Australian Royal Commission – final takeaways for New Zealand

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February 28, 2019

The final report of the Australian Royal Commission into misconduct in the banking, superannuation, and financial services industry paints a harsh picture of Australian financial service provider conduct. Its recommendations are wide reaching and fundamental. What will it mean for us in New Zealand? In this Financial Law Insight, we unpick some of the learnings from the report from a New Zealand perspective, and share our thoughts on how it will shape the future of financial services regulation on this side of the Tasman.

Commissioner Hayne received his letters of patent to conduct a royal commission into financial services misconduct on December 14, 2017. On February 4, 2019 – 530 pages plus appendices, millions upon millions of dollars, 76 recommendations and several careers later – the much anticipated final report was released. At one level, the story it tells is not pretty. At another, it is an incredibly well-researched, objective and insightful analysis of both regulatory and human failings, providing a wealth of guidance for market participants.

Of course, not all of the recommendations made in the final report are going to be directly transportable to New Zealand. We have a different regulatory framework here, and there are significant differences in the obligations prescribed for our market participants. However, many of the principles advanced are of universal application. Much of the commentary and analysis supporting the recommendations is equally applicable to the New Zealand environment.

With that in mind, on February 19 and 20, Dentons Kensington Swan (formerly Kensington Swan) Partners Catriona Grover, David Ireland, and Nicole Xanthopol hosted panel sessions for our clients focusing on the key themes from the final report that are likely to influence the future regulation of financial advice, banking and insurance services in New Zealand. This Financial Law Insight picks out some of the highlights from those sessions, as well as offering some thoughts on the report's implications for provider culture, governance and remuneration.

Setting the scene

As a starting point, it is useful to recap the Australian Royal Commission's four headline observations from its hearings which formed the backbone of the report, as well as note the four key questions the recommendations contained in the report are intended to answer.

Four headline observations:

1. In almost every case, the conduct at issue was driven not only by the relevant entity's pursuit of profit, but also by individuals' pursuit of gain, relegating customer service to second place.
2. Entities and individuals acted in the ways they did because they could.
3. Consumers often dealt with financial service entities through an intermediary, yet the interests of client, intermediary and provider are opposed. 'Good enough' outcomes for consumers were pursued instead of 'best' interests. Conflicts between duty and interest can seldom be managed – self-interest will almost always trump duty.

4. Financial services entities that broke the law were not properly held to account.

The overarching message is that the financial services industry in Australia has a made a poor fist of addressing the risk of sub-optimal customer outcomes created by conflicts of interest, as has the current regulatory framework.

The four key questions the recommendations attempt to answer:

1. To what extent can the law be simplified so that its intent is met, rather than merely its terms being complied with, and how can this be done?
2. Should the approach to addressing conflicts of interest change from managing conflicts to removing them – either by banning all or some forms of conflicted remuneration and sales or profit based remuneration, and/or changing industry structures.
3. What can be done to improve compliance with the law and the effectiveness of the regulators?
4. What more can be done to achieve effective leadership, good governance and appropriate culture within financial services firms?

Taking initiative from the Australian Royal Commission and setting the scene here for answering the above questions, the RBNZ and FMA have already completed initial reviews of the conduct and culture in New Zealand Banks and life insurers. The FMA has also reviewed bank incentive structures and soft commissions in the life insurance industry. The New Zealand Government has responded to that work by announcing it will fast track consumer protection measures in the finance sector, with a consultation paper on proposed regulatory changes due out in May, and initial legislation proposed to be introduced by the end of the year.

What is clear is that there is still much water to flow under the bridge of financial services regulatory reform in New Zealand. However, with the final report of the Australian Royal Commission now out, coupled with the related work in New Zealand of the RBNZ and the FMA, the scene is now firmly set. For the foreseeable future, regulatory initiatives in this space are going to feed off this body of work, with the final report of the Australian Royal Commission and its comprehensive case studies providing the bedrock on which future reforms will be based.

