Interim Report

Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

VOLUME 1

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Letter of Transmittal

28 September 2018

His Excellency General the Honourable Sir Peter Cosgrove AK MC (Retd)
Governor-General of the Commonwealth of Australia
Government House
CANBERRA ACT 2600

Your Excellency

In accordance with the Letters Patent issued to me on 14 December 2017, I have made inquiries and prepared an Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

Yours sincerely

[Signed]

Kenneth M Hayne
Commissioner

Contents

Volume 1

Executive summary

The Commission's work, so far, has shown conduct by financial services entities that has brought public attention and condemnation. Some conduct was already known to regulators and the public generally; some was not.

Why did it happen? What can be done to avoid it happening again? These are now the key questions.

In this Interim Report these questions – 'why' and 'what now' – are asked with particular reference to banks, loan intermediaries and financial advice, with a view to provoking informed debate about both questions.

Why did it happen?

Too often, the answer seems to be greed – the pursuit of short term profit at the expense of basic standards of honesty. How else is charging continuing advice fees to the dead to be explained? But it is necessary then to go behind the particular events and ask how and why they came about.

Banks, and all financial services entities recognised that they sold services and products. Selling became their focus of attention. Too often it became the sole focus of attention. 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.

When misconduct was revealed, it either went unpunished or the consequences did not meet the seriousness of what had been done. The conduct regulator, ASIC, rarely went to court to seek public denunciation of and punishment for misconduct. The prudential regulator, APRA, never went to court. Much more often than not, when misconduct was revealed, little happened beyond apology from the entity, a drawn out remediation program and protracted negotiation with ASIC of a media release, an infringement notice, or an enforceable undertaking that acknowledged no more than that ASIC had reasonable 'concerns' about the entity's conduct. Infringement notices imposed penalties that were immaterial for the large banks. Enforceable undertakings might require a 'community benefit payment', but the amount was far less than the penalty that ASIC could properly have asked a court to impose.

What can be done to prevent the conduct happening again?

As the Commission's work has gone on, entities and regulators have increasingly sought to anticipate what will come out, or respond to what has been revealed, with a range of announcements. These include announcements about new programs for refunds to and remediation for consumers affected by the entity's conduct, about the abandonment of products or practices, about the sale of whole divisions of the business, about new and more intense regulatory focus on particular activities, and even about the institution of enforcement proceedings of a kind seldom previously brought. There have been changes in industry structure and industry remuneration.

The law already requires entities to 'do all things necessary to ensure' that the services they are licensed to provide are provided 'efficiently, honestly and fairly'. Much more often than not, the conduct now condemned was contrary to law. Passing some new law to say, again, 'Do not do that', would add an extra layer of legal complexity to an already complex regulatory regime. What would that gain?

Should the existing law be administered or enforced differently? Is different enforcement what is needed to have entities apply basic standards of fairness and honesty: by obeying the law; not misleading or deceiving; acting fairly; providing services that are fit for purpose; delivering services with reasonable care and skill; and, when acting for another, acting in the best interests of that other? The basic ideas are very simple. Should the law be simplified to reflect those ideas better?

This Interim Report seeks to identify, and gather together in Chapter 10, the questions that have come out of the Commission's work so far. There will be a further round of public hearings to consider these and other questions that must be dealt with in the Commission's Final Report.

Glossary

Term	Definition
anti-hawking provisions	Provisions set out in Sections 736, 992AA and 992A of the *Corporations Act 2001* (Cth) that prohibit offering financial products for issue or sale during, or because of, an unsolicited meeting or telephone call with a retail client.
authorised deposit-taking institution (ADI)	A body corporate authorised under the *Banking Act 1959* (Cth) to carry on a banking business in Australia.
Australian Credit Licence (ACL)	A licence issued under the *National Consumer Credit Protection Act 2009* (Cth) that authorises a licensee to engage in particular credit activities.
Australian financial services licence (AFSL), Australian financial services licensee	A licence under the *Corporations Act 2001* (Cth) that authorises a person who carries on a financial services business to provide financial services. A licensee is the person who provides the services.
Bank Bill Swap Rate (BBSY)	An interest rate used as a benchmark when pricing financial products.
buyer of last resort (BOLR)	Arrangements whereby a licensee or an authorised representative acquires the business of another representative. The purchase price is determined using a specific formula.
conflicted remuneration	Any benefit, whether monetary or non-monetary, given to a **financial services licensee**, or their representatives, who provides financial product advice to retail clients that, because of the nature

Term	Definition
	of the benefit or the circumstances in which it is given could reasonably be expected to influence the choice of financial product recommended by the licensee or representative or could reasonably be expected to influence the financial product advice given to retail clients by the licensee or representative: see Section 963A of the *Corporations Act 2001* (Cth).
enforceable undertaking	An undertaking enforceable in a court. Issued under the *Australian Securities and Investments Commission Act 2001* (Cth) and the *National Consumer Credit Protection Act 2009*.
external dispute resolution (EDR)	An independent service for resolving disputes between consumers and providers of financial products and services, as an alternative to the court system.
financial product	Under the *Corporations Act 2001* (Cth), a facility through which, or through the acquisition of which, a person makes a financial investment, manages financial risk and/or makes non-cash payments.
financial services entity	Defined by the Letters Patent as (among other things) 'an ADI (**authorised deposit-taking institution**) within the meaning of the *Banking Act 1959*', 'a person or entity required by section 911A of the *Corporations Act 2001* to hold an **Australian financial services licence**, or who is exempt from the requirement to hold such a licence by virtue of being an authorised representative', and 'a person or entity that acts or holds itself out as acting as an intermediary between borrowers and lenders'.

Term	Definition
Financial Services Guide (FSG)	A guide that contains information about the entity providing financial advice, and explains the services offered, the fees charged and how the person or company providing the service will deal with complaints.
financial services licensee	An individual or business that has been granted an **Australian financial services licence** (AFSL) by ASIC.
Future of Financial Advice (FoFA)	A 2012 package of legislation intended to improve the trust and confidence of Australian retail investors in the financial services sector and ensure the availability, accessibility and affordability of high quality financial advice.
Household Expenditure Measure (HEM)	A measure of what families spend on different types of household items, calculated quarterly by the Melbourne Institute of Applied Economic and Social Research.
mortgage aggregator	An intermediary between mortgage brokers and lenders. Mortgage aggregators have contractual arrangements with lenders that allow brokers operating under the aggregator to arrange loans from those lenders.
mortgage broker	An intermediary between borrowers and lenders of home loans.
third party guarantor	A person or business other than the borrower who guarantees to pay back a loan if the borrower does not.

Term	Definition
Tier 1 Capital	Capital against which losses can be written off while an **authorised deposit-taking institution** (ADI) continues to operate and can absorb losses should the ADI ultimately fail.
trail commission	A regularly recurring commission to an intermediary, such as a broker, based on a proportion of the current or average loan balance and payable periodically after the loan is made/drawn. Distinct from a commission that is paid up front.
vertical integration	A description of the relationship between entities where financial advice, platforms and funds management are controlled by a single entity.

Abbreviations

ABA	Australian Bankers' Association (now Australian Banking Association)
ABARES	Australian Bureau of Agricultural and Resource Economics and Sciences
ACBF	Aboriginal Community Benefit Fund
ACCC	Australian Competition and Consumer Commission
ACL	Australian Credit Licence
ADI	authorised deposit-taking institution
AFCA	Australian Financial Complaints Authority
AFA	Association of Financial Advisers
AFSL	Australian financial services licence
APRA	Australian Prudential Regulation Authority
ASBFEO	Australian Small Business and Family Enterprise Ombudsman
ASIC	Australian Securities and Investments Commission
AUSTRAC	Australian Transaction Reports and Analysis Centre
BOLR	buyer of last resort
EDR	external dispute resolution

FASEA	Financial Adviser Standards and Ethics Authority
FoFA	Future of Financial Advice (legislation reforms)
FOS	Financial Ombudsman Service
FPA	Financial Planning Association of Australia
FSG	Financial Services Guide
HEM	Household Expenditure Measure
KPI	Key Performance Indicator
LVR	loan-to-value ratio
PDS	product disclosure statement
SME	small and medium enterprises
SMSF	self managed superannuation fund

Legislation

Australian Securities and Investments Commission Act 2001 (Cth) (The ASIC Act)

Australian Small Business and Family Enterprise Ombudsman Act 2015 (Cth)

Banking Act 1959 (Cth)

Competition and Consumer Act 2010 (Cth)

Corporations Act 2001 (Cth) (the Corporations Act)

Fair Work Act 2009 (Cth)

Farm Business Debt Mediation Act 2017 (Qld)

Farm Debt Mediation Act 1994 (NSW)

Farm Debt Mediation Act 2011 (Vic)

Financial Services Reform Act 2001 (Cth)

Income Tax Assessment Act 1997 (Cth)

Insurance Contracts Act 1984 (Cth)

National Consumer Credit Protection Act 2009 (Cth) (the NCCP Act)

Privacy Act 1988 (Cth)

Royal Commissions Act 1902 (Cth)

1. Introduction

The Letters Patent establishing the Commission authorise, but do not require, me to submit an interim report. I have decided that it is important that I provide an interim report and that I explain why that is so.

The Commission has now conducted six rounds of public hearings. The first four rounds of hearings related to issues that focused principally on the provision of banking services to consumers, to small enterprises, and to rural and remote communities. Those first four rounds of hearings also looked at issues arising from the use of intermediaries between borrowers and lenders and from the provision of financial advice to retail customers.

Taken together, those first four rounds of hearings, coupled with the very large amount of work undertaken outside the hearing room by counsel assisting, by the solicitors assisting and by the Office of the Royal Commission allow me to identify issues about conduct by banks and their associated entities that call for further debate and consideration before I make my final report.

The Letters Patent record that 'Australia has one of the strongest and most stable banking, superannuation and financial services industries in the world, which performs a critical role in underpinning the Australian economy'. And, as the Letters Patent also record, 'Australia's banking system is systemically strong with internationally recognised and world's best prudential regulation and oversight'.

The Letters Patent require me to inquire into, and report on, whether any conduct by financial services entities, including banks and their associated entities, might have amounted to misconduct and whether any conduct, practices, behaviour or business activities by those entities fall below community standards and expectations. I must execute those tasks conscious of the fact that the banking system is a central artery in the body of the economy. Defects and obstructions in the artery can have very large effects. Likewise, prolonged injections of doubt and uncertainty can affect performance. Therefore, I must execute my tasks promptly, and I must execute those tasks in ways that will achieve two related purposes.

First, as far as reasonably possible, I must seek to identify properly the underlying causes of conduct of the kinds referred to in the Terms of Reference: conduct that might amount to misconduct and conduct falling short of community standards and expectations. As the Terms of Reference say, I must inquire whether the relevant conduct is 'attributable to the particular culture and governance practices of a financial services entity or broader cultural or governance practices in the relevant industry or relevant subsector' and whether the conduct 'result[s] from other practices, including risk management, recruitment and remuneration practices of a financial services entity, or in the relevant industry or relevant subsector'. The second purpose must be to conduct the inquiry in ways that will prompt proper consideration of how best to avoid recurrence of conduct that might amount to misconduct or conduct falling short of community standards and expectations.

To these ends, this interim report records the conclusions reached about the particular case studies that were examined in the first four rounds of hearings. This interim report seeks to identify the issues about banking, loan intermediaries and provision of financial advice that I consider arise out of the matters examined in those hearings. This interim report poses a series of questions, directing attention to considerations that may bear upon what conclusions I should reach, and what recommendations I should make, about banking, lending intermediaries, and financial advice in response to the more particular issues identified in the Terms of Reference namely:

- the adequacy of the existing laws and policies of the Commonwealth relating to the provision of banking and related financial services;
- the adequacy of the internal systems of financial services entities;
- the adequacy of existing forms of industry self-regulation, including industry codes of conduct, to identify, regulate and address misconduct and conduct falling short of community expectations and to provide appropriate redress to consumers;
- the effectiveness and ability of regulators to identify and address misconduct;
- whether any further changes to the legal framework, practices within entities, or the financial regulators are necessary to minimise the likelihood of misconduct in the future; and

- the effectiveness of mechanisms for redress for consumers of financial services who suffer detriment as a result of misconduct.

Before the Commission was appointed, all four major banks had publicly recognised that their conduct, or the conduct of associated entities, had fallen short of what the community expected. Regulators and others had examined particular aspects of the conduct of banks and their associated entities and had sometimes levelled sharp criticism at those who had engaged in the conduct that was the subject of inquiry. Thus, when the Commission began its work, as many as 70 public inquiries concerning the conduct of banks and their associated entities had been or were being conducted. Regulatory authorities had conducted and were continuing to conduct numerous investigations into allegations of misconduct.

The Commission therefore began its work from the established premise that some banks and their associated entities had engaged in conduct during the preceding 10 years that was conduct that might amount to misconduct or was conduct that fell short of community standards and expectations.

In these circumstances, I thought it right to begin my enquiry by asking financial services entities, including banks and their associated entities, to tell me what conduct over the previous 10 years they had identified as amounting to misconduct or conduct falling short of community standards and expectations. In light of both the responses to those requests and what had been established before the Commission was appointed, I determined that the Commission's hearings should proceed by examining case studies, rather than by seeking to investigate every separate case in which it was said that a financial services entity had or might have engaged in misconduct, or had or might have engaged in conduct falling short of community standards and expectations.

Nevertheless it remained, and it remains, vitally important to the work of the Commission to find out not only what complaints had been made and investigated but also what other complaints members of the public wanted to make. And, as later explained, many thousands of members of the public have made submissions to the Commission. Many of the consumers who have given evidence, or whose cases have been considered in the course of deciding which cases should be the subject of hearings have been identified because they made a submission to the Commission.

Before I deal with the particular case studies that were undertaken in the first four rounds of hearings, the issues that arise from those case studies and the questions that those case studies provoke, I should say something about the establishment of the Commission and the steps that were taken to set it up to do its work.

1 Establishment

By Letters Patent dated 14 December 2017, I was appointed to be a Commission of Inquiry and required and authorised to inquire into the matters stated in the Letters Patent. Ten subjects of inquiry were identified:

(a) whether any conduct by financial services entities (including by directors, officers or employees of, or by anyone acting on behalf of, those entities) might have amounted to misconduct and, if so, whether the question of criminal or other legal proceedings should be referred to the relevant Commonwealth, State or Territory agency;

(b) whether any conduct, practices, behaviour or business activities by financial services entities fall below community standards and expectations;

(c) whether the use by financial services entities of superannuation members' retirement savings, for any purpose, does not meet community standards and expectations or is otherwise not in the best interests of those members;

(d) whether any findings in respect of the matters mentioned in paragraphs (a), (b) and (c):

  (i) are attributable to the particular culture and governance practices of a financial services entity or broader cultural or governance practices in the relevant industry or relevant subsector; or

  (ii) result from other practices, including risk management, recruitment and remuneration practices, of a financial services entity, or in the relevant industry or relevant subsector;

(e) the effectiveness of mechanisms for redress for consumers of financial services who suffer detriment as a result of misconduct by financial services entities;

(f) the adequacy of:

(i) existing laws and policies of the Commonwealth (taking into account law reforms announced by the Commonwealth Government) relating to the provision of banking, superannuation and financial services; and

(ii) the internal systems of financial services entities; and

(iii) forms of industry self-regulation, including industry codes of conduct;

to identify, regulate and address misconduct in the relevant industry, to meet community standards and expectations and to provide appropriate redress to consumers;

(g) the effectiveness and ability of regulators of financial services entities to identify and address misconduct by those entities;

(h) whether any further changes to any of the following are necessary to minimise the likelihood of misconduct by financial services entities in future (taking into account any law reforms announced by the Commonwealth Government):

(i) the legal framework;

(ii) practices within financial services entities;

(iii) the financial regulators;

(i) any matter that has occurred or is occurring overseas, to the extent the matter is relevant to a matter mentioned in paragraphs (a) to (h);

(j) any matter reasonably incidental to a matter mentioned in paragraphs (a) to (i).

The Letters Patent directed me to have regard to the implications of any change to laws that I proposed to recommend 'for the economy generally, for access to and the cost of financial services for consumers, for competition in the financial sector and for financial system stability'. The Letters Patent further directed me to 'give priority to matters that in [my] opinion, have greater potential for harm if not addressed expeditiously'.

The Letters Patent defined 'financial services entity' as meaning (among other things) 'an ADI (authorised deposit taking institution) within the meaning of the *Banking Act 1959*', 'a person or entity required by

Section 911A of the *Corporations Act 2001* [the Corporations Act] to hold an **Australian financial services licence**, or who is exempt from the requirement to hold such a licence by virtue of being an authorised representative', and 'a person or entity that acts or holds itself out as acting as an intermediary between borrowers and lenders'. (Bolded terms like Australian financial services licence are defined in the Glossary at the start of this volume.) Banks, financial advisers and loan intermediaries are all relevant 'financial services entities'.

The Letters Patent defined 'misconduct' as including four kinds of conduct:

- conduct that 'constitutes an offence against a Commonwealth, State or Territory law, as in force at the time of the alleged misconduct';
- conduct that 'is misleading, deceptive or both';
- conduct that 'is a breach of trust, breach of duty or unconscionable conduct'; and
- conduct that 'breaches a professional standard of a recognised and widely accepted benchmark for conduct'.

2 The first steps

Before the Letters Patent were issued, Ms Toni Pirani of the Attorney General's Department was nominated to act as the Chief Executive Officer of the Office of the Royal Commission (ORC). Again, before the Letters Patent were issued, I nominated some counsel to assist me. Pursuant to the *Royal Commissions Act 1902* (Cth)[1] the Attorney-General appointed Ms Rowena Orr QC, Ms Eloise Dias and Mr Mark Costello as counsel assisting the Commission. Subsequently, Mr Michael Hodge QC and Mr Albert Dinelli were also appointed as counsel assisting. As the work of the Commission proceeded, the Australian Government Solicitor retained additional counsel to prosecute the work of the Commission: Ms Claire Schneider, Ms Sarah Zeleznikow, Mr Mark Hosking and Mr Tim Farhall.

1 *Royal Commissions Act 1902* (Cth) s 6FA.

On 7 December 2017, expressions of interest were sought from 27 firms of solicitors to act as solicitors assisting the Commission. Eight bids were received by the deadline of 14 December 2017. The Australian Government Solicitor was selected and on 18 December 2017 commenced in that role.

The Commission's CEO set about the tasks of assembling the staff of the ORC and finding premises from which the staff, counsel and solicitors could work. Those (very large) tasks were substantially completed by 2 March 2018. In the meantime, with the assistance of the Attorney-General's Department, the Commission established its website. On 22 January 2018, with the assistance of document management contractor Law In Order, the Commission established the means by which members of the public could make submissions to the Commission electronically by completing a form available through the Commission's website.

3 Initial inquiries

On the day after the Letters Patent were issued, I wrote to 61 financial services entities inviting each to answer three (or, in the case of superannuation entities, four) questions.[2]

- First, each entity was asked, in effect, whether it had identified any misconduct by the entity that had occurred at any time since 1 January 2008 and, if it had, to state 'the nature, extent and effect of that misconduct'.
- Second, each entity was asked whether it had identified 'any conduct, practice, behaviour or business activity' in which it had engaged since 1 January 2008 that it considered had fallen below community standards and expectations and again, if it had, to state the nature and effect of that conduct, practice, behaviour or activity.
- Third, each entity that identified misconduct or conduct falling short of community standards and expectations was asked a number of other questions about that conduct including:

[2] The text of the letters is set out in Appendix 2.

- whether the conduct was the subject of another inquiry, investigation or legal proceeding;
- whether the entity attributed any of the conduct to the culture or governance practices of the entity or the industry or to other practices;
- what steps the entity had taken to remedy the consequences of the conduct; and
- what steps the entity had taken to prevent recurrence of conduct of the kind reported.

The additional question asked of superannuation entities need not be noticed here.

At the same time, I wrote to industry associations and to the Australian Competition and Consumer Commission, the Australian Prudential Regulation Authority and the Australian Securities and Investments Commission (ACCC, APRA and ASIC) asking each of them the same kinds of question I had asked of financial services entities.

I gave the financial services entities six weeks to make their responses, asking each to make its response by 29 January 2018.

All of the entities, associations and regulators to which I wrote provided written responses to the questions I asked. As will be seen from what is said later in this report about individual case studies, each of the larger financial services entities acknowledged that, since 1 January 2008, it had engaged in conduct that fell short of community standards and expectations. Some acknowledged that some conduct might have amounted to misconduct. But none of the submissions by the four largest banks (ANZ, CBA, NAB or Westpac) or by AMP suggested that the submission that it made in answer to the questions I had asked in my letter of 15 December 2017 set out a comprehensive and detailed list of all conduct of the kinds that the letter had asked them to provide. In several cases, the submission said expressly that it set out 'examples' of conduct that the entity had identified.

This being so, on 2 February 2018, I wrote again to a number of entities, including the four largest banks and AMP asking each to provide me with a detailed and comprehensive list of all conduct occurring in the previous five years that the entity considered amounted to 'misconduct' as defined in the

Terms of Reference. CBA and NAB protested that the task was too large and could not be completed within the time allowed. Instead, each provided the Commission with printouts produced by risk management programs that those entities maintained as a record of every incident that any employee of the entity considered might constitute a breach of law. After Senior Counsel Assisting noted, during the first round of hearings, that the answer that CBA had made to my 2 February letter was unhelpful, CBA provided a further submission on 22 March 2018 (the last day of that round of hearings). This further submission set out in two tables conduct that it had identified as misconduct occurring in the preceding five years. Two tables were provided: one relating to Aussie Home Loans and the other relating to other entities in the CBA group. The Aussie Home Loans table had 139 entries, the other table had 309 entries.

The point to be made about the course of events is that at least CBA and NAB found it difficult to comply with the requests that I made. Each explained the difficulty by pointing to the need to assemble information from many separate sources. NAB said that, to make its response to the 15 December requests, it had examined 'NAB's significant litigation reports, reported Australian court judgments, NAB's breach registers and underlying reports to ASIC, APRA and AUSTRAC, adverse FOS determinations relating to "systemic issues", significant breaches of the Code of Banking Practice reported in NAB's Annual Statements of Compliance, and reports to the Australian Information Commissioner'.[3] NAB said that to provide details of misconduct that had occurred over the preceding five years it would have to look at, among other things, the Annual Compliance Statements it had made under the Code of Banking Practice (which recorded 1,914 breaches of the Code in the last five full financial years), 300 events reported as significant breaches to ASIC or APRA occurring during that period, 370 FOS determinations, 375 determinations by the Credit and Investments Ombudsman, 246 significant litigation matters and five different databases recording customer complaints.[4]

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[3] Letter dated 13 February 2018 from John Sharpe, General Manager, Dispute Resolution & Regulatory Investigations, NAB, to Simon Sherwood, AGS, [5(a)]. AUSTRAC is the Australian Transaction Reports and Analysis Centre and FOS is the Financial Ombudsman Service.

[4] Letter dated 13 February 2018 from John Sharpe, General Manager, Dispute Resolution & Regulatory Investigations, NAB, to Simon Sherwood, AGS, [15]–[31].

Taken together, the course of events and the explanations proffered can lead only to the conclusion that neither CBA nor NAB could readily identify how, or to what extent, the entity as a whole was failing to comply with the law. And if that is right, neither the senior management nor the board of the entity could be given any single coherent picture of the nature or extent of failures of compliance; they could be given only a disjointed series of bits of information framed by reference to particular events. Information presented in that way points too easily towards explaining what has happened as 'a small number of people choosing to behave unethically'[5] or as the product of 'people, policies and processes that existed with a pocket of poor culture in that area at that time'.[6]

The extent to which these issues extend beyond CBA and NAB remains to be explored.

4 Public engagement

As already mentioned, the Commission invited members of the public to make submissions to the Commission using the form available on the Commission's website. I sought to emphasise the importance of public submissions at every public hearing conducted by the Commission, including the first, formal sitting that was held on 12 February 2018.[7]

At that first sitting I noted that there had been some public discussion about the effects on the work of the Commission of contractual provisions about confidentiality in settlement agreements and non-disparagement clauses in employment, settlement or severance agreements. I said:

> This Royal Commission, like every Federal Royal Commission, has extensive compulsory powers. A confidentiality or non-disparagement clause in an agreement will not act as a reasonable excuse against production in answer to a notice to produce or a summons. It would not be

[5] NAB, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry NAB Group's Response dated 29 January 2018 to the Commission's Letter dated 15 December 2017*, 29 January 2018, 5 [3.1].

[6] CBA, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Submission*, 29 January 2018, 9 [27].

[7] Transcript, Commissioner Hayne, 12 February 2018, 11.

> a reasonable excuse not to answer a question in a hearing. It seems to me to follow that answering a notice or summons would not amount to a breach of any confidentiality or non-disparagement clause. Further – and this is very important – under section 6M of the Royal Commissions Act, if a witness gives evidence or produces a document under a notice or summons, no injury can be done to that person. Suing the person would almost certainly fall within that prohibition.
>
> In many cases where a dispute had been settled on confidential terms, the most immediate fact for the Commission will be that the dispute was settled, not the particular terms on which it was settled, and the fact of the settlement of the dispute will not be within any confidentiality provision. But whether or not that is so, any institution which sought any form of legal redress against a member of the public or a whistleblower seeking to volunteer information to the Commission in anticipation of the possible exercise of the Commission's coercive powers would be taking a step which would very likely provoke two immediate consequences. First, the Commission would be very likely indeed to exercise its compulsory powers to secure the information in question. Second, the very fact that an institution sought to inhibit or prevent the disclosure of the information would excite the closest attention not only to the lawfulness of that conduct by the institution, but also to what were the institution's motives for seeking to prevent the Commission having that information.[8]

Thereafter many financial services entities, including most if not all banks, said publicly that they would not seek to enforce or rely upon any confidentiality provision to prevent anyone making a complaint to the Commission. And, nothing in the later work of the Commission, its lawyers or its staff has so far suggested that confidentiality or non-disparagement provisions have inhibited in any way any communication with the Commission.

Many members of the public have submitted complaints about financial services entities by using the Commission's web-form. By 31 August 2018, more than 8,646 forms had been submitted. In addition, there had been more than 5,500 emails and 3,200 telephone calls to the Office of the Royal Commission, some asking for help in making a complaint, some asking about the work of the Commission, some offering comments on the work that had been done.

