, processes and culture;
- conflicts between the financial interests of the adviser and duties owed to clients including conflicted remuneration and confusion of roles, the extent to which conflicts can and should be "managed" and structural considerations including vertical integration (the manufacture and selling of financial products while at the same time advising clients which products to use or buy);
- detection, including inadequate systems and lack of consequences for poor audit results (which did nothing to penalise bad work or encourage better work);
- the effectiveness of regulators including failures to enforce non-compliance with breach reporting and whether, with the benefit of hindsight, regulatory responses have been adequate.

Conflicts of interest had been considered previously by ASIC in its report published 24 January 2018. That report found that financial advisers had failed to consider the best interests of customers in three-quarters of the advice files it had reviewed. It concluded there was an inherent conflict of interest where banks provided financial advice to clients while also selling them financial products.

Role of Regulators

The Commission has noted that when confronted with misconduct, ASIC's starting point appears to have been: How can this be resolved by agreement? The Commission observed that this should not be the starting point – rather, the regulator should ask whether it can make a case of breach and, if so, why it would not be in the public interest to do so and to penalise the breach. This approach does not preclude discussion about how the matter might be resolved, including remediation of people affected. The report also notes that negotiations with regulators have taken far too long, including due to a willingness by the regulator to accommodate the entity's wishes rather than driving its own desired outcomes. The Commission specifically noted that APRA, the prudential regulator, never went to court when misconduct was revealed.

ASIC explained its approach to enforcement by reference to its limited resources and the high cost of litigation. It also pointed to gaps in its power, a subject of the ASIC Enforcement Review Taskforce.

The report asks why regulatory breaches were as widespread as they were and whether changing the law would make any difference. Is the law governing financial services entities and their conduct too complicated and does it impede effective conduct risk management and regulatory enforcement? What are banks and regulators doing to meet the danger of conduct risk?

The report acknowledges that adding a new layer of law and regulation might serve only to distract from the core, simple concepts that must inform conduct of financial services entities including: 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. Regulatory complexity may drive a "box-ticking" approach to compliance, with entities asking "Can I do this?" rather than "Should I do this?" or "What is the right thing to do?"

The report hints at the introduction of annual reviews of regulators' performance against their mandates and asks whether the current remit of the regulators is too broad. It suggests that industry codes relating to the provision of banking services might usefully be given statutory effect. It also poses the question as to what steps the regulators should take to address the serious issues of governance, culture and accountability that have been identified.

NEXT STEPS

There has been strong reaction from across the financial sector to the interim report. The Australian Bankers' Association CEO Anna Bligh said in a statement that *"there are no excuses for the behaviour that has been exposed by the Royal Commission. Banks accept responsibility for their failures and right now they are working day and night to make things right for their customers. We will fix these problems and make them right without delay, to earn back the trust of the Australian public. We will build a banking industry which acts with integrity and is once again respected by our customers and the Australian community."* The statement concluded that the Association would respond to the specific findings in the report in the coming weeks.

Australia's Treasurer Josh Frydenberg was quoted as saying there was *"clearly more work to be done"* and that the Government looked forward to receiving the Commission's final report, which is due by 1 February 2019.

Increasingly there are indications that change is already occurring with entities anticipating potential outcomes of the Royal Commission and taking proactive steps including initiating changes to products, processes and procedures, implementing remediation programmes for consumers and seeking to resolve regulatory issues.

COMMENT

The interim report contains a scathing indictment on certain parts of Australia's banking industry over the last decade, including the institutions themselves, third party intermediaries and the regulators.

Despite the Commission's broad terms of reference, the focus of its inquiries has been somewhat constrained by timeframes and reporting deadlines. This has left many aspects of banking beyond the retail market unexamined.

The Commission's work has already been effective in bringing about change with many financial services institutions taking proactive steps to address recognised shortcomings. This is likely to continue as the issues and common themes identified in the interim report, and questions posed for further consideration, will assist entities setting priorities and implementing necessary changes to ensure that past misconduct is not repeated.

The Commission's work has also already resulted in numerous cases being brought against the institutions involved, often involving multiple funded class actions. Action by regulators against some institutions in relation to conduct addressed in the interim report is inevitable; in fact ASIC may be more disposed to litigate given the Commission's criticisms that its past approach has been too soft and slow. All financial institutions will need to be conscious of the high likelihood of regulatory investigation and prosecution and private proceedings (particularly class actions) in relation to conduct examined by the Commission to date, even if the financial institution itself was not the subject of investigation by the Commission.

Ten years on from the Global Financial Crisis, financial institutions across the world may have reason to ask whether there is more they could be doing to protect the interests of customers and ultimately, the reputation of the entire banking industry.

The Commission's interim report is available here.

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