Financial advice

Misconduct in the provision of financial advice flowed through all areas of the financial services industry covered in the report, as well as ‘enjoying’ its own special section.

There were three key themes running through Commissioner Hayne’s analysis of conduct in the provision of financial advice and related recommendations. The analysis provided in respect of each theme and those recommendations are likely to resonate with regulator activity in New Zealand, and influence our upcoming disclosure regulations and future conduct regulation.

Vertically integrated models

What was particularly interesting was the anticipated recommendation that was not made – the deconstruction of vertically integrated models.

Earlier speculation was that the final report would tackle the conflicts inherent in an entity controlling all steps in the financial product supply chain. The final report tabled the issues, but noted it was unclear if the benefits of mandating structural separation would outweigh the associated costs and disruption. This seems to be a wait and see position. How the industry responds to Commissioner Hayne’s recommendations will dictate whether the need for forced separation will be revisited. We expect the New Zealand response will be similar.

So vertically integrated models are safe (sort of) for now. What then were the themes in financial advice conduct that were pushed?

Fees for no service

At its most basic, this theme boils down to the charging of ongoing advice or service fees when no advice is given or services actually performed. We are picking this theme as having major ramifications for those receiving an ongoing fee from clients, as well as those facilitating the deduction or payment of those fees.

Clearly, charging for what you do not do is wrong. That form of misconduct breaches existing fair dealing laws. The issue on both sides of the Tasman is that the appropriateness of descriptions placed on ongoing fee payments is not really questioned, and not much seems to be done to verify that the services described were actually being provided.

A further issue raised by Commissioner Hayne was that licensees responsible for co-ordinating payment of ongoing fees did nothing to prevent advisers having more clients on their books than they could handle. This observation could well impact on business practices of providers and prospective financial advice provider licensees over here.

Apart from the fact that no services were actually being performed to justify the ongoing fees, the contractual concern expressed was that the fees in question tended to be charged invisibly by deduction, often in reliance upon historic arrangements that a client may have signed up to but by now may well have forgotten.

The proposed remedy to this particular theme was to recommend a requirement for there to be fully informed annual renewals of ongoing fee arrangements, with express authority granted each year by the affected client for fee deductions to be made. Whether such a requirement will be imposed here remains to be seen, but what seems inevitable is that there will be a heightened regulatory spotlight placed on the propriety of ongoing fee arrangements.

Inappropriate or poor advice leading to poor outcomes

Despite the heading, this concern largely boiled down to the issue of conflicts of interest in delivering advice. Commissioner Hayne observed that until something is done to address conflicts, the financial advice industry will not be a profession.

Commissioner Hayne was highly sceptical that conflicts of interests are able to be effectively managed. The report's conclusion was that as far as reasonably possible, conflicts should be eliminated and conflicted payments should not be accepted. Nevertheless, the report contained a number of recommendations aimed at better managing conflicts of interest:

- Require advisers and their licensees to disclose any interest in giving advice that might prevent them describing themselves as independent
- Repeal the previous grandfathering of old commission arrangements
- Widen the scope of commission payments that should be banned and/or limited.

The other measure recommended to address the risk of inappropriate advice was to remove the current safe harbour relief for advisers charged with operating in their clients' best interests. Commissioner Hayne noted that the much-touted "best interests" duty had become a tick box compliance exercise, reflecting a triumph of process over outcome.

The recommendation was for the safe harbour to be reviewed over the next three years and then repealed unless its continuation could be justified. This recommendation pours cold water over any enthusiasm New Zealand law-makers may have had for offering safe harbour protection for participants here.

Fragmented and ineffective disciplinary system

The report noted that regular and random auditing of adviser files was largely ineffective. Instead, what was required was a coherent system of professional discipline for financial advisers to be established, based on universal registration and a single disciplinary body. In New Zealand, we are already heading in that direction with the proposed regime for financial advisers under the FSLAB reforms. However, the current carve out for the way nominated representatives are proposed to be regulated seems at odds with what Commissioner Hayne has recommended.