[8] Transcript, Commissioner Hayne, 12 February 2018, 11–12.

All of the complaints made by the public are read. Many of the case studies examined in public hearings have come to the attention of the Commission only because a member of the public submitted a web-form complaint. Some information about the nature of the complaints that have been received is set out in Appendix 8. As that information shows, roughly two out of three of the complaints that have been made are complaints about banking. And most of the complaints have been made by persons who give an address in the three eastern mainland states.

Why did the Commission proceed by case study?

5 Proceeding by case study

Consideration of what had been the subject of earlier inquiries and investigations showed that it would be impossible for the Commission to investigate every instance of conduct that it was alleged might have amounted to misconduct or was conduct falling short of community standards and expectations. Before the establishment of the Commission, banks and their associated entities had paid hundreds of millions of dollars of compensation to thousands of consumers to remedy the consequences of things that the entities had done or not done. Hundreds, soon thousands, of members of the public made submissions to the Commission complaining about the conduct of banks or their associated entities.

Evidently, then, not every case could be investigated or examined in the course of public hearings. Choices had to be made. What criteria could be applied in making those choices?

The main criterion applied in choosing case studies was whether the cases chosen were likely to permit identification and useful exploration of issues having a wider application than the particular case. Were the cases particular examples of widespread or frequently occurring conduct? Did the cases raise issues that may be systemic?

The Commission's Terms of Reference require it not only to investigate conduct but also to identify the causes of conduct of the relevant kinds. As already noted, the Commission began its work knowing that there had been conduct of the relevant kinds. In those cases, the focus fell upon why rather than what. What had happened was known. Why it had happened required further investigation and consideration. Accordingly, when selecting the

cases that were to be examined in the course of public hearings it was important to identify cases that might give some understanding of why the conduct had occurred. And it also followed that sometimes it would be desirable to look at more than one case to see what, together, they might show about causes.

Finally, regard had to be paid, and significance given, to the importance of the Commission conducting a public inquiry into conduct that might amount to misconduct or was conduct falling below community standards and expectations. Public exposure of misconduct and the vindication that those affected by that conduct derive from its exposure is an important consequence of conducting a public inquiry into misconduct. The cases that were chosen had to be selected as reasonably illustrative of the kinds of conduct about which members of the public had complained.

Some considerations were irrelevant to choosing the case studies that were undertaken. Neither the continuing existence of a dispute between entity and customer, nor the customer's desire to start or reopen a dispute, could bear upon whether the Commission would look at the conduct. This Commission, like every federal Royal Commission, exercises executive power. It does not, and cannot, exercise judicial power. The Commission cannot decide disputes between parties. It cannot award damages or any other form of relief to a person who complains that a financial services entity engaged in conduct of a kind that falls within the Terms of Reference. It cannot decide whether there *has been* misconduct. That is a task for a court. The most that the Commission can do is decide whether conduct 'might have amounted to misconduct and, if so, whether the question of criminal or other legal proceedings should be referred to the relevant Commonwealth, State or Territory agency'.[9] (I say more about this subject under the heading 'The Commission's tasks' when dealing with the case studies.)

It is then necessary to recognise some possible consequences of pursuing particular case studies.

Because the Commission was required to examine whether conduct might amount to misconduct or was conduct falling short of community standards and expectations, the Commission's work focused upon bad behaviour. Like

[9] *Letters Patent*, 14 December 2017, (a).

any inquiry that is required to investigate whether there has been wrongdoing, and if there has, to identify its causes, there is always a risk that the resulting picture of the industry is distorted. There is always a risk of losing sight of the fact that, in any industry as large as the financial services industry (or any of the chief subsectors of the industry) there will always be cases where participants do the wrong thing. Sometimes participants will act from base motives; sometimes participants will act thoughtlessly or will be careless of whether their actions are morally or legally justifiable.

In addition it is important not to be dazzled by the amounts of money financial services entities have spent in compensating customers for the harm done by conduct that is now recognised to have been misconduct or, at least, conduct falling short of community standards and expectations. Large financial entities engage in very many dealings with very many people. The entity's conduct will often affect thousands of customers. If it does, the total amount that must be paid to remedy damage done to customers as a result of the conduct may be very large. Often that reflects the scale of the entity's enterprise. It may say little or nothing about how or why the conduct occurred. And *for the entity*, the amount, though large, may not materially affect the entity's financial results.

Those observations may be important. They may be relevant when considering what entities have done in response to identifying conduct if a relevant kind. But, it remains important to recognise that, *for the individual customer*, the effect of an entity's conduct may be very large, regardless of what effect it may have on the entity. Some of the case studies examined concerned amounts that may look to be small. The figure appearing after the dollar sign is not always an accurate measure of the effect that conduct may have had.

6 Work outside hearings

Much of the work of the Commission has been undertaken outside the hearing room.

6.1 Research

First, considerable research has been undertaken both by staff of the Commission and by consultants. Their research has been recorded in a series of substantial papers published by the Commission. At the

Commission's request, several other papers have been provided to the Commission by Commonwealth authorities and published by the Commission.

The papers that relate to the subjects dealt with in this report and had been published by the Commission before the completion of the report are listed and reproduced in Appendix 9.

As can be seen from the list, the papers describe:

- features of the banking industry;[10]
- features of the financial planning industry;[11]
- features of the mortgage broking industry;[12]
- matters bearing upon financial services and small and medium sized enterprises;[13] and
- features of car financing in Australia.[14]

The papers also provide essential information about the existing legal framework governing a number of different aspects of the provision of financial services:

[10] FSRC, *FSRC Background Paper No. 1: Some Features of the Australian Banking Industry*, 9 February 2018.

[11] FSRC, *FSRC Background Paper No. 6 (Part A): Some Features of the Australian Financial Planning Industry*, 5 April 2018; FSRC, *FSRC Background Paper No. 6 (Part B): Education and Training Requirements for Financial Advisers*, 5 April 2018; FSRC, *FSRC Background Paper No. 6 (Part C): Financial Products Available to Retail Investors*, 5 April 2018.

[12] FSRC, *FSRC Background Paper No. 2: Some Features of the Australian Mortgage Broking Industry*, 22 February 2018.

[13] FSRC, *FSRC Background Paper No. 12: Financial Services and Small and Medium-Sized Enterprises*, 14 May 2018.

[14] FSRC, *FSRC Background Paper No. 3: Some Features of Car Financing in Australia*, 9 March 2018.

- consumer credit;[15]
- financial advice and sale of **financial products**;[16] and
- credit for small business.[17]

Two other papers consider more specific issues about the regulatory capital framework for ADIs[18] and the relationship between the regulatory capital framework and impairment of loans, provisioning for impaired loans and enforcing security for loans.[19]

All of these papers provide information that is important to a proper understanding of the work of the Commission. The work of the Commission, in its public hearings and the work that has been done outside the hearing room is necessarily shaped by reference to the nature and characteristics of the industry with which it is dealing and the legal and regulatory framework within which the industry has been working during the times that are relevant to the conduct being examined.

6.2 Public engagement

Second, as has already been noted, staff of the Office of the Royal Commission have spoken to and communicated with many members of the public in the course of their work.

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15 Jeannie Marie Paterson and Nicola Howell, *FSRC Background Paper No. 4: Everyday Consumer Credit – Overview of Australian Law Regulating Consumer Home Loans, Credit Cards and Car Loans*, 12 March 2018; Treasury, *FSRC Background Paper No. 5: Request for Information Reforms to Consumer Lending*, 19 March 2018.

16 Pamela Hanrahan, *FSRC Background Paper No. 7: Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households*, 5 April 2018; Treasury, *FSRC Background Paper No. 8: Key Reforms in the Regulation of Financial Advice*, 13 April 2018.

17 Andrew Godwin, Jeannie Marie Paterson and Nicola Howell, *FSRC Background Paper No. 10: Credit for Small Business – An Overview of Australian Law Regulating Small Business Loans*, 7 May 2018; Treasury, *FSRC Background Paper No. 11: Request for Information – Reforms to Small Business Lending*, 9 May 2018.

18 APRA, *FSRC Background Paper No. 9: The Regulatory Capital Framework for Authorised Deposit-Taking Institutions (ADIs)*, 27 April 2018.

19 APRA, *FSRC Background Paper No. 13: The Regulatory Capital Framework – Impairment Provisioning and Enforcing Security*, 18 May 2018.

6.3 Choosing case studies

Third, solicitors and counsel assisting have considered many more cases of alleged relevant conduct than those taken as case studies in hearings. To do that, Notices to Produce have been prepared and served and witness statements sought and examined to see whether the case concerned is one that the Commission should examine in public hearings.

As later explained in more detail when dealing with the four case studies in the third round of hearings that concerned loans made by Bankwest, solicitors and counsel examined thousands of pages of documents relating to dozens of loans before the four that were examined in evidence were chosen as illustrating issues that should be examined in public hearings.

For the fourth round of hearings concerning dealings with customers in rural and remote areas, there were extensive consultations with financial counselling services and legal aid providers. Close attention was given to the web-form complaints. Cases were identified. Complainants were contacted and interviewed, often more than once. Entities were required to produce relevant documents and, more often than not, statements of evidence. Then counsel and solicitors reviewed what had been assembled to decide whether it should be pursued in public hearings.

6.4 Moving targets

As the Commission went on with its work, entities and regulators went on about theirs.

More than once, the Commission's announcement of its intention to hold public hearings into particular kinds of conduct was followed soon after by an entity announcing some change in its products, processes or procedures or by an entity and a regulator announcing that some agreement had been made about the regulatory response to some past conduct. Two examples of that kind of conduct will illustrate the point. Further examples are noted elsewhere in this report.

A few days before the Commission was to hear evidence about CBA's conduct in connection with the sale of 'add-on insurances' (including consumer credit insurance) CBA announced that it would no longer offer those products and would implement a refund program for those who had been sold unsuitable consumer credit insurance.

Shortly before the Commission was to embark on its hearings about financial advisers charging clients for ongoing services that had not been provided, ASIC reached agreement, first with ANZ and then with CBA, for the relevant entities to provide **enforceable undertakings** as a consequence of the conduct in question.

Further, after the Commission had conducted public hearings about some kinds of conduct, entities announced changes in products, processes or procedures that had been the subject of inquiry. Not only were there changes in products, processes and procedures and new regulatory steps, some entities announced plans to dispose of parts of their business. Some, but by no means all of these changes are noted elsewhere in this report.

2. Consumer lending

Introduction

The Commission's first round of hearings explored issues that have arisen for consumers in their dealings with financial services entities about:

- home loans;
- car loans;
- credit cards;
- forms of 'add-on' insurance sold with home loans, car loans and credit cards;
- offers of pre-approved overdrafts and credit cards; and
- 'processing' and 'administrative' errors.

The Commission took these issues as subjects for its first round of hearings for two reasons. First, dealings about home loans, car loans and credit cards are important to both consumers and financial services entities. Second, the information that the Commission obtained from members of the public making submissions, from regulators, from consumer advocacy groups and from financial services entities, all pointed to the occurrence in connection with these kinds of dealings of conduct that might amount to misconduct and conduct falling below community standards and expectations. Information from all four sources (public submissions, regulators, consumer advocates and financial services entities) pointed towards consumers not always having been 'treated honestly and fairly' in their dealings.[1]

[1] The Letters Patent establishing the Commission recited that: '[A]ll Australians have the right to be treated honestly and fairly in their dealings with banking, superannuation and financial services providers. The highest standards of conduct are critical to the good governance and corporate culture of those providers.' *Letters Patent*, 14 December 2017.

The issues described affected hundreds of thousands of consumers. Financial services entities paid hundreds of millions of dollars to remedy what had happened.

This chapter deals with the issues in seven sections:

1 The purposes of consumer protection.

2 The responsible lending provisions.

3 Some background information about

- home loans and car loans;
- credit cards; and
- add-on insurance.

4 The magnitude and prevalence of the issues.

5 The consequences of the conduct.

6 The issues that arise:

- intermediaries – the confusion of roles and responsibilities;
- customer needs – you 'need' what we have to sell;
- credit risk or unsuitable lending? Lending is not unsuitable if the consumer is unlikely to default; and
- processing errors – failure to deliver promised features of products sold.

7 Regulatory compliance.

1 Purposes of consumer protection

Consumers of financial services cannot expect to be insulated from loss, but they can properly expect to be treated fairly and honestly.

As the Murray Inquiry said, 'fair' treatment requires that **financial products** and services perform in the way that consumers expect or are led to

believe.[2] What a consumer is led to believe about a product's performance depends upon what that consumer is told or not told about its performance, and that can be measured against the standard of honesty reflected in the basic command of 'do not mislead or deceive'. What a consumer can or should expect about performance of a product may present more difficult issues.

Treating consumers fairly and honestly has important economic consequences.

In its 2008 report, the *Review of Australia's Consumer Policy Framework*, the Productivity Commission identified respects in which it thought that Australia's consumer policy framework needed an overhaul. The Productivity Commission said that 'addressing these problems will have significant direct benefits for consumers' and that 'by better engaging and empowering consumers and furthering the development of nationally competitive markets, reform will enhance productivity and innovation.'[3] The Productivity Commission concluded that '[t]he overarching objective should be to improve consumer wellbeing by fostering effective competition and enabling the confident participation of consumers in markets in which both consumers and suppliers can trade fairly and in good faith.'[4]

The laws that now regulate the financial industry and dealings in financial products, and make specific provisions affecting dealings with consumers, must be understood and applied in light of these considerations. They are considerations that find direct expression in the overarching, and fundamental, requirements of the *Corporations Act 2001* (Cth) (the Corporations Act) and the *National Consumer Credit Protection Act 2009* (Cth) (the NCCP Act) that a financial services licensee must do *all* things necessary to *ensure* that the financial services provided by the licensee are provided 'efficiently, honestly and fairly'[5] and that the holder of an **Australian Credit Licence** (ACL) must do *all* things necessary to ensure

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2 Exhibit 2.1.24, November 2014, Financial System Inquiry Final Report, 193.

3 Productivity Commission, *Review of Australia's Consumer Policy Framework,* 30 April 2008, vol 1, 2.

4 Productivity Commission, *Review of Australia's Consumer Policy Framework,* 30 April 2008, vol 1, 2.

5 Corporations Act s 912A(1)(a).

that the credit activities authorised by the licence are engaged in 'efficiently, honestly and fairly'.[6]

2 Responsible lending

A critical legislative step towards fostering effective competition in the consumer lending market, and enabling the confident participation of consumers in a lending market in which both consumers and lenders trade fairly and in good faith, has been the introduction of the responsible lending provisions of the NCCP Act. More precisely, it is the requirements imposed by Division 3 of Part 3-2 of the NCCP Act on credit licensees to assess 'unsuitability'. The licensee must assess whether the credit contract will be *unsuitable* for the consumer if the contract is made or (in the case of a credit limit increase) the limit is increased.[7]

2.1 'Unsuitable'

A credit licensee *must* assess that the credit contract (or the proposed credit limit increase) is unsuitable if certain conditions are met.[8] The most important of those conditions is that a contract will be unsuitable for the consumer if, at the time of the assessment, it is likely that the consumer will be unable to comply with the consumer's financial obligations under the contract, or could only comply with substantial hardship.[9] And the NCCP Act further provides that it is to be presumed that, if the consumer could only comply with the consumer's financial obligations under the contract by selling the consumer's principal place of residence, the consumer could only comply with those obligations with substantial hardship, unless the contrary is proved.[10]

6 NCCP Act s 47(1)(a).

7 NCCP Act s 129.

8 NCCP Act s 131(1).

9 NCCP Act s 131(2)(a).

10 NCCP Act s 131(3).

2.2 Necessary steps

Before making the assessment of whether the loan is unsuitable, the licensee *must* take a number of steps. Those steps include:

- making reasonable inquiries about the consumer's *requirements* and *objectives* in relation to the credit contract;[11]
- making reasonable inquiries about the consumer's *financial situation*;[12] and
- taking reasonable steps to *verify* the consumer's financial situation.[13]

The content of these three steps is important. The first two require reasonable *inquiries*; the third requires reasonable steps to *verify.*

2.2.1 Reasonable inquiries: Requirements and objectives

The consumer's requirements and objectives in relation to the credit contract are personal to the consumer. The NCCP Act requires the credit licensee to make reasonable inquiries about them. In many cases, perhaps most, identifying the consumer's requirements and objectives will require some identification of what the consumer proposes to do with the facility that is provided or the amount that is to be borrowed under the credit contract. Whether, in the case of a revolving credit facility like a credit card, the consumer's requirements and objectives are sufficiently identified as being simply to make the proposed credit contract is an issue to which further attention is given in connection with credit card lending.

One negative proposition, however, may be made with a degree of certainty. The consumer's requirements and objectives are not identified if all that the credit licensee looks at is whether the consumer may be expected not to default under the credit contract. And as the case studies examined in the first round of hearings show, credit licensees too often have focused, and too often continue to focus, only on 'serviceability' (which is to

[11] NCCP Act s 130(1)(a).

[12] NCCP Act s 130(1)(b).

[13] NCCP Act s 130(1)(c).

say credit risk) rather than making the inquiries and verification required by law.

2.2.2 Reasonable inquiries: Financial situation

In determining a consumer's financial situation it will always be necessary to consider both sides of the ledger – income *and* expenditure. That is, the credit licensee must make reasonable inquiries about what income the consumer has had in recent times and whether the consumer can reasonably expect to enjoy that level of income for a reasonable time in the future. But the credit licensee must also make reasonable inquiries about the consumer's expenditures – both what expenditures the consumer has had, and what level of expenditures the consumer can reasonably be expected to have in the future.

These inquiries are more than an inquiry about whether the credit licensee thinks that the consumer is unlikely to default in performance of the loan. Credit risk is an inquiry that prudent lenders have always made. The responsible lending provisions of the NCCP Act introduced new and additional requirements. They require more than the lender being satisfied that the loan is an acceptable credit risk.

More particularly, identifying that the consumer's income is larger than a general statistical benchmark for expenditures by consumers whose domestic circumstances are generally similar to those of the person seeking the loan does not reveal the particular consumer's financial situation. All it does is convey information to the credit licensee that it may judge sufficient for it to decide that the risk of the consumer failing to service the loan is acceptable.

2.2.3 Reasonable steps to verify

Verification calls for more than taking the consumer at his or her word. If the consumer claims to have regular income, what step has the credit licensee taken to verify the claim? Verification is often not difficult. Most persons have income deposited to a bank account and there is, therefore, a bank statement showing receipt of the income claimed that will be readily available to the consumer (and readily available to the credit licensee if it is the **authorised deposit-taking institution** (ADI) at which the consumer maintains the account). And many of a consumer's main outgoings will be recorded (or at least reflected) in the same bank statement.

The evidence showed that, more often than not, each of ANZ, CBA, NAB and Westpac took some steps to verify the income of an applicant for a home loan. But the evidence also showed that much more often than not none of them took any step to verify the applicant's outgoings. The general tenor of the evidence was that a lender satisfied responsible lending obligations to verify a borrower's financial position if the lender assessed the suitability of the loan by reference to the higher of a borrower's declared household expenses and the **Household Expenditure Measure** (HEM) published by The Melbourne Institute (or some equivalent measure) and that verifying outgoings was 'too hard'.

But what was meant by verifying outgoings being 'too hard' was that the benefit *to the bank* of doing this work was not worth the bank's cost of doing it.

This understanding of the position emerged from the evidence given in the fourth case study. There a borrower supplied ANZ a copy of his bank statement (with another ADI) as verification of his income. The outgoings recorded in that statement were obviously inconsistent with what the borrower recorded as his outgoings. But ANZ's procedures did not require consideration of, and in fact the relevant bank employees did not look at, the bank statement for any purpose other than verifying income.

During the same case study, Mr William Ranken, the leader of the 'Homeowners team' for ANZ, was asked about some recommendations that KPMG had made to ANZ as a consequence of KPMG's conduct of the Australian Prudential Regulation Authority (APRA) targeted review. KPMG had recommended, first, that ANZ ask customers to provide a more detailed breakdown of their expenses that would provide 'greater insight and assist customers in ensuring stated expenses are complete and accurate'; second, that ANZ could ask customers to supply bank statements for their main transaction accounts as well as credit card statements; third, that asking customers to supply these statements would 'address the risk that customers fail to disclose major items of expenditure; and fourth, that bank statements could also be reviewed for general account conduct to identify whether 'there are any obvious inconsistencies between a customer's stated expenses and transaction history, or any general indicators of financial

stress.'[14] Mr Ranken said that ANZ was trialling the first three proposals in its proprietary channel, but not the fourth.[15] Of that he said, in effect, that the cost for the benefit was not sufficient, or as he put it, 'we don't think that that's a material uplift'.[16] Tellingly, Mr Ranken made no reference to whether the responsible lending requirements suggested or required otherwise.

Since March 2018, Westpac has expanded the number of expense categories included in its home loan application process from six to 13, and made some mandatory. Categories now include 'telephone, internet, pay TV and media streaming subscriptions', 'medical and health', and 'childcare'. Any category given a value of $0 must be accompanied by an explanation.[17] A separate set of expense categories termed 'commitments', being fixed outgoings, is also collected.[18] Westpac policies require that staff scrutinise all transaction accounts provided by the customer for inconsistencies with these declared amounts. But in most cases Westpac does not require customers to provide regular transaction statements for non-Westpac accounts, and the 'verification', as distinct from the 'inquiry', of the customer's expenses remains largely with the customer.[19]

In as many as three out of every four home loans examined in the course of APRA's 2016/2017 targeted review into home lending practices, the banks assumed that the borrower's household expenditures were equal to the relevant HEM – amounts published by The Melbourne Institute as the Household Expenditure Measure – 'a measure that reflects a modest level

14 Exhibit 1.87, 28 April 2017, KPMG Targeted Review 2016/2017, 9–10; Transcript, William Andrew Ranken, 19 March 2018, 474.

15 Transcript, William Andrew Ranken, 19 March 2018, 475.

16 He continued: 'And that's the one where, as I've previously stated, the complexity, the time, the cost for the benefit, we don't think that that's a material uplift to having the detailed, you know, in combination with the first one, having the detailed conversation with the customer, then attesting to that, and signing that's the correct statement of position and us referencing that to an independent statistical benchmark.' Transcript, William Andrew Ranken, 19 March 2018, 475.

17 Witness statement of William Malcolm 2 August 2018, 26 [133]–[134].

18 Witness statement of William Malcolm 2 August 2018, 18 [95]–[97].

19 Witness statement of William Malcolm 2 August 2018, Exhibit WDM1-58.

of weekly household expenditure for various types of families'.[20] (Some of the banks subject to the targeted review were found to use a HEM figure for a borrower's household expenditure less frequently than others. Even so, a significant number of the files inspected by the external accountants who conducted the targeted review showed reliance on HEM.)

The HEM

As The Melbourne Institute explains:

> [The HEM] report examines household expenditure in Australia. Using local survey data linked to the Consumer Price Index, the HEM looks at what families actually spend in relation to different types of household.
>
> The HEM classifies more than 600 items in the Australian Bureau of Statistics' *Household Expenditure Survey* as absolute basics, discretionary basics or non-basics. These items are then used to calculate modest expenditure for eight types of household.
>
> Notes
>
> - The HEM is defined as the median spend on absolute basics plus the 25th percentile spend on discretionary basics.
> - *Absolute basics* are most food items, children's clothing, utilities, transport costs and communications.
> - *Discretionary basics* include take-away food, restaurants, confectionery, alcohol and tobacco, adult clothing, childcare and entertainment.
> - *Non-basics* include luxury services such as gardeners and overseas holidays.
> - Rents and mortgage payments are not included, as the HEM is a net-of-housing costs measure.[21]

As the first of the notes just quoted records, HEM represents the median spend on absolute basics, but only the 25th percentile spend on discretionary basics. Three out of four households spend more on things

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[20] The Melbourne Institute, *Publications 2018* (undated) The Melbourne Institute <https://melbourneinstitute.unimelb.edu.au/__data/assets/pdf_file/0003/2162550/MI-Publications-Brochure-2018.pdf>.

[21] The Melbourne Institute, *Social Indicators Report* (undated) The Melbourne Institute <https://melbourneinstitute.unimelb.edu.au/publications/social-indicator-reports>.

like alcohol and tobacco, adult clothing and childcare than HEM includes in its result. And, HEM takes no account of spending on 'non-basics'. Together, these considerations show why it is right to describe HEM as being used to calculate only '*modest* expenditure'.

Further, and obviously, HEM takes no account of whether a particular borrower has unusual household expenditures as may well be the case, for example, if a member of the household has special needs or an aged parent lives with, or is otherwise cared for, by the family.

It follows that using HEM as the default measure of household expenditure does not constitute any *verification* of a borrower's expenditure. On the contrary, much more often than not it will mask the fact that no sufficient inquiry has been made about the borrower's financial position. And that will be the case much more often than not because three out of four households spend more on discretionary basics than is allowed in HEM and there will be some households that spend some amounts on 'non-basics'. Using HEM as the default measure of household expenditure assumes, often wrongly, that the household does not spend more on discretionary basics than allowed in HEM and does not spend anything on 'non-basics'.

The practice described in connection with home loans extended, and continues to extend, well beyond that area of lending. Evidence led in the first round of hearings showed that entities making car loans have taken, and continue to take a generally similar approach of taking some steps to verify borrower income but none to verify borrower household expenditures. Instead the entity considers whether the customer can service the debt by determining an amount of uncommitted monthly income by deducting from income the higher of a borrower's declared household expenses and either the HEM measure, or a sum derived from a HEM measure. And entities considering whether to allow a credit limit increase on a credit card account have followed substantially the same approach in those cases where they made any inquiry about a customer's financial position.

2.2.4 'Reasonable' inquiries: Scalable

The Australian Securities and Investment Commission's (ASIC's) Regulatory Guide 209: Credit Licensing: Responsible Lending Conduct explains how ASIC interprets the law relating to responsible lending and sets out ASIC's 'expectations for compliance with the responsible lending

obligations'.[22] The Guide says that the obligation to make reasonable inquiries, and to take reasonable steps to verify information 'is scalable', an expression it amplifies by saying that 'what you need to do to meet these obligations will vary according to the circumstances'.[23]

Understood in this way, the proposition that the obligations are 'scalable' is undeniable. What the Act requires is *reasonable* inquiries and *reasonable* steps. And what is reasonable will often be affected by the particular nature and amount of the credit contract in issue.