In addition, a proposed system for reference checking and information sharing amongst licensees, coupled with misconduct notification obligations, was recommended. It seems likely that similar measures will be introduced as part of the FSLAB regime licensing system.

Banking

In addition to the financial advice concerns that flow across to the banking sector, a number of specific recommendations were made in relation to traditional banking services. The key themes from the report of relevance to New Zealand are set out below.

Mortgage broker arrangements

The manner in which mortgage brokers are remunerated and go about their work was perhaps the most pointed of the criticisms Commissioner Hayne levelled at the lending sector. While there are significant differences in the way mortgage brokers are regulated in New Zealand, many of the observations made in the report are likely to play out here.

At the most fundamental level, the recommendations were to the effect that mortgage brokers should be treated in the same fashion as other financial advisers (as is the case in New Zealand already). The key recommendation made by Commissioner Hayne that mortgage brokers must act in the best interests of the borrower is likely to flow through to New Zealand in some shape or form. Whatever the standard is that gets applied to financial advisers under the FSLAB reforms will inevitably apply to mortgage brokers, with a possible extension of the types of advice that will be caught.

The second recommendation in relation to mortgage brokers may have a more direct practical impact here. That was to change broker remuneration so as to prohibit trail commissions after a transition period, and then ban lenders from paying remuneration to brokers full stop. Instead, mortgage brokers should be paid by borrowers.

Interestingly, this was the one recommendation that the Australian Government declined to adopt in full at this point in time. The Australian Government was concerned that any regulatory changes should not adversely impact consumers' access to lenders and competition in the home lending market. While trail commissions will be prohibited, the Australian Government was not prepared to ban upfront commissions, instead more tightly regulating them and banning campaign and volume based commissions and payments, as well as limiting clawback periods. These reforms will be reviewed by regulators in three years' time to gauge their effectiveness at improving conduct in the mortgage broking industry. We will possibly see moves towards more of a borrower-pays system, and a complete ban on all commissions only if there is insufficient improvement in conduct by that point.

We can expect to see lender practices in relation to facilitating remuneration payments for mortgage brokers to be addressed in some shape or form as part of the next wave of regulatory reforms in New Zealand. The onus will fall on the sector to evidence good customer outcomes from the services they perform.

Direct lending – enquiries

While the report noted many cases of misconduct in failing to make the required enquiries into a borrower's financial situation and to verify information before entering into loan contracts, the recommendations did not extend to amending applicable responsible lending obligations. Instead, the report noted that banks need to apply the law as it currently stands.

Access to banking services

A number of recommendations were made to improve the accessibility of banking for all Australians, noting that banking should be regarded as an essential service – full participation in society includes access to banking services. This translated to placing greater obligations on banks to support particular types of vulnerable customers access and undertake banking.

Agricultural loans

A number of specific recommendations were made to benefit agricultural borrowers, noting the particular challenges faced by that sector. The headline recommendations were that a national scheme of farm debt mediation be introduced, requiring lenders to offer mediation to farmers before taking enforcement action. Lenders will also be denied the ability to charge default interest on loans secured on agricultural land in areas declared to be affected by drought or other natural disaster.

While the specific recommendations made were peculiar to the Australian environment, the overall analysis appears equally applicable here. The onus is now on our own agricultural lenders to evidence good conduct in their business practices.

Accountability

A final recommendation made in the area of banking that is likely to grab the attention of senior executives and directors over here is that responsibility should be placed on one person at each bank to be responsible for all steps in the design, delivery and maintenance of all products offered to customers and any necessary remuneration. So not only should banks be held accountable for their practices, but one senior executive within each bank should be charged with ownership of the overall process, with that individual held to account if anything goes wrong.