The Guide gives four examples of factors that may bear upon performing the obligations of inquiry and verification:

- the potential impact on the consumer of entering an unsuitable credit contract;
- complexity of the credit contract;
- capacity of the consumer to understand the credit contract; and
- whether the consumer is an existing customer or a new customer.[24]

As the Guide makes plain, the first of these factors requires consideration of the *particular* consumer's position. It does not depend upon whether the loan can be described as 'large' or 'small'. '[E]ven a small loan can cause financial difficulties for a consumer on a low income'.[25] Often enough for a customer with little leeway between income and expenditure, it is the small additional loan that may tip the balance.[26]

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22 ASIC, Regulatory Guide 209: Credit Licensing: Responsible Lending Conduct, November 2014, reg 209.14.

23 ASIC, Regulatory Guide 209: Credit Licensing: Responsible Lending Conduct, November 2014, reg 209.19.

24 ASIC, Regulatory Guide 209: Credit Licensing: Responsible Lending Conduct, November 2014, reg 209.22, Table 3.

25 ASIC, Regulatory Guide 209: Credit Licensing: Responsible Lending Conduct, November 2014, reg 209.22, Table 3.

26 As Dickens wrote in *David Copperfield,* "'My other piece of advice, Copperfield," said Mr. Micawber, "you know. Annual income twenty pounds, annual expenditure nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds nought and six, result misery."'

2.3 Non-delegable obligations

The legislation imposes the obligations described on the licensee. It is for the licensee to satisfy them. Of course the licensee can engage others to do some or all of the work, but the responsibility remains that of the licensee. Hence, if the licensee agrees with a third party that the third party will make relevant inquiries and verify relevant information, the third party's failure to perform those obligations presents the question whether the licensee has failed in performing its obligations. The question is not answered by observing that the licensee had made a contract obliging the third party to take the necessary steps and that the third party had breached its contract with the licensee.

3 Background information

3.1 Home loans

Almost every person buying a house in Australia will borrow a large part of the cost. Many Australians have home loans with one of the major lenders.

In its first published Background Paper, the Commission set out information showing the size and importance of the home loan market to ADIs and to the economy generally.[27] That paper recorded the following information.

Home loans are the largest asset on the books of ADIs, comprising around 42% of assets as at the September quarter 2017.

As at November 2017, there was a total of $1.07 trillion in finance for owner-occupied housing provided by ADIs and a further $560 billion in investment housing finance provided by ADIs (a total of around $1.6 trillion in housing finance provided by ADIs). The vast majority of housing finance is provided by banks (around 98%), with the remainder provided by permanent building societies and credit co-operatives.[28]

[27] FSRC, *FSRC Background Paper No. 1: Some Features of the Australian Banking Industry*, 9 February 2018.

[28] ABS data cited in: FSRC, *FSRC Background Paper No. 1: Some Features of the Australian Banking Industry*, 9 February 2018, 19 [4.2].

As at the September quarter 2017, there were around 5.8 million residential term loans provided to households by an ADI, with greater than $1 billion of term loans. Of these, around 1.6 million (27%) were interest-only loans, 2.2 million (38%) were loans with offset facilities and 4.1 million (71%) were loans with redraw facilities.[29]

3.1.1 Average home loan size

The average balance of residential term loans to households was $264,000 as at the September quarter 2017. The average home loan balance is significantly higher for interest-only loans ($347,000) and loans with offset facilities ($314,000).

3.1.2 Number of mortgage defaults per year

At the time of Background Paper 1 (February 2018), there were only a small number of mortgages in arrears in Australia, according to Standard & Poor's, which estimates the value of residential mortgages in arrears (that is, mortgages with late repayments) using residential mortgage-backed securities (RMBS) data.

According to Standard & Poor's, only 1% of the total value of Australian 'prime'[30] mortgages (where borrowers have a high likelihood of repaying their debt) were in arrears of 31 days or more. Of the total value of Australian 'non-conforming' mortgages (where borrowers have a lower likelihood of repaying their debt – often referred to as 'sub-prime'), 3.4% were in arrears of 31 days or more. This figure had dropped substantially since 2007.[31]

These values dropped further when considering loans that were 90+ days in arrears. Only 0.6% of Australian 'prime' mortgages were 90+ days in arrears, and around 1.5% of Australian 'non-conforming' mortgages were

[29] See FSRC, *FSRC Background Paper No. 1: Some Features of the Australian Banking Industry*, 9 February 2018, 19 [4.2].

[30] For a detailed explanation of prime and non-conforming loan definitions, see Guy Debelle, 'A Comparison of the US and Australian Housing Markets' (Speech delivered at the Sub-prime Mortgage Meltdown Symposium, Adelaide, 16 May 2008) <www.rba.gov.au/speeches/2008/sp-ag-160508.html>.

[31] See FSRC, *FSRC Background Paper No. 1: Some Features of the Australian Banking Industry*, 9 February 2018, 20.

90+ days in arrears.[32] The data, when split by type of ADI, showed that the proportion of Australian prime mortgages 90+ days in arrears had generally increased for major banks and regional banks, although they remained low as a proportion of total balances.[33]

3.1.3 Home loans and intermediaries

Intermediaries play important roles in the home loan industry. The exact role each form of intermediary fulfils at various stages of a home loan transaction is not always clear. Those issues are considered separately.

In its second Background Paper, the Commission set out some features of the Australian Mortgage Broking Industry.[34] The paper made five points:

- The mortgage broking industry is a key distribution channel for residential mortgage financing in Australia, settling 55.7% of all residential home loans in the September quarter 2017.
- **Mortgage aggregators** act as intermediaries between **mortgage brokers** and lenders, by providing brokers with access to lenders on their aggregator's panel.
- Residential property investors and residential owner-occupiers are the main customers of mortgage brokers, collectively accounting for over 75% of the customers of mortgage brokers.
- Banks still finance the majority of the loans originated through mortgage brokers, although there is a modest increase in the volume of loans financed by non-bank lenders.
- Mortgage brokers and mortgage aggregators do not charge borrowers directly for their services. Instead, they typically receive upfront and **trail commissions** from the lender.

[32] See FSRC, *FSRC Background Paper No. 1: Some Features of the Australian Banking Industry*, 9 February 2018, 20.

[33] See FSRC, *FSRC Background Paper No. 1: Some Features of the Australian Banking Industry*, 9 February 2018, 21.

[34] FSRC, *FSRC Background Paper No. 2*: *Some Features of the Australian Mortgage Broking Industry*, 22 February 2018.

3.2 Car loans

In its third Background Paper, the Commission described some features of car financing in Australia.[35] That paper made seven points:

- Indicatively, 90% of all car sales are arranged through finance, of which around 39% are financed through a dealership and around 61% are financed from other sources.
- In the December quarter 2017, car loan payments were the largest vehicle-related expense for the 'hypothetical household' in both capital cities and regional areas, with repayments larger than weekly fuel costs.
- In 2017, new finance commitments for motor vehicles were around $35.7 billion, equivalent to around 4.2% of all new finance commitments in 2017.
- In 2017, finance commitments for motor vehicles were the equivalent of around 2.0% of nominal GDP, similar to its share in 2007.
- Over the past 10 years there has been an increase in financing for new motor vehicles and a decrease in financing for used motor vehicles.
- Profit margins for car dealers rely not only on car sales, but on ancillary services, including the sale of finance and insurance.
- Delinquency rates for motor vehicle loans have increased since 2012, but remain at low levels.

3.3 Credit cards

Credit cards are a common feature of everyday life in Australia. In its first Background Paper, the Commission made three observations about credit cards:[36]

[35] FSRC, *FSRC Background Paper No. 3: Some Features of Car Financing in Australia*, 9 March 2018.

[36] FSRC, *FSRC Background Paper No. 1: Some Features of the Australian Banking Industry,* 9 February 2018.

- Credit card debt comprises a very small amount of the overall assets of ADIs − around 1% ($51.4 billion of the $4.6 trillion in assets held by ADIs), as at the end of the September quarter 2017.[37]
- As at November 2017, there were around 16.7 million credit and charge card accounts in existence in Australia, with total balances of around $52.2 billion. The average balance per account (total balance divided by number of accounts) was around $3,128.[38]
- Credit card debt has declined over the past 10 years. In financial year terms, total balances have reduced from a peak of 3.6% of nominal GDP in 2007/2008 to 3% of GDP in 2016/2017.[39]

Credit cards are used as a means of payment and as a revolving credit facility. Those holders who use the card as a means of payment and pay the whole balance of the account when due are known as 'transactors'. Those who pay less than the balance due are known as 'revolvers'. Obviously, holders may act as transactors for a time and then as revolvers for a time.

3.4 Add-on insurance

Consumer credit insurance has been a common form of insurance sold in connection with different forms of credit arrangements, including credit cards, personal loans, car loans and home loans. The policies are sold as insurance that will respond to some events that may prevent or hinder the borrower meeting the obligations undertaken to the lender. The principal events are death, disability or unemployment.

In addition, other forms of 'add-on' insurance have been sold in connection with the financing and sale of motor vehicles. Those other forms of insurance include comprehensive motor vehicle insurance (covering loss or damage to the vehicle), 'tyre and rim' insurance (sold as covering the cost of replacing tyres or wheel rims damaged by accident), 'gap' insurance (sold as covering the gap between the value of the vehicle and the amount owed

[37] See FSRC, *FSRC Background Paper No. 1: Some Features of the Australian Banking Industry,* 9 February 2018, 23 [4.4].

[38] See FSRC, *FSRC Background Paper No. 1: Some Features of the Australian Banking Industry,* 9 February 2018, 23 [4.4].

[39] See FSRC, *FSRC Background Paper No. 1: Some Features of the Australian Banking Industry,* 9 February 2018, 23 [4.4].

on the loan used to buy it) and 'mechanical' insurance (sold as providing cover for the consequences of mechanical breakdown).

Entities that sell add-on insurance commonly receive a commission on the sale fixed by reference to the amount of premium charged. Since the NCCP Act, the commission that may be paid for has been capped at 20%.[40]

In 2011, ASIC reported that the net loss ratio for consumer credit insurance (calculated as the net incurred claims divided by the net premium revenue) for the years 2008 to 2010 had varied from 18% in 2008 to 34% in 2010.[41] For more recent years, figures published by APRA in its *General Insurance Claims Development Statistics* recorded an ultimate net loss ratio[42] for consumer credit insurance of about 20%.[43] Consumer credit insurance has been, and remains, a very profitable form of insurance.

4 Magnitude and prevalence

4.1 Past remediation programs

4.1.1 Home loans

In recent years, banks have acknowledged that aspects of their conduct in connection with home loans have been unacceptable and have caused detriment to consumers. As a result, a number of banks have provided refunds to customers as part of significant remediation programs, generally overseen by ASIC. Information provided to the Commission by ASIC indicated that between 1 July 2010 and 28 February 2018, financial services entities paid almost $250 million in remediation to almost 540,000

40 NCCP Act sch 1 s 145.

41 ASIC, *Report 256: Consumer Credit Insurance: A Review of Sales Practices by Authorised Deposit Taking Institutions*, October 2011, 15 [47], Table 3.

42 APRA defines 'ultimate net loss ratio' as 'Net ultimate cost of claims (inflated and undiscounted) divided by Net earned premium'. See APRA, *General Insurance Claims Development Statistics* (28 June 2018) APRA, Glossary <www.apra.gov.au/sites/default/files/GICDS%2520Glossary.pdf>.

43 APRA, *General Insurance Claims Development Statistics* (28 June 2018) APRA, Table 13 <www.apra.gov.au/publications/general-insurance-claims-development-statistics>.

consumers as a result of three particular forms of conduct in connection with home loans. The three forms of conduct were:

- reliance on fraudulent documentation;
- processing or administration errors; and
- breaches of responsible lending obligations.

During the same period (1 July 2010 to 28 February 2018), ASIC banned and suspended from providing credit services or placed conditions on the licences of 51 individuals or companies for engaging in home loan application fraud. Through the Commonwealth Director of Public Prosecutions, ASIC brought criminal prosecutions against 13 credit providers for conduct in relation to home loan applications, 12 of whom were convicted of fraud or dishonesty offences. ASIC also banned one person from providing credit services and cancelled the credit licence of two entities on the basis of breaches of responsible lending obligations in connection with home loan applications.

4.1.2 Car loans

ASIC told the Commission that, between 1 July 2010 and 28 February 2018, financial services entities paid almost $90 million to almost 17,000 consumers as a result of two forms of conduct in connection with car loans, being reliance on fraudulent documentation and breaches of responsible lending obligations.

During the same period, ASIC banned or cancelled or suspended or placed conditions on the licences of 19 individuals or companies in the car financing industry. Through the Commonwealth Director of Public Prosecutions, four car loan credit service providers were convicted of criminal offences. As a result of action taken by ASIC in the car financing industry, over $5.7 million has also been paid in civil penalties.

4.1.3 Credit cards

Between 1 July 2010 and 28 February 2018, over $11 million in remediation was paid to over 34,000 consumers by financial services entities in response to breaches of responsible lending obligations in connection with credit cards. During the same period, ASIC obtained four outcomes against three credit card providers for breaches of responsible lending obligations in

connection with credit cards. And, as a result, $1.5 million was paid in civil penalties.

4.1.4 Add-on insurance

Between 1 July 2010 and 28 February 2018, more than $128 million has been paid in remediation to consumers by financial services entities as a result of particular conduct in connection with add-on insurance. Approximately $900,000 of this sum related to home loan add-on insurance remediation programs, affecting over 10,500 consumers. Approximately $117 million related to car loan add-on insurance remediation programs, affecting over 212,000 consumers. Approximately $10 million related to credit card add-on insurance, affecting approximately 65,000 consumers.

4.1.5 Processing and administrative errors

Information from both regulators and entities showed that there had been various forms of 'processing error' that resulted in consumers being charged more under their home loan contracts than the loan contract provided. Those errors included failures to link offset accounts and failures to apply the correct interest rate. Between 1 July 2010 and 28 February 2018, approximately $239 million was repaid to almost 540,000 consumers who had been affected by account administration and processing errors in connection with home loans.

4.2 Summary of the remediation programs

The figures set out in the preceding paragraphs, which are tabulated below, were given to the Commission by ASIC immediately before the first round of hearings. They reflected information of which ASIC had been made aware and cases and circumstances that had then been brought to a final outcome.

Between 1 June 2010 and 28 February 2018, nearly 900,000 consumers were identified as having been affected. That number comprised:

- home loans – 540,000;
- car loans – 17,000;
- credit cards – 34,000;
- add-on insurance – home loan – 10,500;

- add-on insurance – motor vehicle – 212,000; and
- add-on insurance – credit card – 65,000.

The monetary effects of the conduct were significant.

Treating the administration and processing errors identified in connection with home loans as subsumed in the total figures given in respect of issues about home loans, the various forms of conduct that have been described yielded remediation payments totalling more than $470 million comprising:

- home loans – $250 million;
- car loans – $90 million;
- credit cards – $11 million; and
- add-on insurance – $128 million.

4.3 How widespread?

The prevalence of the issues that have been identified can be gauged by reference to the responses that the four largest banks (ANZ, CBA, NAB and Westpac) made to the inquiries that the Commission made immediately after its establishment about what events of misconduct, or conduct falling short of community standards and expectations, the entities had identified.

Before referring to what was revealed by those responses it is necessary to say something first about the approaches that each of the four largest banks took to answering the inquiries that were made.

4.4 Responses to the Commission's initial inquiries

As is explained in Chapter 1, on the day after the grant of the Letters Patent establishing the Commission, I wrote to a number of entities asking them what misconduct and conduct falling short of community standards and expectations they had identified as occurring during the previous 10 years. After receiving the responses made to the initial inquiries, I asked a number of entities (including ANZ, CBA, NAB and Westpac) to supply more specific information about events of misconduct (as distinct from conduct falling short of community standards and expectations) that the entities had identified over the last five years. These further inquiries were made on 2 February 2018.

How did the four largest banks respond?

4.4.1 ANZ

In its two responses to the Commission's inquiries, ANZ acknowledged that it had engaged in misconduct and conduct falling short of community standards and expectations in connection with home loans, credit cards, processing errors and car finance. On their face, ANZ's responses appeared to be detailed and comprehensive.

4.4.2 CBA

CBA's first submission in response to the Commission's initial inquiries was made on behalf of the whole CBA group including, in particular, Aussie Home Loans (by then a wholly owned subsidiary of CBA).[44] The first submission was cast at a general level. It did not disclose with any particularity the conduct that CBA, or entities within the CBA group, had engaged in in relation to consumer lending over the last 10 years that CBA identified as having constituted misconduct or conduct that falls below community standards and expectations.

In its first submission, CBA acknowledged that it had engaged in misconduct in limited respects. So, for example, it acknowledged that it had been involved in legal proceedings in which an adverse comment or finding had been made against one or more of the entities of the group. And, in that first submission, it also acknowledged that it had engaged in conduct that fell short of community standards and expectations in relation to add-on insurance, responsible lending and offers of credit. But the first submission gave very little detail about the conduct to which it referred. And at least in respect of what was said in that response about Aussie Home Loans, the

[44] The CBA Group acquired a 33% interest in Aussie Home Loans in August 2008 and increased that investment to 80% in December 2012. On 9 August 2017, the Group announced that it had acquired the remaining 20%, giving it 100% ownership. Exhibit 1.80, 29 January 2018, Paragraphs 170 to 177 of CBA Submission, 31 [170].

response was cast in terms suggesting, wrongly, that there had been few if any problems identified in that business.[45]

When the Commission asked CBA (and others) to specify more precisely what misconduct it had identified over the previous five years, CBA protested that it could not do this within the time allowed and instead proffered spreadsheets derived from its risk management system recording events that had been thought appropriate to record in that system during the relevant period.

In her opening address to the Commission at the commencement of the first round of hearings, Senior Counsel Assisting the Commission criticised the adequacy of CBA's responses to the Commission's inquiries of 15 December 2017 and 2 February 2018. Within 10 days, the solicitors for CBA provided to the Commission tables answering the inquiries made on 2 February 2018; one related to CBA and companies in the group other than Aussie Home Loans; the other related to Aussie Home Loans. Why the first two responses CBA made were deficient and why the tables produced on 22 March 2018 had not been prepared and made available earlier was not explained.

The table that related to the conduct of Aussie Home Loans contained 182 entries, organised under three headings:

[45] What was said was that: 'During the relevant period, Aussie has identified isolated and unauthorised incidents of conduct issues and some technical breaches of the law, in relation to the credit assistance services provided by Aussie brokers and in interactions between employees and Aussie brokers. There have also been isolated issues which required customer remediation in relation to Aussie's white label products. Examples of the nature of isolated and unauthorised conduct issues that Aussie has identified include former brokers using customer information and seeking to contact Aussie customers in contravention of their contractual and privacy obligations; provision or facilitation by brokers of false or misleading information and false declarations from customers in the process of applying for loans; [and] behavioural conduct such as offensive or otherwise unprofessional behaviour directed towards or amongst employees and/or brokers. Aussie also identified some minor system or process errors resulting in incorrect calculation of interest, fees or charges by the credit provider(s) on Aussie white label products and a small number of self-identified contraventions of the *National Consumer Credit Protection Act 2009* (Cth) …'. Exhibit 1.80, 29 January 2018, Paragraphs 170 to 177 of CBA Submission, 31–2 [173]–[174].

- False Documents and/or Declarations and/or Misleading Information;
- NCCP Act Breaches; and
- Breach of Broker Agreement/Franchise Agreement/Policy/Operations Manual.

The contrast between the information supplied after the first hearings had begun and the information about Aussie Home Loans supplied by CBA in response to the Commission's first inquiry is evident.

4.4.3 NAB

NAB provided two submissions to the Commission in which it acknowledged it had engaged in misconduct and conduct falling below community standards and expectations in relation to home lending, credit cards, personal loans and processing or administration errors.

NAB's second submission elaborated on a number of aspects of its first submission and provided some further detail. But the submission did not provide detailed or comprehensive information about instances of misconduct, including instances of possible misconduct still under investigation of which the bank had become aware at any time since 1 January 2013 and NAB protested that it could not perform such a task within the time fixed. Like CBA, NAB provided the Commission with spreadsheets derived from its risk management system recording events that had been thought appropriate to record in that system during the relevant period.

NAB's apparent inability to draw together information about instances of misconduct identified during the immediately preceding five years shows that it was then unable to identify promptly, whether for its own internal purposes or for any external purpose, a single, reasonably comprehensive and accurate picture of whether and how it had failed to comply with applicable financial services laws. On the face of it, information of that kind would be important not only for managing compliance with those laws but also for identifying whether separate events stemmed from similar causes.

The difficulties raised by NAB, and by others, about meeting the Commission's requests suggest that those entities deal with regulatory compliance piecemeal rather than comprehensively. Approaching compliance piecemeal does not readily permit identification of underlying

causes. Particular events are too readily seen as isolated departures from an assumed norm caused only by aberrant behaviour of individuals. Deeper causes and connections remain unconsidered and unidentified.

4.4.4 Westpac

Westpac also made two submissions to the Commission. Westpac has a number of brands, including St George Bank, Bank of Melbourne, Bank of South Australia and RAMS, which it uses in its dealings with consumers. In its initial submissions Westpac acknowledged that across these brands it had engaged in actual or potential misconduct and conduct falling below community standards and expectations relating to home lending, credit cards, car loans, add-on insurance, processing or administration errors and unsolicited offers of credit.

Shortly before the first round of hearings began, however, Westpac told the Commission that the information it had provided in those submissions did not take account of some categories of data and that further acknowledgments may be provided. Westpac thereafter made a number of further acknowledgments of conduct amounting either to misconduct or conduct falling short of community standards and expectations. Again, this course of events points towards a disjointed, piecemeal approach to monitoring compliance with applicable laws.

4.5 Conduct acknowledged by the entities

The four major banks disclosed that they had identified a range of misconduct and conduct falling short of community standards and expectations in connection with home loans, car loans, credit cards, add-on insurance and so-called 'processing errors'.

4.5.1 Home loans

ANZ

ANZ acknowledged that between 2013 and 2018 it had engaged in at least 20 events of misconduct or conduct falling below community standards and expectations in relation to home lending and residential mortgages. (In this context, of course, a single 'event' may affect many consumers.) By way of example, during 2015 and 2016, ASIC conducted an industry-wide review into interest-only home loans. ASIC, after calling for a sample of 25 customer files from ANZ, queried whether ANZ had made genuine inquiries

into customers' living expenses. ANZ recognised that there were instances where it lacked evidence to show that genuine inquiries had been made, but it did not accept that it had not made those inquiries.

CBA and Aussie Home Loans

CBA's first and second responses to the Commission's inquiries did not distinctly acknowledge any significant relevant conduct in connection with home loans. By contrast, the table of Aussie Home Loans conduct that CBA provided in the course of the first round of hearings acknowledged various forms of relevant conduct.

No less importantly, the other table that CBA provided in the course of that first round disclosed 10 events of relevant conduct by CBA in relation to home loans. Three related to responsible lending; three related to the charging of incorrect interest, or interest-only charges; one related to the incorrect charging of fees; and the other three raised other issues. Some of the events had been reported to ASIC; some had not. Some could be seen as having been embraced by what had been said in the first response to the Commission's inquiries; some could not. Some had resulted in remediation programs; some had not.

In the Aussie Home Loans table, under the 'False Documents' heading, the first four entries related to the four brokers whose activities were the subject of the evidence led in the course of the Aussie Home Loans case study. As later explained, each of those brokers was convicted of several counts of offences of fraud. The remaining 25 entries made under this heading were described as providing false or misleading information to either a lender or to customers.

Nineteen entries in the Aussie Home Loans table were listed under the heading 'NCCP Act Breaches'. All were said to relate to responsible lending. The third and most numerous category of events in the Aussie Home Loans table embraced such matters as the misuse of data and 'inappropriate professional and personal conduct'.

NAB

In its response to the Commission's initial inquiry, NAB acknowledged misconduct in connection with NABs 'Introducer program' and said that it had by then identified about 2,480 customers who may have been affected

by this misconduct. It said that investigations were continuing. These events were the subject of the first case study.

NAB also acknowledged misconduct in the advertising of variable interest rates in October 2014, when it incorrectly advertised that it was offering the lowest standard variable rate for more than five years, a statement that should have been qualified to make clear that it was only correct insofar as it applied to rates offered by the four major banks.

In addition, NAB provided examples of conduct that it considered fell below community standards and expectations in relation to home lending. These included that, before June 2013, NAB may not have been carrying out further inquiries into the declared living expenses of home loan applicants when the declared expenses were below the relevant benchmark used by NAB to assess home applications.

The examples also included an acknowledgment that NAB had identified an issue in relation to UBank, a division of NAB, and its offer of an EFTPOS gift card to customers who took out a home loan with UBank in a four-month period between December 2013 and March 2014. ASIC had raised concerns that some details of UBank's offer were not disclosed in some of the advertisements or were not disclosed sufficiently clearly.

Westpac

Westpac acknowledged that, at the time of the first round of hearings, it was the subject of ASIC enforcement action in relation to alleged breaches of responsible lending obligations.[46] In those proceedings, ASIC alleged that Westpac failed to properly assess whether borrowers could meet their repayment obligations before entering into home loan contracts. Westpac defended the proceedings. On 4 September 2018, ASIC and Westpac announced that they would join in seeking orders of the Federal Court of Australia that Westpac had contravened its responsible lending obligations and should pay a civil penalty of $35 million.[47]

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[46] Westpac, *Response of Westpac Banking Corporation Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry 29 January 2018,* 29 January 2018, 23.

[47] ASIC, 'Westpac Admits to Breaching Responsible Lending Obligations when Providing Home Loans and a $35 Million Civil Penalty' (Media Release, 18-255MR, 4 September

Westpac also acknowledged that, in 2016, it had identified that some of its authorised home lending bankers were not correctly completing customer income and expense verification activities at the point of sale.

Westpac further acknowledged that, over a seven-year period, customers with Westpac, St George, Bank of South Australia and Bank of Melbourne did not receive benefits for which they were eligible in relation to a home loan package they held. Approximately 175,000 Westpac customers were affected. The number of affected customers with St George, Bank of South Australia and Bank of Melbourne had not been determined when Westpac made its initial submissions to the Commission.