Insurance

New Zealand insurers already have the recently released findings from FMA and RBNZ's review of conduct and culture on life insurers to grapple with and respond to. The Royal Commission's reports key issues and recommendations in relation to insurance provides some further reading to inform the work required in response to that review. In particular, the report on life insurer conduct and culture in New Zealand contains a clear expectation that all insurers undertake a gap analysis of their business against the Royal Commission report, including all findings relevant to the insurance and sales advice process for insurance. The bulk of the specific recommendations made in relation to insurance by Commissioner Hayne address law reform issues that are currently the subject of an MBIE review in New Zealand. Issues such as the remedies for non-disclosure and misrepresentation and the relevant obligations placed on insureds, and unfair contract terms, are squarely within the scope of MBIE's review, with the approach taken in Australia likely to influence the final shape of our reforms in this area. In particular:

Sales

The Commission's view was that it is impossible to sell insurance via an unsolicited meeting, in a manner that is fair to the customer. Hence the recommendation was made that the 'hawking' of insurance products via unsolicited sales should be banned, similar to the ban we currently have on hawking investment products under the Financial Markets Conduct Act.

Duty of disclosure

The recommendation made in relation to disclosure is that the duty be changed to a duty upon insureds to take reasonable care not to make a misrepresentation to the insurer, and for the avoidance of a contract for non-disclosure to only be a remedy where the insurer would not have entered into the contract on any terms. In essence, this will shift the burden from the consumer to the insurer by requiring insurers to ask sufficient questions.

Unfair contract terms

The New Zealand carve out for prohibiting unfair contract terms is already tighter than the broad relief currently provided in Australia for insurance contracts. Given the findings and recommendations of Commissioner Hayne, we may see a further tightening of the permitted exceptions from unfair contract terms relief in New Zealand.

Culture, governance and remuneration

In addition to the recommendations made in relation to particular sectors of the financial services industry in Australia, Commissioner Hayne rounded out the final report with some fairly extensive guidance for the boards and senior management of all financial market participants.

In terms of governance, boards must:

- ensure they get the right information, seek further or better information, and challenge the approach taken to risk
- reassess priorities to ensure non-financial risks are included
- be clear about who is responsible for what – and hold personnel to account.

Board's must set the tone – and this encompasses the culture of the organisation. Boards need to identify the culture, identify problems, and prepare a plan to address those issues and reassess frequently.

Remuneration practices should be reviewed, and consideration given to the role incentives play in creating good conduct for both executives and front line staff.

The sections of the report dealing with organisational culture, governance, and remuneration arrangements are essential reading for all boards of financial service providers in New Zealand. While a number of the recommendations made are directed at APRA and ASIC, and the current Australian regulatory framework, the overall themes are of direct relevance over here. The report offers extensive guidance as to what is likely to be regarded as best practice in the new world.

Next steps

In our panel sessions we described the Commission's final report as the end of the beginning in establishing the platform for the future regulation of financial services in New Zealand. What are the next steps from here?

First, we are going to finally see the FSLAB reforms passed into law, to come into effect at some stage next year. It is possible that there might be some 11th hour tweaks to some of the details in light of the report. However, it is hard to see any fundamental shift in direction.

Similar with the new Code of Conduct poised to be recommended to the Minister of Commerce. The principles proposed in the draft Code are not contradicted in the report. Rather, the manner in which financial advice providers go about putting those principles into practice may shift even further towards ensuring good customer outcomes, informed by the work of the Commission and our own regulators.

What may well change will be the prescribed disclosure obligations to be placed on the provision of financial advice. Draft regulations should be released within the next month or so, and it's hard to see them not reflecting some of the work of Commissioner Hayne.

The big one we now await is the discussion paper feeding off last month's cabinet decision to fast-track customer protection measures in the financial sector in May. That will include new initiatives for regulating good conduct amongst banks and insurers, with the Minister of Finance seeking a strong response to internal sales incentives and soft commissions, amongst other things.

All that before the winter solstice – and we haven't even touched on the further work the FMA will be carrying out in the next phase of its conduct and culture reviews of banks and life insurers. That work is going to have an impact on all providers. It's going to be a busy few months ahead!

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