Westpac also acknowledged a number of other events of misconduct in relation to home lending. In one instance Westpac approved a loan referral from a third party broker for a home loan of over $529,000 to an 80-year-old man who spoke poor English. A credit card debt approved at the same time was later written off.

4.5.2 Car loans

ANZ

ANZ acknowledged at least seven events of misconduct or conduct falling below community standards and expectations in relation to car loans and car finance, including failures to take reasonable steps to verify income stated in car finance applications.

ANZ identified a number of issues relating to the Esanda dealer finance portfolio that was owned by ANZ until April 2016. Between 2011 and 2014, a car finance broker had arranged loans for customers that did not meet Esanda's lending criteria by writing the application in the name of an individual who did not own or have possession of the vehicle, but who agreed to guarantee the loan. ANZ accepted that the systems that Esanda had in place at the time were ineffective to detect this and therefore failed to meet community standards and expectations.

ANZ has also accepted, in litigation brought by ASIC, that it failed to take reasonable steps to verify the income figures in relation to 12 car finance

2018) <https://asic.gov.au/about-asic/media-centre/find-a-media-release/2018-releases/18-255mr-westpac-admits-to-breaching-responsible-lending-obligations-when-providing-home-loans-and-a-35-million-civil-penalty/>.

applications introduced to Esanda by third party intermediaries.[48] These matters were considered in the 10th case study in the first round of hearings.

Westpac

Westpac acknowledged at least four events of misconduct or conduct falling below community standards and expectations in relation to car loans, primarily comprising breaches of the responsible lending obligations. Westpac also identified issues relating to the unsuitable sale of insurance and the use of flex commissions which, as Westpac noted, ASIC considered could operate unfairly by providing an incentive for intermediaries to increase the price of a credit contract to a consumer.

4.5.3 Credit cards

ANZ

ANZ acknowledged at least nine events of misconduct or conduct falling below community standards and expectations in relation to credit cards, including the lack of disclosure of overseas transaction fees in the terms and conditions of consumer credit card products. By way of example, ANZ acknowledged that between 2009 and February 2016 there were inconsistencies between interest rates contained in customers' original letters of offer for certain commercial credit cards and those charged by ANZ systems to some customers. This affected 52,135 customer accounts, and customers were ultimately refunded approximately $10.4 million last year.

CBA

Similarly, CBA acknowledged that it had engaged in misconduct, in late 2011 or early 2012, in its approach to seeking consent from credit card customers to receive credit limit increases, which resulted in CBA giving an **enforceable undertaking** to ASIC. CBA also referred to a further event in 2014 relating to a failure to correctly follow scripts when processing credit limit increases. (Some further detail was provided on this issue in CBAs second submission of 13 February 2018.)

[48] *ASIC v Australia and New Zealand Banking Group Ltd* [2018] FCA 155.

NAB

NAB acknowledged that it had engaged in conduct in connection with credit cards that fell below community standards and expectations. By way of example, NAB acknowledged that 10 NAB employees had deviated from NABs policies and processes by failing to contact credit card customers to confirm their needs and objectives, or to make it clear that they were not obliged to accept a NAB credit card. The number of customers potentially affected was 215, and the number confirmed to have been affected was 18.

Similarly, NAB also told the Commission that between February and May 2009, NAB migrated customers with NAB Gold Reward accounts to NAB Qantas Gold accounts and sent these customers an American Express credit card without being requested to do so by the customers. The number of customers affected by this conduct was not disclosed by NAB.

In addition, NAB acknowledged that it had engaged in misconduct between 2008 and 2013, arising from the erroneous recording of 16,288 credit defaults against customers with NAB credit cards or personal loan accounts. NAB noted that some of this conduct also involved contraventions of the *Privacy Act 1988* (Cth).

Westpac

Westpac acknowledged at least 12 events of misconduct or conduct falling below community standards and expectations in relation to credit cards, including a practice of proactively selling credit cards with limits exceeding the levels advised under lending policy rules to clients over the phone.

In addition, Westpac acknowledged that, between 2012 and 2014, approximately 6,600 accounts may have been affected by an automated approval process that did not adequately take income and employment factors into account. These matters were explored further in the 12th case study about credit card credit limit increases.

Westpac also acknowledged that, between 2012 and 2015, it had applied higher interest rates to credit cards than required by an enforceable undertaking Westpac had given to ASIC. This issue affected 67,000 customers.

Finally, Westpac acknowledged that it had sent a message to at least 3,700 customers that was deemed by ASIC to be misleading, because it created

the impression that a customer had to consent to receive invitations for credit limit increases in order to receive the full benefits of their credit card.

4.5.4 Overdrafts

ANZ

In relation to overdrafts, ANZ's responses to the Commission recorded that, between November 2014 and January 2015, ANZ sent letters to a group of existing customers offering them an overdraft facility with limits of $500, or $1,000, in circumstances where ANZ had not made any inquiries of the customer before sending the letter. In February 2016 ASIC issued five infringement notices totalling $212,500 for these alleged failures. These events were examined in the seventh case study.

CBA

Similarly, in CBA's first submission, CBA acknowledged that ASIC had issued four infringement notices to CBA in 2016, totalling $180,000. The infringement notices related to breaches of responsible lending laws when providing personal overdraft facilities. (Further detail on this event was provided in CBAs second submission, dated 13 February 2018.)

4.5.5 Add-on insurance

CBA

In its first submission, CBA acknowledged that approximately 65,000 of its customers had purchased 'CreditCard Plus' insurance in circumstances where they may not have met the employment eligibility criteria in the product terms and therefore may not have been able to claim certain benefits under the policy. CBA acknowledged that refunds of approximately $10 million, including interest, had been made to those customers as at the date of the 29 January 2018 submission. This was described by CBA not as misconduct, but as conduct falling below community standards and expectations.

CBA also acknowledged that a further 20,000 consumers had purchased their 'Loan Protection' product, another insurance product sold in connection with a home or personal loan, in circumstances where those consumers may not have met the employment eligibility criteria that would permit the consumer to claim benefits under the policy. CBA indicated that its

investigation into this conduct was at an early stage, but that it estimated that about $3.4 million of refunds would need to be made to consumers. This conduct was again not described by CBA as misconduct, but as conduct falling below community standards and expectations.

About one week before the beginning of the first round of hearings, CBA announced that it would stop selling CreditCard Plus insurance and Personal Loan protection insurance.

Westpac

Westpac also acknowledged at least three events of misconduct or conduct falling short of community standards and expectations in relation to add-on insurance products.

4.5.6 Processing errors

CBA

In its 29 January response to the Commission's initial inquiries, CBA referred to a number of 'other issues of community interest or concern'. One example it gave of those matters was of its having told ASIC, in 2015, of 'errors in its serviceability calculator that applied to some personal overdraft applications'.[49] But CBA in that submission did not deal with any of the processing and administration errors that were later examined in the course of the Commission's hearings. And the tables of identified misconduct that CBA provided on 22 March did not distinctly identify matters of that kind.

ANZ

In relation to processing errors, ANZ acknowledged that between 2003 and July 2013, some ANZ home loan customers were charged a higher interest rate than they should have been according to the terms and conditions of their loan contracts. In addition, some offset accounts were not properly linked to home loans, resulting in customers being charged excess interest. This affected approximately 400,000 customer accounts, and ANZ ultimately refunded customers approximately $69.3 million. ANZ has also identified other home loan processing or administration errors. These issues

[49] CBA, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Submission,* 29 January 2018, 34 [192].

are described further in what is said about the eighth case study undertaken in the first round of hearings.

NAB

NAB also acknowledged processing or administration errors in relation to consumer lending during the relevant period. For example, NAB acknowledged that on 24 November 2010 and 15 April 2011 two separate failures of the customer account processing systems occurred, with the 2011 incident resulting in approximately 70,000 customers not receiving expected payments into their accounts.

NAB acknowledged that between 2007 and 2010 customers with NAB Visa debit cards were being incorrectly charged reference or overdraw fees, resulting in approximately $1.8 million in fees being refunded.

In addition, NAB acknowledged offset account failures, whereby it overcharged interest on certain home loans in the period between 2010 and 2017, because it had not linked some offset accounts to broker-originated home loans. This resulted in approximately 178,000 customers overpaying interest on their home loans.

Westpac

Westpac acknowledged at least 16 events of misconduct or conduct falling below community standards and expectations in relation to processing or administration errors for home loans and credit cards.

By way of example, Westpac acknowledged that processing failures resulted in approximately 69,000 home loan customers being required to pay more interest over the life of their loan, because their interest-only loan was not switched to principal interest and fees, at the conclusion of the agreed interest-only term. Remediation to customers was expected (at the time of the initial submissions) to cost Westpac $11 million.

In addition, Westpac acknowledged that 133,000 accounts held by customers under the age of 21 did not have the correct fee waivers applied to their accounts, and a further 28,000 St George accounts were also affected. In consequence, Westpac paid about $9.2 million to customers to remedy the errors.

4.5.7 Other consumer lending issues

ANZ

ANZ acknowledged at least 22 events of other misconduct and conduct falling below community standards and expectations in connection with consumer lending, including customers being charged incorrect fees or interest amounts, customers accessing inflated redraw balances and redrawing amounts in excess of the amount of principal they paid in advance, and failures to send hardship notices to applicable customers within the 21-day period required by the National Credit Code.

In addition, ANZ acknowledged that in the last seven years approximately 120 cases had been brought against it in the Financial Ombudsman Service that related to consumer and small business responsible lending issues. Approximately 50 of these cases were decided against ANZ.

CBA

In its first submission, CBA acknowledged a number of issues in relation to responsible lending. CBA described what it referred to as operational incidents that it said had impacted upon its responsible lending practices, including in relation to inaccuracies in calculations, insufficient documentation and verification, failure to correctly follow scripting, employee and third party misconduct and deficiencies in controls around manual loan approval processing. These events were not categorised by CBA as misconduct but, rather, as conduct that had fallen below community standards and expectations.

CBA acknowledged that it had remediated customers in respect of product administration and disclosure, credit decisions and responsible lending, systems controls and processes failures, sales practices and fraud or misconduct issues. CBA's submission did not show whether the remediation programs in relation to some of these categories of conduct pertained to consumer credit products.

Other entities

The four largest banks were not the only entities that acknowledged that they had engaged in conduct of the kinds described. Other entities made submissions to the Commission acknowledging generally similar kinds of conduct.

5 Consequences of the conduct

Observing that those affected by the conduct described were 'consumers' does not fully reveal the nature and extent of the effects of the conduct. Those effects are best understood by considering what can and does happen when the problems become acute.

When financial problems become acute, consumers can and do seek financial counselling. As ASIC records, on its 'MoneySmart' website, financial counselling is a free service offered by community organisations, community legal centres and some government agencies.[50] And assistance is offered through a 'National Debt Hotline' available throughout Australia.

In New South Wales, the National Debt Hotline is operated by the Financial Rights Legal Centre. The Financial Rights Legal Centre is a community legal centre established in the late 1980s. The Centre's Co-ordinator, Ms Karen Cox, described it as specialising in 'helping people understand and enforce their financial rights, especially people on low incomes or who are otherwise marginalised or vulnerable'.

Ms Cox gave evidence that the Centre took close to 25,000 calls for advice or assistance during the 2015/2016 financial year. Of those, about 7,500 related to insurance and the remaining 17,000 or so calls related to credit and debt problems. She said that the most common cause of debt problems for callers were credit cards, followed by home loans, personal loans (including pay day lending), car loans and energy debts.

[50] See ASIC, *Financial Counselling* (8 August 2018) ASIC's Money Smart <www.moneysmart.gov.au/managing-your-money/managing-debts/financial-counselling>.

Ms Cox said that credit cards 'top the list of consumer finance motivating calls to the National Debt Hotline'. As she said, credit cards can help to smooth the irregularities of income and expenditure. But, as she also pointed out, it is not unusual for a person with a credit card 'to become caught in a harmful debt spiral'. And those who have persistent credit card debt are likely to experience harm, both financial (paying high interest and fees) and non-financial (such as forgoing essential expenditure or experiencing personal distress). The consequence, as Ms Cox pointed out, is that consumers can be paying interest on everyday expenditure for years, sometimes decades.

Persistent credit card debt affects the overall financial position of the holder. Sometimes consumers re-finance their credit card debt into their home loans. And, if that is done, the consumer's equity in the home is diluted and the servicing requirements for the home loan will likely be changed.

The evidence that Ms Cox gave in connection with home loans and car loans identified the issues that were the subject of closer attention in the case studies relating to those matters. She spoke of credit providers not making adequate inquiries about a consumer's expenses when deciding whether to make the loan but instead relying on benchmarks such as the Henderson Poverty Index or the HEM. In that regard, she said that the Centre's experience was that mortgage brokers were more likely to say to a client that 'this is the estimated monthly expenditure for a family your size; does that sound right to you' than ask open-ended questions designed to identify actual expenses or consider bills and bank statements to test the reality of the client's estimates.

More particularly, Ms Cox identified the kinds of complaints made to the Centre about mortgage brokers and said that a common feature of many of the complaints was 'the inherent conflict of interest in the broker remuneration model and the imperative for the broker to sign the customer up to a loan in order to receive a remuneration benefit'.

In connection with car loans, Ms Cox said that those loans, and re-possessions, were a common reason for consumers to call the National Debt Hotline. She spoke of 'motor vehicle finance churn' where consumers with older cars still under finance, or with a balloon payment due at the end of the loan term, being 'upgraded or re-financed with increased finance' resulting in large debts, far greater than the value of the vehicle being acquired.

As the evidence given by Ms Cox showed, the conduct identified by entities as misconduct or conduct falling short of community standards and expectations affects individuals. As the evidence adduced in the first round of hearings showed, the effects can be profound. The consumers who gave evidence in those hearings all explained the effects that the conduct in issue had had on them. One (Mr Robert Regan) spoke of coming to depend on charity for food. Another (Ms Nalini Thiruvangadam) spoke of being forced to borrow from her family and of having to sell her jewellery. A third (Mr David Harris) spoke of the consequences he had suffered when, despite admitting to his bank that he had a gambling problem and reaching out to his bank for help, he was offered more credit.

6 Four kinds of issue

The inquiries that the Commission made into conduct in connection with consumer dealings with financial services entities raised many issues. The most important of those issues were illustrated by the case studies undertaken in the first round of hearings. The issues can be gathered in various ways but it is useful to identify four kinds of issue:

- **intermediaries – the confusion of roles and responsibilities;**
- **customer needs – you 'need' what we have to sell;**
- **credit risk or unsuitable lending? Lending is not unsuitable if the consumer is unlikely to default; and**
- **processing errors – failure to deliver promised features of products sold.**

Each will be considered separately. But it is important to recognise that, behind or beneath these issues may lie a deeper observation about unifying causes.

Much if not all of the conduct identified in the first round of hearings can be traced to entities preferring pursuit of profit to pursuit of any other purpose.

As commercial enterprises, each of the entities whose conduct was considered in the first round of hearings rightly pursues profit. Directors and

other officers of the entities owe duties to shareholders to do that. But the duty to pursue profit is one that has a significant temporal dimension. The duty is to pursue the long-term advantage of the enterprise. Pursuit of long-term advantage (as distinct from short-term gain) entails preserving and enhancing the reputation of the enterprise as engaging in the activities it pursues efficiently, honestly and fairly. And, lest there be any doubt, it also entails obeying the law. But to preserve and enhance a reputation for engaging in the enterprise's activities efficiently, honestly and fairly, the enterprise must do more than not break the law. It must seek to do 'the right thing'.

The evidence that was led in the first round of hearings suggested that the entities examined had done, and were doing, as little as they thought they have needed to do to meet their legal obligations, offering no (or at best, next to no) encouragement to or reward for staff or third parties to pursue the interests of the consumer. Compliance appeared to have been relegated to a cost of doing business. And, the case studies undertaken in the first round of hearings showed, that there had been occasions when profit has been allowed to trump compliance with the law, and many more occasions where profit trumped doing the right thing by customers.

The importance that entities give to profit is reflected most clearly in their remuneration policies for staff and for third parties such as brokers, introducers and aggregators. Those policies have two kinds of effect.

First, staff and others engaged by an entity will treat as important what they believe that the entity values. Rewarding volume and amount of sales is the clearest signal that selling is what the entity values. What staff and others believe that the entity values informs what they do. It is a critical element in forming the culture of the entity.

Second, the importance that entities give to profit is shown also by their allowing third parties whom they authorise to deal with consumers to prefer the interests of the third parties to those of the consumer. Remuneration and similar arrangements (most notably the 'flex-commission' arrangements in relation to car loans, which are considered later) have encouraged those third parties to pursue their own profit interests (and thus the profit of the entity) at the expense of the consumers' interests.

6.1 Intermediaries

As noted earlier, mortgage brokers act in relation to more than half of all residential home loans settled in Australia. Mortgage aggregators act as intermediaries between mortgage brokers and lenders. Neither mortgage brokers nor mortgage aggregators charge borrowers directly. Typically they receive loan-value based commission from the lender – part 'upfront' and part 'trail' commission. Upfront commission is calculated as a percentage of the amount drawn down; **trail commission** is calculated as a percentage of the amount outstanding. The rate of commission varies but it is convenient to indicate their general level by noting that CBA's standard broker commission provided for an upfront commission of 65 basis points (0.65%) with a trail commission of 15 basis points (0.15%) for three years and 20 basis points (0.2%) for the fourth and subsequent years.[51]

Some lenders have used and continue to use 'introducers' to refer potential home loan borrowers to the lender. It is described as a 'spot and refer system'. That is, the introducer tells the potential borrower that the lender lends money, tells the lender that a named person is seeking a loan and gives the lender the contact details for the potential borrower. The introducer is paid a commission if the person introduced takes a loan. In the case study examined in evidence, NAB paid introducers a commission of 0.4% of the amount of the loan drawn down. Between 2013 and 2016, NAB paid introducers nearly $100 million.

To understand what misconduct has occurred in connection with home loans, and why it occurred, it is necessary to consider two matters: first, for whom do intermediaries in the home loan market act, and second, what are the effects of value-based remuneration for intermediaries?

6.1.1 For whom does the intermediary act?

There is no simple legal answer to this question. At a practical level, however, the intermediary is paid only by the lender. The intermediary may hope to deal with a borrower more than once but may never do so. A broker expects to deal with lenders repeatedly and must be accredited by the lender to whom a loan proposal is made or by the aggregator through whom the proposal is made. And the relationship between broker, aggregator and lender will be regulated by contract. Broker, aggregator and lender may all

[51] Transcript, Daniel James Huggins, 15 March 2018, 250.

see the broker as 'the face of the lender', not as 'the face of the borrower'. And again, at a practical level, 'introducers' are even more clearly the face of the lender and not the face of the borrower.

The contracts made between broker and aggregator and between aggregator and lender may contain 'no agency' provisions. So, for example, the Template Head Group Agreement produced by CBA provided that the 'Head Group' (the aggregator) was CBA's 'agent' only in relation to the collection of customer identification, tax file number disclosure, privacy protection of information forms, and any bank account opening application form.[52] And when a broker submits a loan application to a lender, the lender may assert (as CBA did in its submissions) that the broker takes this step as the agent of the borrower.[53]

Five further points may then be made about the question for whom does the intermediary act.

First, **notions of 'agency' are apt to mislead**. To ask only whether the intermediary is 'agent' for the borrower or for the lender is to ask too broad a question. Instead, it is more useful to ask two questions. First, for whom does the borrower *believe* that the intermediary is acting? That is, what is it that the borrower expects of the intermediary? Second, are those beliefs and expectations well-founded? What (if any) duties does the intermediary owe the borrower at any of the several stages between a borrower approaching a broker and the borrower drawing the loan? And how do those duties fit with whatever duties the broker may owe to the lender? (As already noted, the intermediary's duties to the lender are almost always to be found in contracts between intermediary and lender or, where there is a further level of intermediary − for example an aggregator − in the web formed by the separate contracts between lender, broker and aggregator.)

The second point to be made in respect of the question – 'For whom does the intermediary act?' – is that, **in most cases, even if an intending borrower believes or expects the intermediary to be acting in the interests of the borrower, the intermediary owes no general duty to the**

[52] Exhibit 1.27, Witness statement of Daniel James Huggins, 2 March 2018, Exhibit DH-4 [CBA.0001.0028.0344 at .0367]; Transcript, Daniel James Huggins, 15 March 2018, 237.

[53] CBA, *Round 1 Hearing – Consumer Lending Closing Submissions*, 3 April 2018, 3 [11].

borrower to seek out the best and most appropriate deal for the borrower. The intermediary will have told the borrower that he or she deals with a limited group of lenders. Generally, if the intermediary owes a duty to the borrower it will be the statutory obligation to determine only whether the proposed loan is 'unsuitable'.

Third, there may be cases where the intermediary expressly assumes some more specific role with respect to the borrower. This may be the case, for example, if the broker were to agree (or assert) that he or she would act in the borrower's best interests or if the broker were to assert that the loan proposed was the 'best' available. In the first of these cases the broker might be found to have assumed an obligation to act only in the interests of the borrower; in the latter case, the statement made would be measured against the law of misleading and deceptive conduct.

But very often, the relationship between broker and would-be borrower will either be obscure or a relationship in which the broker owes the borrower no duty larger than not to negotiate an unsuitable loan.

Fourth, different considerations may arise when the broker assembles material necessary to submit an application for a loan. In performing those tasks, does the broker owe the lender or the borrower any obligation to inquire about or verify the accuracy of the personal information that the borrower supplies? If the intermediary does owe a duty of that kind to either the borrower or the lender, it is a duty that is often not performed. The fact that so many home loan applications proceed by the lender assuming that the borrower's living expenses are equal to the HEM measure, not as the borrower declares them to be, can lead only to the conclusion that in many of those cases the broker has not taken any effective steps to inquire into, or verify, the expense information supplied by the borrower.

Fifth, **there is no doubt that in the eyes of at least some lenders, the broker's task is to sell that lender's products**. As later explained in connection with the evidence about CBA's broker accreditation program, CBA's broker 'Authority to Act' form records that, to maintain accreditation by CBA, a broker must submit a minimum of four home loan applications and settle a minimum of three home loans every six months.[54] Mr Huggins

[54] Exhibit 1.27, Witness statement of Daniel James Huggins, 2 March 2018, Exhibit DH-11 [CBA.0001.0027.4036 at .4038].

said in evidence that CBA did not enforce this requirement 'systematically' but the fact is that this was what it told its accredited brokers.[55]

6.1.2 Remuneration

How, if at all, is the remuneration of intermediaries associated with misconduct in connection with home loans?

In 2017, on the instructions of the ABA, Mr Stephen Sedgwick AO conducted a review of retail banking remuneration. He published his report in April 2017 and made 21 recommendations. Some of those recommendations have been adopted, some not. The recommendations and the extent to which they have been adopted are considered elsewhere in this report.

For present purposes, it is convenient to focus on only one submission made to Mr Sedgwick: the submission made by CBA on 10 February 2017. One paragraph of the covering letter for that submission captures the essence of the issue that underlies much of the conduct about home loans examined in the first round of hearings.

The covering letter, signed by the then CEO of CBA (Mr Ian Narev), said that:

> We agree with the Reviewer's observations that while brokers provide a service that many potential mortgagees value, the use of loan-size linked with upfront and trailing commissions for third-parties, can potentially lead to poor customer outcomes. Mortgages also sit outside the financial advice framework, even though buying a home and taking out a mortgage is one of the most important financial decisions an Australian consumer will make. We would support elevated controls and measures on incentives related to mortgages that are consistent with their importance and the nature of the guidance that is provided. For example, the de-linking of incentives from the value of the loan across the industry; and the potential extension of regulations such as Future of Financial Advice (FoFA) to mortgages in retail banking.

Three points emerge from that one paragraph:

[55] Transcript, Daniel James Huggins, 15 March 2018, 267–8.

- **First, remuneration can affect outcome.** (CBA recognised and accepted that 'the use of loan-size linked with upfront and trail commissions for third-parties, can potentially lead to poor customer outcomes.')
- **Second, advice about mortgages matters.** (CBA recognised and accepted that mortgages 'sit outside the financial advice framework' and supported 'the potential extension of regulations such as … FoFA to mortgages in retail banking.')
- Third, CBA would not move first, or alone, to meet the issues.

Further content was given to these points in the Issues Paper Submission that accompanied CBA's letter to Mr Sedgwick. In considering 'Issues specific to remuneration of third parties' the submission identified three findings that were 'consistent with the hypothesis that differences in remuneration … are driving different customer outcomes and lends some support to the case for discontinuing the practice of volume-based commissions for third parties,' Those findings were that:

- **Broker loans were reliably associated with higher leverage, even for customers with an identical estimate of risk;**
- **Loans written through brokers have a higher incidence of interest-only repayments, have higher debt-to-income levels, higher loan-to-value ratios (LVRs) and higher incurred interest costs compared with loans negotiated directly with the bank; and**
- **Over time, higher leverage means broker customers have an increased likelihood of falling into arrears, pay down their loans more slowly and on average pay more interest than customers who dealt directly with the bank.**

There is no reason to doubt the accuracy of these findings. They were the findings that ASIC recorded in its *Review of Mortgage Broker Remuneration* published in March 2017.[56] ASIC concluded that, even after controlling for differences between those who deal directly with a lender and those who used a broker, consumers going through broker channels obtained loans with higher LVRs (typically between 1% and 4%, depending on the lender)

[56] ASIC, *Report 516: Review of Mortgage Broker Remuneration*, March 2017.

and larger loans in dollar terms.[57] ASIC further concluded that, again controlling for differences, consumers going through broker channels 'obtained significantly more interest-only loans: for all eight lenders reviewed, brokers arranged at least 50% more interest-only loans, and up to four times as many interest-only loans in the case of one lender'.[58]

Nor is there any reason to doubt that **value-based upfront and trail commissions to third parties contribute to those outcomes**. CBA, the largest home lender in Australia, acknowledges this to be so. ASIC found it to be so. The assertions by Aussie Home Loans and Smartline Home Loans Pty Ltd, that the present remuneration structures for intermediaries are not shown to lead to any consequence that calls for alteration of the system are not to be accepted.

What does require closer consideration, however, is the proposition advanced throughout the CBA submission to Mr Sedgwick that the way in which bank staff are paid does not lead to poor customer outcomes. Two reasons were given. First, the submission pointed to differences in the ways in which staff remuneration structures differed from the value-based remuneration of brokers. Second, it was said that the banks have enough checks and balances to avoid those outcomes: '[r]egardless of the channel in which a customer purchases a Commonwealth Bank product or service, we have strong processes and controls to ensure that we meet our responsible lending obligations and that customers can afford the loan that is being provided to them.' And it is this last assertion, in one form or another, that underpinned the submissions by NAB, Westpac and Aussie Home Loans that no change should be made to broker remuneration arrangements.

Whether, and to what extent, staff incentive schemes and structures contribute to misconduct or conduct falling short of community standards and expectations in connection with home loans is better considered as part of a more general examination in Chapter 8 of the contribution that staff remuneration structures have made to the ways in which ADIs deal with their customers. What is plain, however, is that **value- and volume-based remuneration for intermediaries in the home loan industry has been an**

[57] ASIC, *Report 516: Review of Mortgage Broker Remuneration*, March 2017, 14 [51].

[58] ASIC, *Report 516: Review of Mortgage Broker Remuneration*, March 2017, 14 [53].

important contributor to misconduct and conduct falling short of community standards and expectations and poor customer outcomes. The conduct to which value-based remuneration has contributed is exemplified by the case studies examined in the first round of hearings. And both CBA and ASIC rightly identified the consequences of value-based remuneration of brokers:

- higher leverage;
- higher incidence of interest-only loans;
- higher total debt-to-income ratios;
- higher LVRs;
- higher incurred interest costs; and,
- over time, an increased likelihood of borrowers falling into arrears, borrowers paying their loans more slowly and paying more interest than other borrowers.

In these circumstances, it will be important to consider whether value- and volume-based remuneration of intermediaries should be forbidden.

In December 2017 the Combined Industry Forum (CIF), composed of industry bodies and financial services entities, released a report setting out reforms to broker remuneration agreed upon by its members. The changes included paying commissions based on the amount of funds actually drawn down by a customer (rather than the size of the loan approved), ceasing volume and campaign-based commissions, limiting the value and availability of rewards such as entertainment and overseas trips, and the development of a mortgage broking industry code. In late August 2018, the CIF reported that its members had eliminated volume-based commissions and mooted the adoption of a 'customer first' duty.

The reforms announced are limited. While the perverse incentives created by volume-based commissions, which reward brokers for the number of customers placed with a lender, are to be removed, upfront and trail commissions based on loan value remain. While basing those commissions on funds drawn down removes an incentive for brokers procuring a loan larger than the borrower will use, the change does not deal with the more basic problem of borrowers being encouraged to borrow more than they

need. As noted elsewhere in this report, value-based remuneration conflicts directly with customers' interests.

It is not immediately clear what would be the content of a 'customer first' duty. In particular, it is not clear how this form of duty is intended to differ from the duty to act in the best interests of the client that the Corporations Act imposes on financial advisers. Nor is it clear, if the two forms of duty are to be given different content, why the duty a mortgage broker owes to a borrower should differ from the duty a financial adviser owes a retail client.

6.1.3 Other intermediaries

One other form of intermediary calls for special consideration – retail dealers, especially car dealers, who are entitled to, and do, act as agents for lenders without holding an **Australian Credit Licence**. Under the point-of-sale exceptions to the NCCP Act, many car dealers (and some retailers), without holding an ACL, have offered to consumers loans to be provided by a lender.[59] It has been common for lenders to allow car dealers what are called 'flex-commissions'. Under that kind of arrangement, the lender fixes a base rate of interest that will be charged under the loan agreement. If the dealer can persuade the borrower to agree to pay a higher rate, the dealer receives a large part of interest payable over and above the base rate. In more recent times, lenders have provided that the agreed rate must not exceed a rate fixed by the lender but, below that cap, the dealer is free to offer a loan on behalf of the lender at a rate greater than the base rate fixed by the lender.

Many borrowers know nothing of these arrangements. Lenders do not publicise them; dealers do not reveal them. The dealer's interest in securing the highest rate possible is obvious. It is the consumer that bears the cost. To the borrower, the dealer may appear to be acting for the borrower by submitting a loan proposal to the lender on behalf of the borrower. If the borrower thinks that the dealer is acting for the lender, the borrower is given no indication that in fact the dealer is looking after its own interests rather than as a mere conduit between lender and borrower. For all the borrower knows, the interest rate the dealer quotes as the applicable rate is fixed by

[59] Exhibit 1.158, Witness statement of Michael Saadat, 5 March 2018, 2 [11], 23 [128]; Jeannie Marie Paterson and Nicola Howell, *FSRC Background Paper No. 4: Everyday Consumer Credit – An Overview of the Australian Law Regulating Consumer Home Loans, Credit Cards and Car Loans*, 12 March 2018, 23.

the lender. In fact, however, whenever the dealer quotes a rate larger than the base rate fixed by the lender, the dealer is acting in its own interests.

When a consumer negotiates a loan at point of sale there may be as much confusion about the roles and responsibilities of an intermediary as there is in connection with brokers and aggregators dealing with home loans.

6.2 Customer 'needs'

Unsurprisingly, those employed by the large banks used similar forms of expression when describing dealings between the entity and its customers. There was repeated reference to 'conversations' with the customer and to meeting the customer's 'needs'. The second kind of issue that emerged from the first round of hearings relates to this notion of a customer's 'needs'.

The use of words like 'conversations' and 'needs' must not be permitted to obscure what was being described. A 'conversation' with a customer is treated as an opportunity to sell what the entity has to sell and, for that purpose, to gather some necessary information about the customer.

The customer's 'needs' are formed by reference to what the entity has to sell. And often it is the entity's representative that tells the customer what he or she 'needs'. That is why the banks have rewarded and continue to reward staff and intermediaries for 'cross-selling' products. The customer who seeks a home loan is sold a transaction account or is sold a credit card. The customer who seeks a credit card is sold 'add-on insurance'. The examples could be multiplied. The staff member, or intermediary is rewarded for making the cross-sale. It is said that the customer's 'unmet needs' have been met. But the customer is treated as 'needing' what the entity has to sell.

A clear illustration of this understanding of customer 'needs' is provided by the evidence given about ANZ's conduct in making unsolicited offers of overdraft facilities to customers and Westpac's conduct in offering credit limit increases to credit card holders. In neither case had the customer expressed any 'need' or desire for this facility.

Unsolicited offers to credit card holders of credit limit increases were common throughout the industry. Since 1 July 2012, they have been regulated under the NCCP Act.[60]

Closely connected with these points about customers' needs is the further point, examined earlier in connection with the responsible lending provisions, that the lending decisions examined in the course of the first round of hearings were dictated by reference to credit risk rather than the statutory requirements about unsuitable lending.

6.3 Credit risk or unsuitable lending?

The point just made about lending decisions being made by reference to credit risk rather than the applicable statutory requirements is readily illustrated by reference to the evidence led in the first round of hearings about credit limit increases for credit card holders and unsolicited offers of overdraft limits.

The evidence showed that a credit limit increase would be offered to a credit card holder, and granted, if the bank judged that the card holder was unlikely to default in meeting the minimum repayment due if the increased limit was fully drawn. So too, ANZ made unsolicited offers of overdraft limits to those whom it judged were unlikely to default. The only criterion applied in either kind of case was whether the customer was likely to default. **Lending was treated as not unsuitable if the customer was unlikely to default.**

But that is not what the responsible lending provisions required. Contrary to those provisions, the banks made no inquiry about the customer's circumstances, requirements or objectives. Until ASIC stepped in, in September 2012, none of the banks made any inquiry about the credit card holder's financial situation at the time of the offer. And even after ASIC had sought, in 2012, to have the banks make inquiries about the customer's financial situation at the time of the offer to increase the credit

[60] NCCP Act s 133BE(1), as amended by *National Consumer Credit Protection Amendment (Home Loans and Credit Cards) Act 2011* (Cth) sch 1 pt 3-2B div 4 and *Treasury Laws Amendment (Banking Measures No 1) Act 2018* (Cth) sch 5 pt 2; see also Jeannie Marie Paterson and Nicola Howell, *FSRC Background Paper No. 4: Everyday Consumer Credit – An Overview of the Australian Law Regulating Consumer Home Loans, Credit Cards and Car Loans*, 12 March 2018, 56.

limit, Westpac continued, for more than two years, to offer and to grant credit limit increases without making any inquiry beyond whether the customer's immediately antecedent history of servicing the existing credit card debt showed that the customer could service an increased debt. Westpac estimated its profit from this conduct as more than $23 million.

6.4 Processing errors

What entities described in their submissions to the Commission, and their dealings with ASIC, as 'processing errors' in connection with home loans were failures by the entities to make proper provision in their administrative and computer systems to charge customers only the interest and fees that had been agreed with the customer. That is, in breach of what they had promised, the entities charged customers interest at rates higher than had been agreed and charged fees that should not have been charged, either at all or at the rate they were.

Three fundamental, but simple, points must be made about these issues.

First, entities should not offer to sell what they cannot deliver. And that is what has been done when an entity has offered interest rate or fee discounts but has not charged the proper rate or the proper fee because relevant accounts were not linked, or automated systems were not properly programmed to charge the right rate or fee.

Not to charge the contractually stipulated rate or fee is evidently conduct that falls below community standards and expectations. Performing a contract according to its terms must be seen as a standard of behaviour that the community expects to be met.

But not to charge the contractually stipulated rate or fee is also misconduct. It is a breach of duty or it is a breach of a recognised and widely adopted benchmark for conduct or, most probably it is both.

Further, not charging the correct rate or fee might also constitute a contravention of Section 912A of the Corporations Act. That section obliges a financial services licensee to do *all* things necessary to ensure that the financial services covered by the licence are provided efficiently, fairly and honestly. And not charging the right rate or the right fee may be, in at least many cases, not to provide the relevant service 'efficiently, fairly and honestly'. Regardless of whether failing to charge the right rate and right fee is a breach of Section 912A, it is, on its face, a breach of contract. And if it is

a breach of contract, it would breach 'a widely recognised and widely adopted benchmark for conduct'. It would be misconduct and it would be misconduct that has serious effects on many customers.

Second, the entity that sells a product should have the right systems in place *before* the first sale is made. Selling without knowing that what is sold can be delivered is, at best, careless of the interests of the customers to whom the product is sold. At worst, it is deceptive.

The third, and equally simple observation to make is that, if an entity does not deliver what it has sold, the entity must remedy that default and the consequences of the default as soon as reasonably practicable.

Once this is understood, the so-called processing errors identified by banks called for much quicker responses than exemplified by ANZ's prolonged processes for identifying and then compensating customers affected by failures first identified in 2003,[61] which were still far from complete when the Commission took evidence on the subject in March 2018.

7 Regulatory compliance

The first round of hearings revealed some common and recurring themes about what importance the entities whose conduct was examined in those hearings give to regulatory compliance. Some have been mentioned already but it is as well to bring them together for the purpose of considering what they show.

The evidence led in the first round of hearings pointed towards:

- the entities concerned preferring profit to pursuit of any other purpose; and
- the entities treating regulatory compliance as a cost of doing business rather as a foundation that informs and underpins how the business must be conducted.

[61] Exhibit 1.127, undated, Extract from Final Table, items 134–8, 151; Transcript, Sarah Mary Stubbings, 20 March 2018, 659–60.

Four aspects of the evidence reveal this to be so.

First, there is the body of evidence about how the four largest banks have dealt with responsible lending obligations. They have seen these obligations as satisfied whenever the bank, as lender, is satisfied that the borrower is unlikely to default. That is, they have each understood, and applied, the law that requires lenders to ascertain and form a view about the *borrower's* requirements and objectives and the *borrower's* financial situation as met by asking only whether the *lender* is taking an acceptable credit risk.

Second, there is the body of evidence about how long it has taken the banks to lodge a written report with ASIC under Section 912D of the Corporations Act that the bank has breached, or is likely to breach, any of the obligations under Section 912A or Section 912B. The evidence called in the first round of hearings suggested that in some of the cases examined the bank concerned had not lodged the necessary written report 'as soon as practicable and in any event within 10 business days after becoming aware of the breach or likely breach'.[62]

Third, there was the evidence that showed that even if doing business in a particular way was of actual or possible disadvantage to customers, the banks would not alter that way of doing business if unilateral change would bring significant competitive disadvantage.

So, despite CBA recognising that 'the use of loan-size linked with upfront and trail commissions for third parties can potentially lead to poor customer outcomes',[63] CBA would not unilaterally change its broker and aggregator remuneration arrangements. And more strikingly, ANZ and Westpac would not cease to allow car dealers to earn 'flex-commissions' with respect to car loans despite powerful reasons to abandon the practice. First, as has been explained, the practice allowed (indeed it encouraged) the dealer to prefer its own commercial gain to the borrower's interests. Second, the banks knew that its car loan borrowers suffered disadvantage from these arrangements and those employees of ANZ and Westpac who gave evidence about these matters appeared not to dispute that the disadvantage

62 Corporations Act s 912D(1B).

63 Exhibit 1.37, 10 February 2017, Letter from Mr Narev to Mr Sedgwick dated 10/02/2017 and the Annexed Issues Paper Submission dated 10/02/2017, 2.

arose from the dealer's conflict of interest.[64] Third, the banks not only did nothing to tell consumers that dealers might seek to negotiate an interest rate above the rate required by the lender, the banks readily accepted that the practice was not generally known. And finally, despite it being announced (in September 2017) that the law was to change to outlaw the practice (with effect from 1 November 2018),[65] the banks did nothing to modify their business practices for fear of the resulting commercial disadvantage if other lenders did not follow suit.

The fourth aspect of the evidence led in the first round of hearings that shows that the entities concerned preferred profit to pursuit of any other purpose was the evidence given about Westpac and its offering credit limit increases to credit card holders. Despite being told plainly by ASIC that it considered that practices of the kind followed by Westpac did not comply with the responsible lending provisions, Westpac chose to continue those practices until ASIC threatened legal action. And Westpac chose not to seek, at any time in the intervening two years, to tell ASIC that it proposed to continue with its previous practices or to persuade ASIC that ASIC's stated views of the law were wrong.

These four matters must then be assessed in light of the ways in which banks have, until very recently, structured their remuneration arrangements for staff and for third parties. As is explained in Chapter 8, for most of the last decade, **remuneration arrangements for third party intermediaries and for all staff, both frontline staff and senior executives, have rewarded sales and profitability. Doing the 'right thing' has not been rewarded. And even in the more recent past, 'balanced scorecards' and 'conduct gateways' have too often used doing the 'wrong thing' as a disqualifying criterion. But penalising default is not the same as rewarding the right and proper performance of a task. Penalising default encourages hiding mistakes; it does not encourage doing the**

64 cf NCCP Act s 47(1)(b) obliging a credit licensee to 'have in place adequate arrangements to ensure that clients of the licensee are not disadvantaged by any conflict of interest that may arise wholly or partly in relation to credit activities engaged in by the licensee or its representatives'.

65 ASIC, 'ASIC Bans Flex Commissions in Car Finance Market' (Media Release, 17-301MR, 7 September 2017); see also ASIC, *ASIC Credit (Flexible Credit Cost Arrangements) Instrument*, 2017/780, 5 September 2017.

'right thing'. It does not encourage the intermediary or the employee to ask, 'Should I, should the Bank, do this?'

8 Issues that have emerged

The issues that emerged in connection with consumer lending concerned:

- intermediaries, and confusion of roles;
- communication with customers; and
- responsible lending.

Intermediaries stand between consumers and the providers of financial services. They include **mortgage brokers**, **mortgage aggregators**, introducers, financial advisers, authorised representatives of financial services licensees, and representatives (at point of sale) of credit licensees. Often, intermediaries are given tasks that, done properly, will help to fulfil the entity's responsible lending obligations. There are, therefore, issues about entities' oversight of these contractually stipulated tasks, and their responsibility for their own, non-delegable statutory obligations. Intermediaries are often seen by the customer as the face of the entity. Entities, on the other hand, have given conflicting messages about whether intermediaries represent entities, themselves, or the customer. There are, therefore, questions about intermediaries' obligations toward customers and entities, and customer expectations of the intermediaries with whom they deal.

Both entities and customers appear to be confused about the roles of intermediaries. Issues then arise about how entities can communicate with customers to create realistic expectations of products bought through intermediaries. And questions of communication arise when considering what obligations an entity owes to clients of an employee or intermediary when the entity suspects that employee or intermediary of misconduct toward at least some of their clients.

Responsible lending raises issues about the interpretation and application of obligations imposed by the *National Consumer Credit Protection Act* 2009 (Cth) (the NCCP Act). A particular issue that arose concerned entities' interpretation of the requirement to verify a customer's financial situation.

Later changes to verification processes may suggest some entities have changed their interpretation of the relevant provisions. Examination of responsible lending also directed particular attention to the tension between responsible lending and some products long sold by, and some processes long used by, entities and intermediaries, including add-on insurance, pre-approved credit limit increases and the **Household Expenditure Measure** (HEM).

The particular issues can be identified as including:

- What duties does an intermediary owe to a borrower?
- What duties should an intermediary owe to a borrower?
- How can entities' systems be improved to detect and prevent breaches of responsible lending obligations by intermediaries?
- Are 'introducer' programs compatible with responsible lending obligations?
- Do broker contracts, as they stood at the time of the hearings, meet the statutory requirement imposed by Section 912A of the *Corporations Act 2001* (Cth) to have arrangements in place to manage conflicts of interests? Do broker contracts, as now made, meet those requirements?
- What should be disclosed to borrowers about an intermediary's obligations to the lender and to the borrower?
- What should be disclosed to borrowers about an intermediary's remuneration?
- What steps, consistent with responsible lending obligations, should a lender take to verify a borrower's expenses?
- Do the processes used by lenders, at the time of the hearings, to verify borrowers' expenses meet the requirements of the NCCP Act? Do the processes now used meet those requirements?
- Should the HEM continue to be used as a benchmark for borrowers' living expenses?

- Is the offer of a credit limit increase, where the customer has consented to receive such marketing, consistent with the NCCP Act obligation not to provide credit that is not unsuitable for the customer, having regard to their requirements and objectives?
- Is the offer of a credit limit increase based only on information held by the bank about a customer a breach of the NCCP Act obligation to take reasonable steps to verify the consumer's financial situation?
- When an employee or intermediary is terminated for fraud or other misconduct, should a licensee inform their clients of the reason for termination?
- When an employee or intermediary is terminated for fraud or other misconduct, should a licensee review all the files or clients of that employee or intermediary for incidence of misconduct?
- Are certain types of add-on insurance, by their nature, poor value propositions for customers?

3. Financial advice

Introduction

The Commission's second round of public hearings explored issues relating to the financial advice industry.

The Commission focused on four topics:

- fees for no service, which concerned licensees or advisers charging fees to clients for financial advice that was not provided;
- inappropriate financial advice, which can be broadly described as financial advice that does not comply with the 'best interests' obligation and related obligations in Part 7.7A of the *Corporations Act 2001* (Cth) (the Corporations Act) or advice that does not take proper account of a client's circumstances;
- improper conduct by financial advisers, which included falsifying documents, misappropriating customer funds and engaging in misleading or deceptive conduct in relation to clients; and
- disciplinary matters, which included how disciplinary matters involving financial advisers are now dealt with and whether there are any gaps in the existing system.

These four topics were chosen in light of what the relevant entities told the Commission in their initial submissions and in light of what members of the public told the Commission in their online submissions.

Together the four topics presented issues about conduct and culture which, in turn, raised issues about regulation and about the structure of the financial advice industry. **Two themes recurred: dishonesty and greed.**

- **Charging for doing what you do not do is dishonest.**
- **Giving advice that does not serve the client's interests but profits the adviser is equally dishonest.**

- **No matter whether the motive is called 'greed', 'avarice' or 'pursuit of profit', the conduct ignores basic standards of honesty.**
- **Its prevalence and persistence require consideration of the issues of culture, regulation and structure.**

The discussion of these issues begins by looking at the history of the financial advice industry.

1 History

The issues considered by the Commission are related to the history of the financial advice industry. In particular, the roots of the industry are in sales and that has had a key influence in shaping the culture of the industry. Early scandals, how the industry responded to those scandals and the phenomenon of **vertical integration** (discussed further in Section 1.2, below) also provide an insight into the nature of the industry and why issues persist despite ongoing attempts at legislative reform.

1.1 How did the financial advice industry emerge?

The traditional business of banking comprised lending, deposit-taking and the provision of transaction services.[1] Through the first half of the twentieth century, banking was a regulated, local, low risk business based on a customer's credit worthiness and yielded returns based on interest.[2] Much has changed, but the mid-century model persists in the popular consciousness. Bank advertising draws heavily on this historical image.

During the 1950s, banking had little to do with funds management, where an entity pools and invests money on behalf of customers. The funds management sector was composed largely of superannuation and life

1 Malcolm Edey and Brian Gray, 'The Evolving Structure of the Australian Financial System' (Paper presented at The Future of the Financial System Conference, H.C. Coombs Centre for Financial Studies, Kirribilli, 8–9 July 1996) 8–9 <www.rba.gov.au/publications/confs/1996/pdf/conf-vol-1996.pdf>.

2 Malcolm Edey and Brian Gray, 'The Evolving Structure of the Australian Financial System' (Paper presented at The Future of the Financial System Conference, H.C. Coombs Centre for Financial Studies, Kirribilli, 8–9 July 1996) 7 <www.rba.gov.au/publications/confs/1996/pdf/conf-vol-1996.pdf>.

insurance.[3] For reasons discussed below, the reach of this sector was limited until regulatory and financial conditions changed.

In the 1970s, Australia began to deregulate its financial markets. Restrictions on bank interest rates and liability structures were removed; foreign banking was made easier to access; the Australian dollar was floated.[4] The financial sector expanded. At the same time, growth in the size and liquidity of securities markets allowed more diverse **financial products** to develop.[5]

The next critical steps were the expansion of superannuation, which shifted the responsibility for and control of provision for retirement from employers into the hands of individuals. From 1983, successive changes to the tax treatment of superannuation increased the complexity of superannuation but also established it as a vehicle for compulsory saving. These developments included the incorporation of superannuation into employment awards in 1986 and legislation in 1991 imposing tax penalties where employer contributions were not made.[6]

With greater amounts of savings invested in superannuation funds, Australians now have a far higher exposure to capital markets and since the 1980s Australians have increasingly seen a need for financial advice.

3. Malcolm Edey and Brian Gray, 'The Evolving Structure of the Australian Financial System' (Paper presented at The Future of the Financial System Conference, H.C. Coombs Centre for Financial Studies, Kirribilli, 8–9 July 1996) 7 <www.rba.gov.au/publications/confs/1996/pdf/conf-vol-1996.pdf>.

4 RBA, *Submission to the Financial System Inquiry,* March 2014, 16 <http://fsi.gov.au/files/2014/04/Reserve_Bank_of_Australia.pdf>.

5 Malcolm Edey and Brian Gray, 'The Evolving Structure of the Australian Financial System' (Paper presented at The Future of the Financial System Conference, H.C. Coombs Centre for Financial Studies, Kirribilli, 8–9 July 1996) 17–20 <www.rba.gov.au/publications/confs/1996/pdf/conf-vol-1996.pdf>.

6 Malcolm Edey and Brian Gray, 'The Evolving Structure of the Australian Financial System' (Paper presented at The Future of the financial System Conference, H.C. Coombs Centre for Financial Studies, Kirribilli, 8–9 July 1996) 35 <www.rba.gov.au/publications/confs/1996/pdf/conf-vol-1996.pdf>.

Before the early 1980s, Australians who required financial advice often went to their bankers, accountants and insurance advisers.[7]

As the market for superannuation and investment products grew, the life insurance and other financial institutions that manufactured financial products looked to financial advisers to sell them.[8] At that time most financial advisers came from a background of life insurance, in which a sales-driven, commission-based culture prevailed and comprehensive advice was not commonly sought or given.[9] These being the roots of today's financial planning industry, the culture has endured.

The 1990s brought even more of the Australian public into the market for financial products and services, and therefore advice.[10] A series of privatisations (such as CBA, Telstra and Qantas) and demutualisations (such as AMP and NRMA Insurance)[11] increased middle class share ownership. Further deregulation of the financial sector contributed to a surge in credit provision and the design of new and more complex financial products. These developments in combination with the prevailing low interest rates raised household indebtedness and increased the value of market-linked financial assets households held.[12] At this time, banks were beginning their expansion into wealth management, which later accelerated and is discussed below.

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7 Janet Cowan, William Blair and Sharon Taylor, 'Personal Financial Planning Education in Australian Universities' (2006) 15 *Financial Services Review* 43, 46.

8 Robert Brown, 'Reinventing financial planning' (2008) 3(1) *Australian Journal of Financial Planning* 17, 20.

9 Robert Brown, 'Reinventing financial planning' (2008) 3(1) *Australian Journal of Financial Planning* 17, 20.

10 Pamela Hanrahan, *FSRC Background Paper No. 7*: *Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households,* 5 April 2018, 5.

11 See also ASX, *The Australian Share Ownership Study* (2014) <www.asx.com.au/documents/resources/australian-share-ownership-study-2014.pdf>.

12 Marianne Gizycki and Philip Lowe, 'The Australian Financial System in the 1990s' (Paper presented at The Australian Economy in the 1990s Conference, H.C. Coombs Centre for Financial Studies, Kirribilli, 24–5 July 2000) 187 <www.rba.gov.au/publications/confs/2000/>.

The regulatory framework that governs financial advice and product sales today was designed in response to, and in the midst of, these changes. A number of design decisions should be noted for their part in shaping the financial advice industry as it is today.

The 1997 Financial System Inquiry chaired by Mr Stan Wallis (the Wallis Inquiry) reviewed the then fragmented regulation of the financial system and recommended that there be a 'consistent and comprehensive disclosure regime' administered by a single regulator. The adoption of this model marked the start of the uniform treatment of traditional intermediary services and financial sales and advice relating to funds management. In 1998, the Australian Securities and Investments Commission (ASIC) was established, combining the responsibilities of the then Australian Securities Commission and the Insurance and Superannuation Commission.[13]

In December 1999, Treasury released its Corporate Law Economic Reform Program Paper No. 6 (CLERP 6). Although extensive amendments have been made to the legislation passed to implement CLERP 6, a number of its underlying principles have endured. One of those principles was to fold sales and advice relating to insurance and superannuation into the regulation of securities. That regulatory framework was premised on independent intermediation and the use of mandatory disclosure as a means of investor protection.[14] It did not take into account that insurance and superannuation decisions were usually made with consumption (a payment in case of injury; an income stream at retirement), rather than investment, in mind, or that those products were usually sold by sales agents and not independent brokers like those who traded in securities.[15]

Another key principle in CLERP 6 was to regulate intermediaries (including advisers) at firm level rather than at the individual level, in part to allow ASIC

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13 Pamela Hanrahan, *FSRC Background Paper No. 7: Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households,* 5 April 2018*,* 6.

14 Pamela Hanrahan, *FSRC Background Paper No. 7: Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households*, 5 April 2018, 8.

15 Pamela Hanrahan, *FSRC Background Paper No. 7: Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households,* 5 April 2018, 8.

to target its resources efficiently.[16] Thus, under the Corporations Act, individual advisers do not hold licences. The licensed entity is commonly the relevant **financial services entity** and individual advisers act as authorised representatives of the licensed entity. Authorised representatives fall under the firm's statutory obligation to ensure they comply with financial services laws.

Importantly, CLERP 6 did not provide that financial advisers were to be independent from product issuers. It is not clear whether the authors considered the possibility that financial advisers may be employed or authorised by issuers of products about which they advise, a situation that is now widespread. Nor did CLERP 6 engage with the fiduciary duties or other general law obligations that may attach to financial advisers but conflict with their employment conditions. The financial advice industry is still caught in this structural link between product issuers and the adviser's legal obligation to act in the best interests of the client.[17]

Finally, CLERP 6 established that household access to wholesale markets and complex products would not be restricted.[18] Rather, it relied on mandatory pre-disclosure as the means to inform consumers about risks on the basis that consumers would then make informed and rational choices about the best investment strategies for them. That meant leveraged and complex investments could be marketed and sold in the retail market.[19]

1.2 Vertical integration

The Wallis Inquiry reflected the prevailing conditions of deregulation and globalisation, which produced a sense that financial markets would displace

16 Pamela Hanrahan, *FSRC Background Paper No. 7: Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households*, 5 April 2018, 9.

17 Pamela Hanrahan, *FSRC Background Paper No. 7: Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households,* 5 April 2018, 10.

18 Pamela Hanrahan, *FSRC Background Paper No. 7: Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households,* 5 April 2018, 10–11.

19 Pamela Hanrahan, *FSRC Background Paper No. 7: Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households,* 5 April 2018, 10–11.

banks from their core functions and cause financial service providers to specialise and disaggregate.[20] It expected that this rise in competition would eliminate mispricing of financial products and services, create efficiencies in the system and ultimately produce lower costs for consumers.[21] The RBA has said that the Wallis Inquiry underestimated banks' capacity to expand and acquire businesses along their supply chains.[22]

From the time of the Wallis Inquiry, banks' accumulation of wealth management businesses accelerated. During the late 1990s and early 2000s, each of the major banks acquired or merged with a fund manager. More recently, banks have sold off a number of those acquisitions, the returns on which have proved lower than expected.[23]

The vertical integration of product manufacture with product sale and financial advice is a 'one stop shop' vision in which retail customers' investment needs can be provided alongside traditional banking facilities such as loan and deposit services. Vertical integration has seen the acquisition by entities of a number, or all, of the steps in supply of financial products to consumers, starting with designing and creating the product, providing asset management services and investment platforms, and engaging in distribution to customers by way of financial advice or sales.[24]

Vertical integration promises the virtue of efficiency, which is then passed on to consumers in the form of lower costs and greater access to financial advice. Customers may also enjoy the simplicity of dealing with just one institution. But the internal efficiency of the 'one stop shop' does not necessarily produce efficiency in outcomes for customers. The one-stop

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20 Treasury, *Financial System Inquiry Final Report* (Commonwealth of Australia, 1997) Chapter 4; Reserve Bank of Australia, *Submission to the Financial System Inquiry,* March 2014, 14 <http://fsi.gov.au/files/2014/04/Reserve_Bank_of_Australia.pdf>.

21 Treasury, *Financial System Inquiry Final Report* (Commonwealth of Australia, 1997) Chapter 4 <http://fsi.treasury.gov.au/content/FinalReport.asp>.

22 RBA*, Submission to the Financial System Inquiry*, March 2014, 14 <http://fsi.gov.au/files/2014/04/Reserve_Bank_of_Australia.pdf>.

23 Productivity Commission, *Competition in the Financial System: Productivity Commission Draft Report,* January 2018, 82.

24 See generally Productivity Commission, *Competition in the Financial System: Productivity Commission Inquiry Report No. 89,* June 2018, Chapter 9.

shop has an incentive to promote the owner's products above others, even where they may not be ideal for the consumer.[25]

From the perspective of banks, vertical integration always promised the benefit of cross-selling opportunities (the opportunities for cross-selling financial products to existing and new customers).[26]

In 2000, CBA acquired Colonial Mutual Life Assurance Ltd,[27] which conducted life and other insurance business, and a funds management business. In September 2017, CBA announced that it was selling its life insurance business to AIA,[28] and, in July 2018, announced that it would seek to sell the remainder of that business.[29] In late June 2018, CBA announced that it would demerge its other wealth management and mortgage broking businesses, including Colonial First State, Colonial First State Global Asset Management Count Financial, Financial Wisdom and Aussie Home Loans, into a separately listed entity.[30]

In 2000, NAB acquired the financial services businesses of Lend Lease, including MLC Holdings Ltd.[31] In May 2018, NAB announced that it

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25 Productivity Commission, *Competition in the Financial System: Productivity Commission Draft Report*, January 2018, 82, quoting Choice, *Competition in the Australian Financial System Submission to the Productivity Commission*, September 2017, 30; ASIC, *Report 562 Financial Advice: Vertically Integrated Institutions and Conflicts of Interest*, January 2018, 16.

26 See, eg, Theodore Golat, 'Banks' Wealth Management Activities in Australia', *Reserve Bank Bulletin* (2016) September Quarter, 53, 54–6.

27 CBA, 'Intention to Merge with Colonial' (ASX Announcement, 10 March 2000) <www.asx.com.au/asx/statistics/displayAnnouncement.do?display=text&issuerId=1517&announcementId=167694&documentDate=2000-03-10&documentNumber=203643>.

28 CBA, 'Divestment of Australian and New Zealand Life Insurance Businesses' (ASX Announcement, 21 September 2017) <www.asx.com.au/asxpdf/20170921/pdf/43mhnzcfywb1rs.pdf>.

29 CBA, 'Completion of New Zealand Life Insurance Divestment' (ASX Announcement, 2 July 2018) <www.asx.com.au/asxpdf/20180702/pdf/43w71lfllx3gb0.pdf>.

30 CBA, 'Intention to Demerge Wealth Management and Mortgage Broking Business' (ASX Announcement, 25 June 2018) <www.commbank.com.au/content/dam/commbank/about-us/shareholders/pdfs/2018-asx/cba-intention-to-demerge-wealth-management-and-mortgage-broking.pdf>.

31 Lend Lease, 'LLC Ann: Sale of MLC Businesses to NAB Uncon Settlement 30/6' (ASX Announcement, 27 June 2000).

proposed to sell its MLC advice, platform and superannuation and asset management businesses.[32]

In 2002, ANZ entered joint venture arrangements with ING Group in respect of wealth management and life insurance businesses in Australia and New Zealand,[33] and later acquired the full business. ANZ has since sold most of those businesses.

Westpac took a different path. In 1999, Westpac founded Magnitude Group Pty Ltd. In 2008, as part of its merger with St George Bank Ltd, Westpac acquired St George's financial advice business, which included employed advisers as well as Securitor Financial Group Ltd. In 2002, Westpac acquired all of BT Financial Group's asset accumulation businesses.[34]

By contrast, AMP's structures remain substantially unchanged. AMP has a network of about 2,800 financial planners. About 90% of those are self-employed and act as authorised representatives of one of the various AMP advice licensees, which include AMP Financial Planning Pty Ltd, Charter Financial Planning Pty Ltd and Hillross Financial Services Ltd (all of which are subsidiaries of AMP).

By the time of the Final Report of the Financial System Inquiry in 2014[35] (Murray Inquiry), the 'one stop shop' model was well established in the market. The Murray Inquiry report observed that the high concentration and steadily increasing vertical integration in some sectors had the potential to limit the benefits of competition in the future.[36] While the report did not express a view as to the merits of vertical integration, the Murray Inquiry recommended ways in which to make ownership and alignment more transparent.[37] It did, however, note that the Global Financial Crisis (GFC) had exposed 'significant numbers of Australian consumers holding financial

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32 NAB, '2018 Half Yearly Results – Appendix 4D' (ASX Announcement, 3 May 2018) 15, 53.

33 ANZ, 'ANZ & ING Complete Funds Management and Life Insurance JV' (ASX Announcement, 30 April 2002).

34 Westpac, 'Westpac Completes BT Financial Group Transaction' (ASX Announcement, 31 October 2002).

35 Exhibit 2.1.24, November 2014, Financial System Inquiry Final Report.

36 Exhibit 2.1.24, November 2014, Financial System Inquiry Final Report, 255–6.

37 Exhibit 2.1.24, November 2014, Financial System Inquiry Final Report, 271–2.

products that did not suit their needs and circumstances' and that there were 'significant problems relat[ing] to shortcomings in disclosure and financial advice'.[38]

1.3 Early scandals

Scandals dating back to the GFC began to shed light on the conflicts and culture in the financial advice industry. **Regulatory responses, however, focused on the remediation of specific instances of poor advice, rather than seeking to identify root causes within institutions and the industry. Those responses largely set the tone for future approaches to misconduct by financial advisers, that is, to compensate customers according to arrangements negotiated with ASIC while requiring few changes to the business itself.**

1.3.1 Storm Financial

Shortly before the second half of 2008, Storm Financial was a profitable company with $77 million in annual revenue and $120 million in consolidated gross assets.[39] Initially largely conducting its business in north Queensland before its liquidation in 2009, Storm was conducting business throughout most of Queensland and in many other parts of Australia, attracting thousands of customers.[40] Between 2007 and 2008, Storm Financial had offices in a number of States in Australia and had over 100 employees.[41]

The business model of Storm Financial was to provide advice in standard or template form, with minimal tailoring to the investor.[42] Almost 90% of Storm's clients were encouraged to take out loans against the equity in their own homes, obtain a margin loan and use the funds from these loans to

38 Exhibit 2.1.24, November 2014, Financial System Inquiry Final Report, 27.

39 *ASIC v Cassimatis [No 8]* [2016] FCA 1023 [1]; see also *ASIC v Cassimatis [No 9]* [2018] FCA 385 [6].

40 *ASIC v Cassimatis* [2013] FCA 641 [4].

41 *ASIC v Cassimatis [No 8]* [2016] FCA 1023 [135].

42 *ASIC v Cassimatis [No 8]* [2016] FCA 1023 [9].

invest in the share market via index funds.[43] In late 2008 and early 2009, many clients of Storm Financial were in negative equity positions, sustaining significant losses.[44]

This resulted in many investors losing their investment, their homes and their life savings and still having significant debts outstanding. ASIC estimated the total loss suffered by all investors who borrowed from various banks to invest through Storm to be approximately $832 million.[45]

In December 2008, ASIC commenced an investigation into Storm Financial.[46] In early 2009, Storm Financial was placed into voluntary administration and liquidators were subsequently appointed.

ASIC commenced a number of legal proceedings in relation to the Storm Financial scandal including proceedings alleging that the directors of Storm Financial had breached their duties as directors and that Storm Financial had provided inappropriate advice.[47] In March 2018, the Federal Court imposed a penalty of $70,000 (from a maximum penalty of $200,000) on each of the directors of Storm Financial and ordered that each be disqualified from managing corporations for seven years.[48]

ASIC also entered into settlement agreements with various institutions to provide compensation for losses suffered:

- In 2012, ASIC entered into a settlement agreement with CBA to make available up to $136 million as compensation to CBA customers who had

[43] See ASIC, 'Directors of Storm Financial Penalised for Breach of Duties' (Media Release, 18-081MR, 22 March 2018); see also *ASIC v Cassimatis [No 9]* [2018] FCA 385 [7]; *ASIC v Cassimatis [No 3]* (2015) ALD 410 [6].

[44] ASIC, 'Directors of Storm Financial Penalised for Breach of Duties' (Media Release, 18-081MR, 22 March 2018).

[45] ASIC, 'ASIC and CBA Storm Financial Settlement' (Media Release, 8 March 2013) 3 [1.5].

[46] ASIC, *ASIC Investigation Background* (28 October 2016) ASIC <https://storm.asic.gov.au/proceedings/summary-of-asic-actions/asic-investigation-background/>.

[47] ASIC, *Summary of ASIC Actions: Civil Penalty Proceedings against the Cassimatises* (28 October 2016) ASIC <http://storm.asic.gov.au/proceedings/summary-of-asic-actions/>.

[48] ASIC, 'Directors of Storm Financial Penalised for Breach of Duties' (Media Release, 18-081MR, 22 March 2018).

borrowed from the bank to invest through Storm Financial.[49] CBA had already provided approximately $132 million to Storm Financial investors under its resolution scheme.[50]

- In 2013, ASIC intervened in a class action brought against Macquarie Bank in respect of Storm Financial regarding the fairness of settlement arrangements. The Full Federal Court held that the distribution of the settlement sum was not fair and reasonable to all group members and a revised settlement arrangement was arrived at whereby Macquarie Bank agreed to pay $82.5 million by way of compensation and costs.[51]
- In 2014, ASIC entered into a settlement agreement with the Bank of Queensland to pay approximately $17 million as compensation for losses suffered on investments made through Storm Financial.[52]

1.3.2 Commonwealth Financial Planning (CFPL)

In 2010, a whistleblower raised allegations of misconduct by financial advisers employed by CFPL, a subsidiary of CBA.[53] The allegations included that certain CBA financial advisers were advising clients to invest in high risk but profit-generating products that were not appropriate for them, switching products without the relevant client's permission and forging clients' signatures on documents.

As a result, when the GFC occurred, thousands of clients of CFPL, many of whom were nearing retirement or had already retired, lost millions of dollars.

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49 ASIC, 'ASIC and CBA Reach Storm Financial Settlement' (Media Release, 12-227MR, 14 September 2012).

50 ASIC, 'ASIC and CBA Reach Storm Financial Settlement' (Media Release, 12-227MR, 14 September 2012).

51 ASIC, 'ASIC and Bank of Queensland Reach Storm Financial Settlement' (Media Release, 14-244MR, 22 September 2014).

52 ASIC, 'ASIC and Bank of Queensland Reach Storm Financial Settlement' (Media Release, 14-244MR, 22 September 2014).

53 Simon Hoyle, 'For CBA He Was the Wrong Guy in the Wrong Place at the Wrong Time', *Professional Planner* (online), 4 July 2014, <www.professionalplanner.com.au/featured-posts/2014/07/04/striking-a-blow-29119/>; Jeff Morris, 'I Gift Wrapped Commonwealth Bank for ASIC and It Did Nothing', *The Sydney Morning Herald* (online), 27 April 2018 <www.smh.com.au/business/banking-and-finance/i-gift-wrapped-commonwealth-bank-for-asic-and-it-did-nothing-20180427-p4zbyk.html>.

CBA paid more than $20 million in compensation to clients who had received inappropriate financial advice from two CFPL financial advisers (Mr Don Nguyen and Mr Anthony Awkar).[54]

It later became apparent, however, that the misconduct extended beyond these two advisers and CBA subsequently implemented a second compensation program.[55]

In October 2011, ASIC accepted an **enforceable undertaking** from CFPL that required CFPL to review the advice given to clients by an additional 16 advisers, and pay to clients any compensation arising from that review. Three additional CFPL advisers and six advisers from another CBA advice arm, Financial Wisdom Limited, were subsequently identified as also having provided inappropriate advice and CBA paid compensation to those clients.[56]

In 2013, Australian media reported misconduct by financial planners at CFPL, a systematic cover up by management, and inadequate offers of compensation to complaining customers.[57]

In July 2014, CBA commenced the Open Advice Review Program. The program was open to those who had been customers of CFPL and

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54 Exhibit 2.277, undated, 00. Updated CFP Board Pack – 1900214 [CBA.0503.0002.4443 at .4627]; see also Adele Ferguson and Deb Masters, 'Insider's View to CBA Financial Planning Scandal', *The Sydney Morning Herald* (online), 4 May 2014 <www.smh.com.au/business/banking-and-finance/insiders-view-to-cba-financial-planning-scandal-20140504-zr4dp.html>.

55 KordaMentha Forensic, *Compliance Report (Part 3): Commonwealth Financial Planning Limited and Financial Wisdom Limited: Report of Compliance Expert,* 3 November 2017, 6.

56 ASIC, *REP 431 Comparison Report: Commonwealth Financial Planning Limited and Financial Wisdom Limited* (23 April 2015) <http://asic.gov.au/regulatory-resources/find-a-document/reports/rep-431-comparison-report-commonwealth-financial-planning-limited-and-financial-wisdom-limited/>.

57 Adele Ferguson and Chris Vedelago, 'Targets, Bonuses, Trips – Inside the CBA Boiler Room,' *The Sydney Morning Herald* (online), 22 June 2013 <www.smh.com.au/business/banking-and-finance/targets-bonuses-trips-inside-the-cba-boiler-room-20130621-2oo9w.html#ixzz3ls7bmVx0>; quoted in Adam Steen, Dianne McGrath and Alfred Wong, 'Market Failure, Regulation and Education of Financial Advisors' (2016) 10(1) *Australasian Accounting, Business and Finance Journal* 4, 9.

Financial Wisdom between 1 September 2003 and 1 July 2012. The program has offered a total of $37.6 million in compensation to customers.[58]

1.3.3 'Isolated pockets of poor culture'

Consistent with the regulatory focus on compensation, entities' response to financial advice scandals such as Storm and CFPL has frequently been that the misconduct was caused by 'a few bad apples' and that the issue did not raise broader or systemic concerns.

For example:

- In addressing the CFPL scandal in CBA's 2014 Annual Report, Mr Ian Narev, then CEO of CBA, said that the bank's achievements were 'overshadowed by the ongoing impact of the poor actions of some of our financial planners in past years'.[59]
- In CBA's initial submission to the Commission dated 29 January 2018, CBA said that incidents of misconduct may be attributed to an individual, to a small number of individuals or to 'pockets of poor culture'.[60] The same submission also referred to 'isolated and unauthorised incidents of conduct issues' in relation to misconduct in Aussie Home Loans.[61]
- Westpac's submission to the Commission dated 29 January 2018 identified a number of broad cultural or governance themes that it considered may underpin the relevant conduct issues. Of the five themes, three related to individual conduct (individuals failing to

[58] CBA, *Royal Commission into Misconduct in the Banking. Superannuation and Financial Services Industry Submission,* 29 January 2018, 10 [33]; Transcript, Senior Counsel Assisting, 16 April 2018, 1010.

[59] CBA, *Annual Report 2014*, 12 August 2014, 6. The CBA Annual Reports made no reference to the Storm Financial scandal other than noting the commencement of proceedings by ASIC against CBA and the settlement of those proceedings. See CBA, *Annual Report 2012*, 15 August 2012, 176; CBA, *Annual Report 2013*, 13 August 2013, 142.

[60] CBA, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Submission,* 29 January 2018, 3–4.

[61] CBA, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Submission,* 29 January 2018, 31–2.

implement policies or processes, as well as human error and individual dishonesty).[62]

- Following the Commission's hearings into financial advice, AMP's Interim Executive Chairman, Mike Wilkins, addressed the AMP Annual General Meeting on 10 May 2018. In that address, he said that 'a small number of individuals in our advice business made the decision not to follow policy, and inappropriately charged fees to customers where no service was provided'.[63]

Rhetoric of this kind is common. And responses of this kind to revelations of wrongdoings are generally accompanied by apologies and undertakings to take steps to restore public trust. For example, following the CFPL scandal, Ian Narev, then CEO of CBA, noted that CBA 'must now focus on restoring trust with all our financial planning customers and the community generally.'[64] Similar commitments were made after the Comminsure scandal in early 2016[65] and again in 2017 in relation to the Australian Transaction Reports and Analysis Centre (AUSTRAC) investigation into money laundering through CBA ATMs.[66]

That generally similar conduct occurred in all of the major entities suggests that the conduct cannot be explained as 'a few bad apples'. That characterisation serves to contain allegations of misconduct and distance the entity from responsibility. It ignores **the root causes of conduct, which often lie with the systems, processes and culture cultivated by an entity**. It does not contribute to rebuilding public trust in the financial advice industry. The misconduct acknowledged by the major

62 Westpac, *Response of Westpac Banking Corporation Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry,* 29 January 2018, 4–5.

63 Mike Wilkins, 'Address by AMP Interim Executive Chairman to the AMP Annual General Meeting' (Speech delivered at the 2018 AMP Annual General Meeting, 10 May 2018).

64 CBA, *Annual Report 2014*, 12 August 2014, 6.

65 CBA, 'Statement on Comminsure Upgrades and Assurances' (Media Release, 10 March 2016).

66 Clancy Yeates, '"I Am Sorry": CBA Boss Ian Narev Apologises for ATM Money Laundering Scandal', *The Sydney Morning Herald* (online), 6 October 2017 <www.smh.com.au/business/banking-and-finance/i-am-sorry-cba-boss-ian-narev-apologises-for-atm-money-laundering-scandal-20171006-gyvild.html>.

entities gives rise to broader questions than those answered by the 'few bad apples' response.

2 Financial advice and FoFA

As noted above, several financial product and financial services providers had collapsed during or after the GFC. The losses caused had been large and many consumers had been affected. Reforms, known as the **Future of Financial Advice** (FoFA) reforms, were proposed. The reforms were properly seen as radical alterations to the regulation of the financial advice industry that had emerged and developed in the decade or so that preceded their enactment.

The 2012 FoFA reforms[67] had three principal elements:

- the imposition of a best interests obligation on financial advisers giving personal advice to clients;
- a ban on **conflicted remuneration**; and
- measures intended to promote greater transparency about charging of fees for advice by requiring consumer agreement to ongoing advice fees, and enhanced disclosure of fees and the services associated with ongoing fees.

Further changes were made in 2014 and 2015.[68]

The content and extent of changes to be made in 2012, and later in 2014 and 2015, were contested. Before the introduction of the legislation that was enacted in 2012, government established a 'Peak Consultation Group' drawn from bodies as diverse as the Association of Financial Advisers, the Australian Bankers' Association, CHOICE, Industry Super Australia and the Property Council of Australia. For about 12 months before the legislation was enacted, this group met each month to discuss the proposals. It is,

[67] Effected by the *Corporations Amendment (Future of Financial Advice) Act 2012* (Cth); *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012* (Cth).

[68] *Corporations Amendment (Revising Future of Financial Advice) Regulation 2014* (Cth); *Corporations Amendment (Financial Advice) Regulation 2015* (Cth); *Corporations Amendment (Financial Advice Measures) Act 2015* (Cth).

therefore, not surprising that the resulting provisions show signs of compromise and accommodation of widely divergent interests.

For the moment it is useful to focus on two of those compromises. The first was that conflicts of interest between adviser and client should be permitted to remain but be 'managed'. The second was that some forms of conflicted remuneration were, and still are, allowed to continue.

2.1 Conflicts of interest

Section 912A(1)(aa) of the Corporations Act now provides that a **financial services licensee** must have in place 'adequate arrangements for the *management* of conflicts of interest' that may arise in relation to activities undertaken by the licensee *or a representative* of the licensee in the provision of financial services as part of the financial services business of the licensee (emphasis added). Section 961J provides that a provider of advice who knows, or reasonably ought to know, that there is a conflict between the interests of the provider and the client must give priority to the client's interests when giving the advice. But to treat the client's interests as foremost is to do no more than comply with the duty that the client is owed. That is, Section 961J is no more than a restatement of the duty imposed by Section 961B to act in the best interests of the client. When taken together, the two provisions presuppose that conflicts of interest can not only be 'managed' but are to be (and more importantly, *can be*) resolved by giving priority to the client's interests.

To speak in the abstract of conflicts between the interests of a financial adviser and the interests of the client does not reveal (and may even obscure) the way in which those interests intersect and conflict. The interests of the client are to obtain the best financial advice reasonably available. More particularly, if the advice is for the client to acquire some financial product, it is in the client's interests to obtain the best product: best in the sense that it is fit for purpose but best in the sense also that it is the cheapest and (as far as can reasonably be determined) the best performing product available. By contrast, the adviser's interest is to further his or her career and to maximise financial reward and the licensee's interest is to maximise profit. Where an adviser is employed by, or aligned with and acts on behalf of, a principal who manufactures or sells financial products, the adviser's interests (and the principal's) will be advanced by persuading a client to acquire one of the principal's products.

Although spoken of as a conflict of 'interests', **the conflict may be better seen as a conflict between the financial *interests* of the adviser or licensee and the *duty* that each owes to the client**. (The adviser owes the client a best interests duty[69] and the licensee must ensure compliance with that duty.)[70]

Understood in that way, the conflict comes into sharper relief. Recognising that the conflict is between duty and interest emphasises the need to focus on the position of the adviser and the licensee. It is their conduct which is in issue, not the client's.

ASIC's January 2018 report *Financial Advice: Vertically Integrated Institutions and Conflicts of Interest*, and the particular cases examined in evidence, show how often the conflict (whether of interests or between duty and interests) is 'managed' in a way that aligns with the adviser's interests. But both the ASIC report and the particular cases show much more than that. They show that advice that benefits the adviser 'commonly'[71] does not advance the interests of the client and in a significant number of cases does actual harm to the client.

The conclusions recorded in the ASIC report are telling. In 75% of the files that ASIC reviewed for the purposes of its report, the adviser did not demonstrate compliance with the requirements of Section 961G to give 'appropriate advice'. In 75% of the files reviewed, ASIC found that the adviser appeared to have prioritised the adviser's own interests (in breach of Section 961J).[72] And, in 10% of the files reviewed, ASIC had 'significant concerns about the impact of the non-compliant advice on the customer's financial situation'.[73] More particularly, ASIC found that the clients had switched into new superannuation arrangements that gave less, charged

69 Corporations Act s 961B.

70 Corporations Act s 961L.

71 ASIC, *Report 562: Financial Advice: Vertically Integrated Institutions and Conflicts of Interest,* 24 January 2018, 35.

72 ASIC, *Report 562: Financial Advice: Vertically Integrated Institutions and Conflicts of Interest,* 24 January 2018, 42 [174].

73 ASIC, *Report 562: Financial Advice: Vertically Integrated Institutions and Conflicts of Interest,* 24 January 2018, 8 [20].

more, or both gave less and charged more without any countervailing benefit. The detriment to the client is obvious.

The results recorded in ASIC's report were obtained by examining the files of 10 advice licensees associated with the five largest entities: AMP, ANZ, CBA, NAB, and Westpac. They are, therefore, results based on the work of advisers associated with the largest entities that may, because of their size, be assumed to be the best-resourced. **They are results that demonstrate the validity of a basic observation of the world: that the choice between interest and duty is resolved, more often than not, in favour of self-interest. And they are results that, on their face, deny a fundamental premise for the legislative scheme of the FoFA reforms: that conflicts of interest can be 'managed' by saying to advisers, 'prefer the client's interests to your own'.** Experience (too often, hard and bitter experience) shows that conflicts cannot be 'managed' by saying, 'Be good. Do the right thing'. People rapidly persuade themselves that what suits them is what is right. And people can and will do that even when doing so harms the person for whom they are acting.

It may be assumed that the recognition of these basic truths lay behind the provisions of the FoFA reforms that prohibited the payment or acceptance of 'conflicted remuneration'.[74] But the conflicted remuneration provisions also reflected compromise by allowing for some forms of conflicted remuneration to continue to be received.

2.2 Conflicted remuneration

The FoFA reforms included that a financial services licensee must not accept conflicted remuneration and that it must take reasonable steps to ensure that representatives of the licensee do not accept conflicted remuneration.[75]

Section 963A of the Corporations Act defines conflicted remuneration as 'any benefit (whether monetary or non-monetary) given to a financial services licensee or a representative of the licensee, who provides financial product advice to persons as retail clients, that, because of the nature of the

[74] Corporations Act s 963E.

[75] Corporations Act s 963F.

benefit or the circumstances in which it is given, could have either or both of two effects:

- It could reasonably be expected to influence the choice of financial product recommended by the licensee or representative to retail clients; or
- It could reasonably be expected to influence the financial product advice given to retail clients by the licensee or representative.'

That is, the very hinge about which the conflicted remuneration provisions turn is that the payment is one that 'could reasonably be expected to influence the choice of financial product recommended to retail clients'.

An authorised representative[76] or other representative[77] must not accept conflicted remuneration. An employer of a financial services licensee or a representative of a licensee must not give employees conflicted remuneration[78] and a product issuer or seller must not do so.[79]

Volume-based benefits are presumed to be conflicted remuneration.[80] A platform operator cannot accept volume-based shelf-space fees.[81] Financial services licensees[82] and authorised representatives[83] are forbidden to charge asset-based fees on borrowed amounts.

From 1 January 2018, conflicted remuneration includes volume-based benefits given to a licensee or representative in relation to information given on, or dealing in, a life risk insurance product.[84] A monetary benefit relating to a life risk product will not be conflicted remuneration if it is a level

76 Corporations Act s 963G.

77 Corporations Act s 963H.

78 Corporations Act s 963J.

79 Corporations Act s 963K.

80 Corporations Act s 963L.

81 Corporations Act ss 964, 964A.

82 Corporations Act s 964D.

83 Corporations Act s 964E.

84 *Corporation Regulations 2001* (Cth) reg 7.7A.11B.

commission within the applicable cap[85] and provides a 'clawback' arrangement if the policy is cancelled, not continued, or the policy cost is reduced in the first two years of the policy.[86]

Section 965 seeks to prevent avoidance of the conflicted remuneration provisions by forbidding entering into, beginning to carry out or carrying out a scheme if it would be concluded that the sole purpose of the scheme was to avoid the application of any part of the relevant Corporations Act division.

On their face the conflicted remuneration prohibitions may appear to be comprehensive. But there are exceptions[87] relating to general insurance,[88] life risk insurance products[89] and basic banking products,[90] and there is also power to prescribe benefits or circumstances in which a benefit is given that take the benefit outside the definition of conflicted remuneration.[91]

2.3 Grandfathered remuneration

After the commencement of the FoFA reforms, payment and receipt of some forms of conflicted remuneration for financial advice was permitted to continue by 'grandfathering' provisions made by Subdivision 5 of Division 4 of Part 7.7A of the Corporations Regulations 2001 (Cth).[92] It is neither necessary nor profitable to trace the detail or history of those grandfathering provisions. At the risk of some inaccuracy it is enough to note that certain arrangements made before the FoFA reforms came into force in July 2013 that would otherwise have fallen within the ban on conflicted remuneration

85 For the calendar year 2018, 80% upfront commission and 20% trail commission, reducing to 70% upfront and 20% trail in 2019 and 60% upfront and 20% trail from 1 January 2020. See ASIC, *ASIC Corporations (Life Insurance Commissions) Instrument*, 2017/510, 31 May 2017, pts 2, 3; Corporations Act s 963B; *Corporations Regulations 2001* (Cth) regs 7.7A.11C(1)(d), 7.7A.11D(1)(b).

86 See ASIC, *ASIC Corporations (Life Insurance Commissions) Instrument*, 2017/510, 31 May 2017, s 6.

87 ASIC, Regulatory Guide 246: Conflicted and Other Banned Remuneration, December 2017, 72.

88 Corporations Act s 963B(1)(a).

89 Corporations Act s 963B(1)(b).

90 Corporations Act s 963D.

91 Corporations Act s 963B(1)(e).

92 *Corporations Regulations 2001* (Cth) regs 7.7A.15B–7.7A.16F; Corporations Act s 1528.

were, and remain, excluded from the definition of conflicted remuneration. For present purposes, two points are important.

First, despite it being recognised that the grandfathered forms of remuneration are conflicted remuneration (because they could reasonably be expected to influence the choice of financial product recommended by a licensee or representative to retail clients, or could reasonably be expected to influence the financial product advice given to retail clients by the licensee or representative), charging and receiving these exempted forms of remuneration have been permitted to continue. And even now, five years on, licensees and representatives can, and do, continue to charge and receive these fees.

Second, in 2014, when ASIC looked at the value of 'grandfathered' benefits, it found that, '[o]n average, licensees indicated that grandfathered benefits were worth around one-third of their total income (though substantially more or less than the average in some cases).'[93]

2.4 Change grandfathering?

If the premise for the conflicted remuneration provisions is accepted (and no-one suggested that it should not be) how can the grandfathering provisions be justified today? At the time the changes were first made, participants in the industry could say that sudden change in remuneration arrangements may bring untoward consequences for countervailing benefits that would not outweigh the harms of disruption. Has that argument now outlived its validity?

It was said in evidence that to outlaw all conflicted remuneration would diminish income that licensees now receive. It would follow, so the argument went, that clients would have to pay more for advice. And more than one witness suggested that no one licensee could afford to be the 'first mover' in this area for fear of suffering a commercial disadvantage in relation to those who chose to maintain the payments.

In its submissions about this matter, the Financial Planning Association of Australia (FPA) recommended that grandfathered commissions on superannuation and investment advice be phased out over a three-year

[93] ASIC, *Report 407: Review of the Financial Advice Industry's Implementation of the FoFA Reforms,* September 2014, 30 [96].

period and that a 'long-term timeline' be developed to 'lead to the removal of life risk commissions in the future'.[94]

By contrast, AMP submitted that the grandfathering arrangements provided for in the FoFA arrangements should remain in place and, in effect, should, over time, be allowed to wither on the vine.[95] Behind the submission lay unexpressed allusions (expressly advanced when grandfathering was introduced and also mentioned by ANZ in its submissions)[96] suggesting that changing the permitted forms of remuneration may constitute some acquisition of property otherwise than on just terms. Two points may be made about those allusions. First, where would be the 'acquisition'? Who would acquire anything? It is not apparent that any proprietary benefit or interest would accrue to any person.[97] But second, and no less importantly, if the point is good, it was good when most forms of conflicted remuneration were prohibited. Yet no-one sought then to challenge the validity of the relevant provisions and the FoFA bans on conflicted remuneration have now been operating for five years without challenge.

NAB submitted that 'there is insufficient evidence before the Commission to make a definitive recommendation as to whether each of the statutory carve-outs to the ban on conflicted remuneration … ought [to] be maintained.'[98] And ANZ sought to make a generally similar point.[99] CBA made no submission. But Westpac said that it was 'supportive of any industry wide steps to accelerate the move away from grandfathered commissions and [from] any perception of ongoing conflict associated with

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94 FPA, *Written Submissions of the Financial Planning Association of Australia to the Royal Commission into Misconduct in the Banking, Superannuation and Insurance Industry* [Part A], undated, 3–4.

95 AMP, *AMP Group Submission: Counsel Assisting's General Questions in Closing Submissions,* 7 May 2018, 7–8.

96 ANZ, *Submissions by ANZ in Respect of General Questions – Round 2 Hearings*, 7 May 2018, 2–3 [8].

97 cf *JT International SA v The Commonwealth* (2012) 250 CLR 1.

98 NAB, *Submission in Response to Questions Arising from the Second Round of Public Hearings*, 7 May 2018, 26 [107].

99 ANZ, *Submissions by ANZ in Respect of General Questions – Round 2 Hearings*, 7 May 2018, 2–3.

commission based structures'.[100] Westpac submitted that any move to change the grandfathering arrangements must have appropriate regard to the impact that the moves may have on access to advice due to increased costs and to the viability of advisers and advice businesses that are currently affected by those revenue streams.[101]

Since the hearings about financial advice, Westpac, Macquarie, NAB and ANZ have all announced that they will cease paying grandfathered commissions to the advisers they employ. Westpac's BT Financial Group estimates that up to 140,000 client accounts are subject to commissions that will be removed.[102] Westpac noted it may be disadvantaged by its position as the first mover on this policy.[103] It estimated a resulting $40.8 million annual reduction in revenue.[104] But it also noted the countervailing advantage that the products relieved of grandfathered commission will be more attractive to clients and therefore will be more competitive market offerings.[105] Ultimately, Westpac said, it was preferable to make the changes because they were consistent with the intent of the legislation, the interests of customers, and the professionalisation of the financial advice industry.[106] Similarly, in early July 2018, media reported Macquarie had issued a statement that it would turn off commissions paid to its private wealth and private bank advisers, affecting approximately 17,000 client accounts.[107]

ANZ Financial Planning has also announced that it will no longer retain grandfathered commissions in relation to the OnePath investment and superannuation platforms. Clients will receive the amount of the commission

100 Westpac, *General Submissions on Financial Advice*, 7 May 2018, 3 [14].

101 Westpac, *General Submissions on Financial Advice*, 7 May 2018, 3 [18].

102 Exhibit 2.278, Witness statement of Michael Wright, 15 August 2018, 5 [27].

103 Exhibit 2.278, Witness statement of Michael Wright, 15 August 2018, 3 [19](d).

104 Exhibit 2.278, Witness statement of Michael Wright, 15 August 2018, 6 [33](a).

105 Exhibit 2.278, Witness statement of Michael Wright, 15 August 2018, 7 [39].

106 Exhibit 2.278, Witness statement of Michael Wright, 15 August 2018, 3 [19].

107 See, eg, Alice Uribe, 'Macquarie Scraps Grandfathered Commissions', *Financial Review*, 3 July 2018 <www.afr.com/business/banking-and-finance/financial-services/macquarie-scraps-grandfathered-commissions-20180703-h126n8>.

by way of a rebate.[108] Likewise, on 3 September 2018, NAB announced that customers of its Financial Planning and Direct Advice businesses would be rebated grandfathered commissions paid by NAB Wealth product providers from 1 January 2019.[109]

Evidently, some entities have overcome the arguments against removing grandfathered commissions, and now consider it advantageous to do so. The first mover problem has been eliminated. The onus now shifts to the entities wishing to continue to pay and accept grandfathered commissions to demonstrate why the calculations made by Westpac, Macquarie and ANZ do not work for them.

Those points will then have to be considered against the point of principle made by ASIC in its submissions. This is that **'any exception to the ban on conflicted remuneration, by definition, has the ability to create misaligned incentives, which can lead to inappropriate advice'.**[110] That is not a point that depends on evidence. It is the unchallenged (and unchallengeable) basic premise for the conflicted remuneration provisions. The grandfathering arrangements were temporary and exceptional measures. Once the legislative premise is accepted (and it was not challenged) the question must be **'Why should the grandfathering provisions remain?'** The question is not, as AMP, NAB and ANZ suggested, 'What evidence is there to warrant change?'

2.5 Conflicted remuneration: Related issues

That **misaligned incentives can lead to inappropriate advice** calls attention to two other issues: one concerning the separate treatment of benefits given in relation to life risk products (other than a group life policy for members of a superannuation entity, or a life policy for a member of a

[108] Letter from ANZ to Mr Simon Daley dated 20 August 2018.

[109] NAB, 'NAB Moves on Grandfathered Commissions', 3 September 2018 <https://news.nab.com.au/nab-moves-on-grandfathered-commissions/>.

[110] ASIC, *Submissions of the Australian Securities and Investments Commission: Round 2: Financial Advice*, 7 May 2018, 31 <https://financialservices.royalcommission.gov.au/public-hearings/Documents/Round-2-written-submissions/asic.pdf>.

default superannuation fund)[111] and the second concerning the payment of sales-related bonuses (or 'variable remuneration') to advisers.

As noted earlier, changes have been made, with effect from 1 January 2018, to the rules that govern the payment of commissions in connection with life risk products.[112] But, subject to those changes, selling life insurance products is still rewarded by upfront and **trail commissions**. Why do not these arrangements lead to misalignment of incentives? Why should these provisions remain?

Put shortly, if crudely, **sales staff can be rewarded by commission; advisers should not be.**

If, as seems inevitable, appeals are made to both history and the need to maintain the availability of advice by preserving existing advice business models, **what evidence is there that shows that the costs of doing away with payment by commission will outweigh the benefits of improving the overall quality of advice that is given?**

What answer is there to ASIC's observations about advice given by representatives of licensees associated with the five largest banking and financial institutions, that **in three out of every four cases examined, the advisers appeared to have preferred their own interests to those of the clients**?[113]

Likewise, **if licensees engage representatives as advisers, rather than as sales staff, why should the remuneration of the adviser be tied, to any extent, to the volume or value of sales made?** That is, if a balanced scorecard is used to determine eligibility for and amount of variable remuneration, what place does volume or value have in an adviser's scorecard? The scorecard reflects what the business values. The scorecard records what the individual will believe that the business values. What answer is made to ANZ's proposal[114] to remove all sales incentives for

[111] Corporations Act s 963B(1)(b).

[112] See ASIC, *ASIC Corporations (Life Insurance Commissions) Instrument*, 2017/510, 31 May 2017.

[113] ASIC, *Report 562: Financial Advice: Vertically Integrated Institutions and Conflicts of Interest,* January 2018, 42 [174].

[114] ANZ, 'ANZ Unveils Plan to Improve Financial Planning' (Media Release, 7 May 2018).

bonuses and only assess performance on consumer satisfaction, values and risk and compliance standards? It can no longer be said 'everyone rewards sales'.

2.6 Fee disclosure statements

The FoFA reforms included a requirement in relation to the provision of personal advice, and sometimes general advice, that the client must be provided with a **Financial Services Guide** before the financial advice is provided.[115] The Financial Services Guide is to contain prescribed information, including the kinds of remuneration the adviser will receive from the transactions,[116] and information about who the financial services licensee acts for when providing the relevant services.[117] A statement of advice must also accompany personal advice, setting out the advice itself and, among other things, the basis on which the advice was given and any interests – whether monetary or not, and whether direct or indirect – that might be reasonably capable of influencing the advising entity or any of its associates in the provision of the advice.[118]

Where an adviser charges ongoing fees, there is a requirement to provide an annual fee disclosure statement and give clients the option to opt-in to the ongoing fee arrangement every two years.[119]

As noted above, CLERP 6 and the regulatory framework it instituted relied heavily on disclosure to rationalise customer decision-making and impose transparency on licensees. The potential for complexity and duplication in the documents I have just described may derogate from that aim.

2.7 Norms of behaviour in general law

The FoFA reforms supplemented a number of existing protections and requirements in the *Australian Securities and Investments Commission Act 2001* (Cth) (the ASIC Act) such as the prohibitions on unconscionable

[115] See generally Corporations Act ss 941A and 941B.

[116] Corporations Act s 942B(2)(e).

[117] Corporations Act s 942B(2)(d).

[118] See generally Corporations Act ss 946A–947E.

[119] See generally Corporations Act ch 7 pt 7.7A div 3.

conduct and misleading or deceptive conduct in relation to the provision of financial advice.[120] These prohibitions are not novel ideas.

In addition, the ASIC Act imposes two implied warranties that are also relevant to the provision of financial advice.[121] The first warranty (implied into every contract for the supply of financial services to a consumer) is that the services will be rendered with due care and skill.[122] The second warranty applies when a consumer makes known to the supplier of a financial service any particular purpose for which the service is required or the result that the consumer wants to achieve.[123] In these circumstances the supplier is taken to have warranted that the services supplied will be reasonably fit for that purpose or are of such a nature and quality as to achieve that result.[124]

These prohibitions and warranties are longstanding norms of market conduct. The Chalmers *Sale of Goods Act 1893* (UK) codified implied warranties already established in common law that goods would be reasonably fit for purpose and of merchantable quality. Those provisions were widely adopted in the common law world, including in the Australian colonies.

Depending on the nature of a client's interaction with a financial adviser, a general law duty of care may also arise, as may a fiduciary duty.[125]

120 See generally ASIC Act pt 2 div 2 sub-divs C–D.

121 See ASIC Act s 12ED.

122 ASIC Act s 12ED(1)(a).

123 ASIC Act s 12ED(2)(b).

124 ASIC Act s 12ED(2).

125 Pamela Hanrahan, *FSRC Background Paper No. 7: Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households,* 5 April 2018, 29–37.

3 Financial advice industry today

3.1 Overview of the industry

In Part A of its sixth published Background Paper (Background Paper 6A), the Commission provided a summary of the size and the structure of the Australian financial planning industry.[126]

The financial advice industry is highly concentrated. As at late 2017, the top five entities (the four major banks and AMP) collectively held a market share of about 48% by industry revenue. About 30% of the total number of financial advisers on ASIC's Financial Advisers Register worked for one of the major banks and 44% of advisers, both aligned and non-aligned, operated under a licence controlled by the largest 10 financial institutions.

3.2 Licensing regime

The Commission's seventh published Background Paper, prepared for the Commission by Professor Pamela Hanrahan, sets out in detail the relevant legal and regulatory framework for the provision of financial advice in Australia (Background Paper 7).[127] The *Financial Services Reform Act 2001* (Cth) established the current licensing regime for holders of **Australian financial services licences**.[128] It enacted prescriptive conduct and disclosure obligations for financial advice providers dealing with retail clients and required product disclosure statements for financial product sales.

Under the Corporations Act, a person provides financial product advice when they give a client a recommendation or statement of opinion, or a report of either of those things, that is intended to influence, or could reasonably be regarded as being intended to have such an influence, on

[126] FSRC, *FSRC Background Paper No. 6 (Part A): Some Features of the Australian Financial Planning Industry*, 5 April 2018.

[127] Pamela Hanrahan, *FSRC Background Paper No. 7: Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households*, 5 April 2018.

[128] Corporations Act ch 7 pt 7.6.

a person in making a decision in relation to a particular financial product or class of financial product.[129]

There are two types of financial product advice: personal advice, which is advice given to a person in circumstances where the provider of the advice has considered one or more of the person's objectives, financial situation and needs, and general advice, which comprises all other financial product advice.[130]

In most cases, a person may only provide personal advice or general advice if they hold an Australian financial services licence or are a representative of a person who holds such a licence.[131] The regulatory framework for financial advice contemplates that there will usually be two or three separate entities involved in the provision of personal advice to a retail client. Depending on the business structure, these may be:[132]

- the financial services licensee, which is usually a body corporate, and an individual, who is an officer or employee of the licensee acting as its representative in providing advice;[133]
- an individual who is an authorised representative of the licensee (not an employee of the licensee); or[134]
- an employee of an authorised representative.[135]

Some financial advisers operate in dealer groups, which are also known as financial advisory networks. Where advisers operate in this structure, a group corporate entity holds the relevant licence, permitting the financial

[129] Corporations Act sub-s 766B(1); ASIC Act sub-s 12BAB(5).

[130] Corporations Act sub-ss 766B(2)–(4). This distinction is not used for the purposes of the ASIC Act.

[131] Corporations Act ss 911A and 911B.

[132] Pamela Hanrahan, *FSRC Background Paper No. 7: Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households,* 5 April 2018, 72–3.

[133] Corporations Act para 911B(1)(a).

[134] Corporations Act para 911B(1)(b).

[135] Corporations Act para 911B(1)(c).

advisers who are members of the dealer group to operate as its authorised representatives and provide financial advice to consumers on its behalf.

Financial advisers (and dealer groups) can be classified as either independent/non-aligned or as aligned with a financial institution, such as a bank or a wealth management services provider. Financial advisers can only use the terms 'independent' or 'non-aligned' (or similar words or expressions) in relation to their business if they meet certain legislative requirements. These include:

- not receiving commissions, volume-based payments, other gifts or benefits from an issuer of a financial product; and
- operating without any conflicts of interest arising from their associations or relationships with a product issuer.[136]

3.3 The subjects of advice

As indicated in Background Paper 6A, there are five main topics of financial advice sought by consumers.[137] Measured as a percentage of the Australian financial advice industry's revenue for the year 2016–17, those topics represent:

- superannuation and retirement advice (about one third of revenue);
- loan and investment advice (about one quarter of revenue);
- self managed superannuation fund (SMSF) advice (about one fifth of revenue);
- other services such as estate planning (one tenth of revenue); and
- tax advice (one tenth of revenue).

[136] See also ASIC, 'ASIC Clarifies Its Position on the Use of "Independently Owned" under s 923A' (Media Release, 17-206MR, 27 June 2017); ASIC, Regulatory Guide 175: Licensing: Financial Product Advisers – Conduct and Disclosure (March 2017), 20–1.

[137] FSRC, *FSRC Background Paper No. 6 (Part A): Some Features of the Australian Financial Planning Industry* (5 April 2018), 12–13.

Of the approximately 25,000 financial advisers registered in Australia, 8,704 have told ASIC that they have completed a degree at bachelor level or above, representing 35% of all advisers.[138]

4 Pending changes in the law

A number of further legislative changes relevant to the provision of financial services are either pending or have been recently introduced. Many arise out of recommendations from the Murray Inquiry.

4.1 Professional standards

Proposed changes to lift the professional, education and ethical standards of financial advisers were announced in February 2017.[139] The changes include compulsory education requirements, supervision for new advisers, a code of ethics for the industry, an industry exam and ongoing annual professional development obligations. Details regarding these changes (as at April 2018) were set out in Part B of the Commission's sixth published Background Paper.[140]

A new Commonwealth standard setting body, the Financial Adviser Standards and Ethics Authority (FASEA), was established in 2017 to develop these requirements and govern the professional standing of the financial advice sector.[141] FASEA will develop the new code of ethics, and professional organisations will be able to apply to ASIC for approval as code monitoring bodies. All advisers will be required to subscribe to the code of ethics of a monitoring body by 1 January 2020.[142]

[138] ASIC letter dated 29 March 2018, [93].

[139] The Hon Kelly O'Dwyer MP, Minister for Revenue and Financial Services, 'Higher Standards for Financial Advisers to Commence' (Media Release, 9 February 2017).

[140] FSRC, *FSRC Background Paper No. 6 (Part B): Education and Training Requirements for Financial Advisers,* 5 April 2018, 8–12.

[141] See generally Treasury, *Financial Adviser Standards and Ethics Authority Limited (FASEA)* <https://treasury.gov.au/programs-and-initiatives-banking-and-finance/financial-adviser-standards-and-ethics-authority-limited-fasea/>.

[142] Treasury, *Submission: Hearings on Financial Advice*, undated, 15.

Other requirements will commence on 1 January 2019.[143] From that date, new advisers will be required to hold a relevant degree before they are eligible to sit the exam and commence a year of supervised work and training.[144] Existing advisers will have two years to pass the exam (by 1 January 2021) and five years to reach a standard equivalent to a degree (by 1 January 2024).[145]

4.2 Design and distribution obligations on issuers and distributors

The Government accepted the Murray Inquiry's recommendations to introduce design and distribution obligations (DDOs) for financial products to ensure that products are targeted at the right people.[146]

The Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2017 (Cth), if enacted, would introduce DDOs intended to promote the provision of suitable financial products to consumers of those products. The reforms recognise that current disclosure requirements are not, on their own, sufficient to fully inform consumers.[147]

The obligations revolve around making an appropriate target market determination for products and dealing with the product accordingly.

4.3 Product intervention power

Under the Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2017 (Cth), if enacted, ASIC would be granted a new product intervention power. Under the proposed power, ASIC could make an order that a person must not engage in specified conduct in

[143] See generally ASIC, *Professional Standards for Financial Advisers – Reforms* (17 June 2018) <http://asic.gov.au/regulatory-resources/financial-services/professional-standards-for-financial-advisers-reforms/>.

[144] See generally Corporations Act ch 7 pt 7.6 div 8A.

[145] See generally Corporations Act ch 10 pt 10.23A.

[146] Exhibit 2.1.24, November 2014, Financial System Inquiry Final Report, 198–205.

[147] Treasury, *Submission: Hearings on Financial Advice*, undated, 4–5.

relation to a product where ASIC perceives a risk of significant consumer detriment.[148]

4.4 Further changes to industry funding model for ASIC

Also pursuant to Murray Inquiry recommendations, an industry funding model was introduced for ASIC commencing 1 July 2017.[149] The stated purpose of the industry funding model is to have industry bear the cost of regulation.[150]

The 2017–2018 Budget announced that the industry funding model would be implemented as a levy.[151] Legislation to impose and collect the levy commenced on 1 July 2017.[152] At the same time, the existing market supervision cost recovery regime was repealed.[153]

Under the industry funding model, ASIC's regulatory costs are allocated across 48 industry subsectors based on the actual costs of ASIC's regulation of each subsector in the previous financial year.[154]

ASIC's estimated budgets for the 2016/2017, 2017/2018 and 2018/2019 years, compared with the budgets for the Australian Competition and

[148] Treasury, *Submission Hearings on Financial Advice*, undated, 4–5; see Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill (Cth) 2017 sch 2 s 102CC, sch 2 s 301C.

[149] Exhibit 2.1.24, November 2014, Financial System Inquiry Final Report, 250–3; *ASIC Supervisory Cost Recovery Levy Act 2017* (Cth).

[150] The Hon Scott Morrison, Treasurer, and The Hon Kelly O'Dwyer, Minister for Small Business and Assistant Treasurer, 'Turnbull Government Bolsters ASIC to Protect Australian Consumers' (Media Release, 20 April 2016).

[151] Commonwealth of Australia, *Budget Paper No. 2 2017–18: Budget Measures*, 22.

[152] ASIC Supervisory Cost Recovery Levy Act 2017 (Cth) s 2; ASIC Supervisory Cost Recovery Levy (Collection) Act 2017 (Cth) s 2.

[153] ASIC Supervisory Cost Recovery Levy (Consequential Amendments) Act 2017 (Cth) sch 1 items 20–7.

[154] ASIC, *ASIC Industry Funding Factsheet* (June 2018) ASIC, 1 <https://download.asic.gov.au/media/4760195/industry-funding_june2018_07.pdf>; see also ASIC, *Report 535: ASIC Cost Recovery Arrangements: 2017–18* (July 2017).

Consumer Commission (ACCC) and the Australian Prudential Regulation Authority (APRA) are:

	2016/2017	2017/2018	2018/2019
	$'000	**$'000**	**$'000**
ASIC	$589,169 (estimated actual)[155]	$636,969 (estimated actual)[156]	$617,962 (estimate)[157]
ACCC	$211,986 (estimated actual)[158]	$243,363 (estimated actual)[159]	$261,722 (estimate)[160]
APRA	$723,856 (estimated actual)[161]	$671,663 (estimated actual)[162]	$682,100 (estimate)[163]

4.5 ASIC Enforcement Review

In October 2016, the government established the ASIC Enforcement Review Taskforce to review ASIC's enforcement regime.[164] The Taskforce issued its report in December 2017.

[155] Treasury, *Portfolio Budget Statements 2017–18: Treasury Portfolio* (Commonwealth of Australia, 9 May 2017) 150.

[156] Treasury, *Portfolio Budget Statements 2018–19: Treasury Portfolio* (Commonwealth of Australia, 8 May 2018) 146.

[157] Treasury, *Portfolio Budget Statements 2018–19: Treasury Portfolio* (Commonwealth of Australia, 8 May 2018) 146.

[158] Treasury, *Portfolio Budget Statements 2017–18: Treasury Portfolio* (Commonwealth of Australia, 9 May 2017) 82.

[159] Treasury, *Portfolio Budget Statements 2018–19: Treasury Portfolio* (Commonwealth of Australia, 8 May 2018) 80.

[160] Treasury, *Portfolio Budget Statements 2018–19: Treasury Portfolio* (Commonwealth of Australia, 8 May 2018) 80.

[161] Treasury, *Portfolio Budget Statements 2017–18: Treasury Portfolio* (Commonwealth of Australia, 9 May 2017) 128.

[162] Treasury, *Portfolio Budget Statements 2018–19: Treasury Portfolio* (Commonwealth of Australia, 8 May 2018) 126.

[163] Treasury, *Portfolio Budget Statements 2018–19: Treasury Portfolio* (Commonwealth of Australia, 8 May 2018) 126.

[164] See generally Treasury, *ASIC Enforcement Review* <https://treasury.gov.au/review/asic-enforcement-review/>.

On 16 April 2018, the government published its response to the Taskforce's final recommendations, agreeing or agreeing in principle to all 50 recommendations of the Taskforce.[165] Implementation of the recommendations in chapters 1 and 4 of the report, relating to self-reporting of contraventions by licensees (including Section 912D of the Corporations Act), industry codes, and ASIC's directions powers respectively, have been deferred until this Commission makes its report.[166] Other recommendations of the Enforcement Review, relating to ASIC search warrant powers, access to telecommunications intercepts licensing and banning powers, need not be described here.

5 Conduct acknowledged by the entities

In their submissions to the Commission, financial services entities acknowledged conduct that amounted to misconduct or conduct falling below community standards and expectations in connection with the provision of financial advice. The following is a summary of the conduct acknowledged by the entities in relation to fees for no service, inappropriate advice and improper conduct by advisers.

5.1 Fees for no service

5.1.1 AMP

AMP acknowledged conduct that it described as involving possible contraventions of the Corporations Act and the ASIC Act in relation to 'fees for no service':

- AMP acknowledged 196 events, across 14 AMP Advice Licensees, of advisers failing to provide customers with services for which they had

[165] Australian Government, *Australian Government Response to the ASIC Enforcement Review Taskforce Report* (April 2018).

[166] Australian Government, *Australian Government Response to the ASIC Enforcement Review Taskforce Report* (April 2018) 2–3, 5–6, 13–14.

paid, during the period 1 July 2008 to 30 June 2015.[167] This resulted in $193,519 having been paid to customers in compensation.[168]

- AMP also acknowledged numerous events that involved an AMP licensee continuing to charge a customer fees for services that were not provided[169] during the period from 1 July 2008 to 30 June 2015.[170] These events occurred in the context of AMP's 'Buyer of Last Resort' policy, its 'ringfencing' practice, fees charged to advisers whose authority had been terminated, and movement of customer registers between AMP practices. AMP also acknowledged possible misconduct in its reporting to ASIC of charging fees for no service.

5.1.2 ANZ

ANZ acknowledged that between 2006 and 2013, more than 10,000 Prime Access customers paid fees for documented annual reviews that were never provided by ANZ financial planners. ANZ also acknowledged that it had identified failures by eight of its authorised representatives to provide documented annual reviews to 813 customers between May 2013 and April 2016.

ANZ acknowledged that from 2003 to 2015, certain entities associated with ANZ deducted fees for ongoing services from the accounts of about 2,900 members of managed investment schemes and superannuation funds. None of the members had an allocated financial adviser, and as a result none of the members received any services. The total fees deducted from the accounts of these members were $931,647.[171]

ANZ also acknowledged that between June 2007 and August 2016, service fees were deducted from customers' accounts in amounts or at rates in

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[167] AMP, *AMP Group Submission*, 29 January 2018, 11 [5.4.5].

[168] AMP, *Schedule A to AMP Group Response to Letter dated 2 February 2018*, 13 February 2018, 2 [8].

[169] AMP, *AMP Group Submission*, 29 January 2018, 12 [5.4.16]; AMP, *Schedule A to AMP Group Response to Letter dated 2 February 2018*, 13 February 2018, 3 [3].

[170] AMP, *AMP Group Response*, 29 January 2018, 12 [5.4.5]; AMP, *Schedule A to AMP Group Response to Letter dated 2 February 2018*, 13 February 2018, 3 [3].

[171] ANZ, *ANZ Submission in Response to the Commission's Letters of 15 December 2017*, 29 January 2018, 12 [5.31].

excess of those quoted in their service agreements. This affected approximately 4,035 customers to a total cost of $4.5 million. During this period ANZ also continued to deduct ongoing service fees from the accounts of certain customers who had cancelled their services. The total number of customers affected by this event has not, at the time of this report, been determined.[172]

On 29 March 2018 (very soon before the Commission was to begin taking evidence on these matters), ANZ entered into an enforceable undertaking with ASIC in respect of the fees for no service misconduct relating to its Prime Access customers. The enforceable undertaking requires ANZ, among other things, to pay a community benefit payment of $3 million and provide audited attestations that the bank has since provided annual reviews to the relevant customers and improved its compliance systems.[173]

5.1.3 CBA

CBA identified instances in the period from July 2007 to June 2015 where clients of CFPL, BW Financial Advice and Count Financial were charged ongoing fees for financial advice where no such services were provided. CBA acknowledged that as at 31 December 2017, approximately $118.5 million in refunds (including interest) has been offered or paid to customers affected by this conduct.[174]

Again, very soon before the Commission was to begin taking evidence on these matters, on 9 April 2018, CFPL and BW Financial Advice entered into an enforceable undertaking with ASIC in relation to a failure to provide, or evidence the provision of, annual reviews to approximately 31,500 'Ongoing Service' customers in the period from July 2007 to June 2015 (for Commonwealth Financial Planning) and from November 2010 to June 2015 (for BW Financial Advice).

Like the ANZ enforceable undertaking, CBA's enforceable undertaking requires the entities, among other things, to pay a community benefit

[172] ANZ, *ANZ Submission in Response to the Commission's letters of 15 December 2017*, 29 January 2018, 13 [5.32].

[173] ASIC, 'ASIC Accepts Enforceable Undertaking from ANZ for Fees for No Service Conduct' (Media Release, 18-092MR, 6 April 2018).

[174] CBA, *Royal Commission into Misconduct into the Banking, Superannuation and Financial Services Industry Submission*, 29 January 2018, 11–12 [39].

payment of $3 million in total, and provide attestations from senior management demonstrating improvements to their compliance systems and processes.[175]

5.1.4 NAB

NAB acknowledged misconduct concerning the charging of Adviser Service Fees between 2008 and 2015, and of Plan Service Fees between September 2012 and January 2017, in circumstances where no adviser was allocated to the client.[176]

NAB told the Commission that as at 31 January 2018, it had paid or agreed to pay:

- approximately $6.6 million in compensation to more than 25,000 clients affected by the misconduct concerning the charging of Adviser Service Fees;[177] and
- approximately $35 million in compensation to more than 220,000 clients affected by the misconduct concerning the charging of Plan Service Fees.

NAB also told the Commission that it was investigating further circumstances where fees were charged to clients but the relevant services may not have been provided.[178]

5.1.5 Westpac

Westpac acknowledged that BT Financial Group commenced an Ongoing Advice Services review program in 2016. This program identified retail clients who, in the period from 1 July 2008 to 31 December 2015, had been

[175] ASIC, 'ASIC Accepts Enforceable Undertaking from Commonwealth Bank Subsidiaries for Fees for No Service Conduct' (Media Release, 18-102MR, 13 April 2018).

[176] NAB, *NAB Group's Response dated 29 January 2018 to the Commission's Letter dated 15 December 2017*, 29 January 2018, 12 [11].

[177] ASIC letter of 29 March 2018, 2.

[178] NAB, *NAB Group's Response dated 29 January 2018 to the Commission's Letter dated 15 December 2017*, 29 January 2018, 12 [11].

charged fees for ongoing advice, where they had not received the service paid for, or evidence of such service being provided could not located.[179]

As at 31 December 2017, BT Financial Group had paid compensation in excess of $3.2 million to 435 clients as a result of issues identified by the Ongoing Advice Services review program.[180] Westpac also noted that its 2016/2017 annual results provisioned approximately $24 million (including interest) for refunds of fee payments identified in the Ongoing Advice Services review program.[181]

5.2 Inappropriate advice

5.2.1 AMP

AMP acknowledged that inappropriate advice by 14 advisers between 1 January 2009 and 30 June 2015 had resulted in compensation to 1,079 customers.[182] The amount of the compensation was not provided.

AMP also acknowledged misconduct that occurred between March 2010 and September 2014, which it described as 'insurance rewriting' conduct. This was said to involve instances where an authorised representative recommended to a customer that they cancel their existing AMP life insurance policy and replace it with a new AMP life insurance policy, which enabled the authorised representative to collect the maximum rate of upfront commission payable. That commission was higher than the commission that would have been payable had the policies been transferred using an 'internal transfer' function.[183]

AMP acknowledged that one former adviser had engaged in this conduct approximately 57 times in respect of 49 clients, leading to compensation for seven customers of about $61,000.[184]

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179 Westpac, *Response of Westpac Banking Corporation*, 29 January 2018, 29.

180 Westpac, *Response of Westpac Banking Corporation*, 29 January 2018, 29.

181 Westpac, *Response of Westpac Banking Corporation*, 29 January 2018, 29.

182 AMP, *Schedule A to AMP Group Response to Letter dated 2 February 2018*, 13 February 2018, 5 [5].

183 AMP, *AMP Group Submission, 29 January 2018*, 9 [5.1.15], [5.3.1], [5.3.3].

184 AMP, *Schedule A to AMP Response to Letter dated 2 February 2018*, 1 [1].

This conduct is the subject of ongoing investigations by ASIC. In the course of those investigations, five other advisers have been identified as having engaged in the same misconduct, with two of those advisers now banned by ASIC.[185]

5.2.2 ANZ

Among its notifications to ASIC, ANZ acknowledged there were more than 30 events of misconduct or potential misconduct in relation to the appropriateness of advice.[186] This included advice that had been provided with a lack of a reasonable basis,[187] advice that was of little or no benefit to the customer, but generated fees for the adviser;[188] cases where there was no evidence that sufficient research had been undertaken before advice was given;[189] and cases where advisers had not accurately disclosed fees.[190]

5.2.3 CBA

CBA acknowledged that in the period since 1 January 2013:

- It had made 20 breach notifications to ASIC in relation to actual or likely breaches of the Corporations Act by an adviser licensed by CFPL, Financial Wisdom or Count Financial.
- It had made a further five breach notifications in relation to advisers identified through file reviews that were conducted in accordance with the

[185] AMP, *Schedule A to AMP Group Response to Letter dated 2 February 2018*, 13 February 2018, 1 [1].

[186] ANZ, *ANZ Response to the Commission's Letter of 2 February 2018*, 13 February 2018, items 6–7, 9–15, 18, 20–9, 32, 34–5, 37–9, 43–53, 128.

[187] ANZ, *ANZ Response to the Commission's Letter of 2 February 2018*, 13 February 2018, item 22.

[188] ANZ, *ANZ Response to the Commission's Letter of 2 February 2018*, 13 February 2018, item 15.

[189] ANZ, *ANZ Response to the Commission's Letter of 2 February 2018*, 13 February 2018, item 29.

[190] ANZ, *ANZ Response to the Commission's Letter of 2 February 2018*, 13 February 2018, item 45.

Additional Licence Conditions applied to the financial services licences held by CFPL and Financial Wisdom.

- It had made notifications in respect of a further 20 advisers in relation to serious compliance concerns.
- It had made good governance notifications in respect of a further 13 advisers, which largely related to signature irregularities in documents on client files.
- Fifteen former CBA employees or representatives have been the subject of ASIC banning orders or enforceable undertakings since 1 January 2013.
- As at 31 December 2017, it has paid or offered to pay approximately $96 million to customers relating to the provision of poor financial advice or adviser misconduct.

5.2.4 NAB

In its submissions to the Commission NAB did not always distinguish between adviser misconduct involving inappropriate advice and other improper conduct. NAB acknowledged that, in the period from 1 January 2009 to 29 January 2018, it had notified ASIC or otherwise discussed with ASIC approximately 68 advisers whom NAB had identified as giving rise to serious compliance concerns. This included conduct involving multiple instances of inappropriate advice leading to customer loss, backdating of documents, misleading statements, and repeated compliance breaches.[191]

NAB acknowledged that, in the period from 1 January 2009 to 29 January 2018, it had identified instances where customers had been provided with inappropriate advice that failed to comply with the requirement to have a reasonable basis for advice and to act in the customer's best interests, including an unspecified number of instances of:

- failing to provide advice tailored to the customers' objectives or appropriate for the customers' risk tolerance;

[191] NAB, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry NAB Group's Response dated 29 January 2018 to the Commission's Letter dated 15 December 2017*, 29 January 2018, item 5.

- recommending a geared strategy that was inappropriate; and
- failing to recommend withdrawal from a geared financial product during a cooling off period when the customer's circumstances had changed.[192]

NAB also acknowledged that it had identified an unspecified number of other instances where customers had been provided with inappropriate advice about insurance, including:

- failing to give appropriate insurance advice given the customer's individual circumstances, including advice resulting in a customer being uninsured;
- cancelling a customer's insurance policies before new insurance was in place; and
- recommending a switch to new insurance that did not benefit the customer.[193]

5.2.5 Westpac

A significant ASIC review, established in 2015 and known as the 'Advice Compliance Program', identified 22 Westpac financial advisers who had provided inappropriate advice and who were reported to ASIC.[194]

BT Financial Group participated in ASIC's Advice Compliance Project, as a result of which a further 11 financial advisers were identified as potentially providing 'problematic advice'.[195] Since 2015, BT Financial Group has identified a further 15 advisers who may have given inappropriate advice.[196]

[192] NAB, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry NAB Group's Response dated 29 January 2018 to the Commission's Letter dated 15 December 2017*, 29 January 2018, item 6.

[193] NAB, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry NAB Group's Response dated 29 January 2018 to the Commission's Letter dated 15 December 2017*, 29 January 2018, item 7.

[194] Westpac, *Response of Westpac Banking Corporation*, 29 January 2018, 29.

[195] Westpac, *Response of Westpac Banking Corporation*, 29 January 2018, 29.

[196] Westpac, *Response of Westpac Banking Corporation*, 29 January 2018, 29.

As at 29 January 2017, Westpac had paid a total of $12.568 million in compensation to 205 clients, with a further $1.024 million in compensation offered but not yet accepted.

When Westpac made its initial submission to the Commission on 29 January 2018, Westpac had not completed its review of the advice received by 468 customers who had been given advice by the initial 22 advisers.[197]

Westpac also provided to the Commission some specific examples of the inappropriate advice of four advisers, being:

- an adviser who provided inappropriate personal advice primarily relating to gearing recommendations, with 116 clients requiring remediation;[198]
- an adviser who had provided inappropriate advice relating to establishment of SMSFs and using limited recourse borrowing arrangements to fund the purchase of real property;[199]
- two advisers whose conduct gave rise to concerns of inadequate disclosure, charging of ongoing fees without providing the relevant services, inadequate documentation of client goals and objectives, inadequate risk profiling and no documented reasonable basis for advice provided or superannuation switching; and
- an adviser who had provided standardised advice across his client base and recorded identical goals and objectives for many of his clients.[200]

These four advisers were reported to ASIC, and three have been the subject of banning orders.[201]

197 Westpac, *Response of Westpac Banking Corporation*, 29 January 2018, 32.

198 Westpac, *Response of Westpac Banking Corporation*, 29 January 2018, 30.

199 Westpac, *Response of Westpac Banking Corporation*, 29 January 2018, 30.

200 Westpac, *Response of Westpac Banking Corporation*, 29 January 2018, 31.

201 Westpac, *Response of Westpac Banking Corporation*, 29 January 2018, 30–1.

5.3 Improper conduct by advisers

5.3.1 AMP

AMP acknowledged that since 2009, it had identified:[202]

- 81 advisers with potential 'Serious Compliance Concerns', a phrase defined by ASIC as including circumstances where a person has engaged in conduct that is dishonest, illegal, deceptive and/or fraudulent, or gross incompetence or gross negligence; and
- 440 advisers with potential 'Other Compliance Concerns', a phrase defined by ASIC as including circumstances where a person has engaged in conduct that would be a breach of internal business rules or standards, result in an adverse finding from audits conducted by or for the licensee or result in actual or potential financial loss to clients as a result of advice received.

In February 2018, AMP provided a supplementary submission to the Commission in which it acknowledged further identified possible misconduct including:

- about 126 additional advisers who had engaged in possible misconduct such as charging fees for no service and providing inappropriate advice.[203] Of those advisers, AMP identified only one as currently being in the remediation program;[204] and
- 28 advisers who had engaged in conduct that breached a statute, regulation, standard or code.[205]

[202] AMP, *AMP Group Submission*, 29 January 2018, 14 [5.5.7]; AMP, *Schedule A to AMP Group Response to Letter dated 2 February 2018*, 13 February 2018, Schedule B 7 [6.2].

[203] AMP, *21 February 2018 Submissions to Royal Commission,* 21 February 2018, tables 1–8.

[204] AMP, *21 February 2018 Submissions to Royal Commission,* 21 February 2018, Table 1 item 40.

[205] AMP, *21 February 2018 Submissions to Royal Commission,* 21 February 2018, items 3, 5, 10–1, 13–22, 24, 26–30, 32–4, 36–7, 39–41.

5.3.2 ANZ

ANZ acknowledged that, in response to a notice issued by ASIC in 2015, it had identified 39 advisers who were employed or authorised by ANZ and who had engaged in improper or non-compliant conduct between 1 January 2009 and 7 July 2015. Between 1 July 2015 and 31 December 2017, ANZ made an additional 40 reports or notifications to ASIC concerning the conduct of a total of 41 financial advisers or authorised representatives.[206] The adviser misconduct covered by these notifications included improper use of customer funds, misleading conduct concerning advisers' qualifications or authorisations, falsifying customer or compliance documentation, deliberate overcharging of fees, provision of poor quality advice and failure to comply with disclosure obligations.[207]

ANZ also acknowledged at least 56 events of misconduct or potential misconduct relating to improper conduct by financial advisers.[208] These included circumstances where customer signatures were forged or falsified,[209] customers impersonated,[210] there had been fraudulent uses of powers of attorney,[211] where financial advisors falsely witnessed documents or facilitated documents being falsely witnessed,[212] or where customer funds had been transferred into a financial adviser's personal bank account.[213]

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206 ANZ, *ANZ Submission in Response to the Commission's Letters of 15 December 2017*, 29 January 2018, 8–9 [5.18]–[5.20].

207 ANZ, *ANZ Submission in Response to the Commission's Letters of 15 December 2017*, 29 January 2018, 9–10 [5.21].

208 ANZ, *ANZ Response to the Commission's Letter of 2 February 2018*, items 6, 8, 9, 12, 16–17, 19, 22, 25, 29, 30–3, 36–8, 40–2, 51, 54–88.

209 ANZ, *ANZ Response to the Commission's Letter of 2 February 2018*, 13 February 2018, items 8, 12, 19.

210 ANZ, *ANZ Response to the Commission's Letter of 2 February 2018*, 13 February 2018, 30.

211 ANZ, *ANZ Response to the Commission's Letter of 2 February 2018*, 13 February 2018, item 31.

212 See, eg, ANZ, *ANZ Response to the Commission's Letter of 2 February 2018*, 13 February 2018, items 51, 59, 60.

213 ANZ, *ANZ Response to the Commission's Letter of 2 February 2018*, 13 February 2018, items 27, 31.

ANZ also acknowledged that on 14 January 2018, it had notified ASIC that a further 29 advisers had falsely witnessed, or facilitated the false witnessing of, certain forms signed by customers.[214]

Further, ANZ acknowledged misconduct by ANZ Financial Planning in failing to pay agreed rebates on approximately $8.5 million in trail commissions to approximately 6,800 customers between 2009 and 2017. At the time of the Round 2 hearing, ANZ estimated it would pay affected customers in excess of $12.5 million in total in remediation in respect of this misconduct, including lost earnings of approximately $4.8 million.[215]

5.3.3 CBA

In its third submission to the Commission, CBA acknowledged 76 specific events of misconduct over the last five years that related to financial advice. These included instances of problems with customer documentation and signatures, failure to comply with disclosure requirements, and asset allocations that failed to align with customer risk profiles.

5.3.4 NAB

In its January 2018 submission to the Commission, NAB identified instances of improper conduct by employed financial advisers and authorised representatives of NAB Wealth entities, including:

- dishonest or otherwise serious illegal conduct such as misappropriation of funds and the provision of advice to invest in a company in which the authorised representative had a financial interest between at least 2011 and 2016;
- involvement or potential involvement in inappropriate early release schemes between at least 2016 and 2017 allowing members access to superannuation benefits before they became entitled to them; and

[214] ANZ, *ANZ Response to the Commission's Letter of 2 February 2018*, 13 February 2018, items 57–70, 72–9, 81–4, 86–8.

[215] ANZ, *ANZ Response to the Commission's Letter of 2 February 2018*, 13 February 2018, item 90.

- the provision of advice by advisers outside the scope of their Letters of Authority between at least 2009 and October 2016.[216]

In addition, NAB acknowledged that, in the period from 1 January 2009 to 29 January 2018, there were instances where it had failed to prevent the misappropriation of customer funds, including misappropriation by financial advisers.[217]

NAB acknowledged that between 1 January 2010 and 30 September 2017, it had paid approximately $38 million to customers, which it said included amounts (which were not specified) paid as compensation to customers for financial adviser misconduct.[218]

The acknowledgments of improper conduct by NAB also included an acknowledgment that, as at October 2017, it had identified 353 NAB employees who had been involved in incorrectly witnessing binding beneficiary nomination forms for superannuation funds. This incorrect witnessing potentially affected the validity of beneficiary nomination forms for about 2,520 customers.

NAB also acknowledged a number of issues in relation to the disclosure that it made to its customers, including a number of NAB Group licensees that had failed to disclose relationships between advisers, advice licensees, and other members of the Group that issue investment products from 2008 to March 2016.[219]

NAB also acknowledged that, in the period from 2008 to March 2016, approximately 150,000 customers received deficient disclosure either

[216] NAB, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry NAB Group's Response dated 29 January 2018 to the Commission's Letter dated 15 December 2017*, 29 January 2018, item 8.

[217] NAB, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry NAB Group's Response dated 29 January 2018 to the Commission's Letter dated 15 December 2017*, 29 January 2018, item 9.

[218] NAB, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry NAB Group's Response dated 29 January 2018 to the Commission's Letter dated 15 December 2017*, 29 January 2018, item 5.

[219] NAB, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry NAB Group's Response dated 29 January 2018 to the Commission's Letter dated 15 December 2017*, 29 January 2018, item 21.

in statements of advice or Financial Services Guides in relation to MLC-branded products and other investment manager products.[220]

5.3.5 Westpac

Westpac acknowledged that a BT Financial Group adviser had established 72 life insurance policies in the names of clients with no existing accounts, with a view to dishonestly obtaining a benefit through the sale of these policies. Criminal charges were laid by Victoria Police and the adviser was permanently banned by ASIC.[221]

Westpac also identified that a financial adviser employed by an authorised representative of Magnitude had performed unauthorised transactions in accounts of five of her clients. Three of these clients suffered losses as a result of these transactions. The adviser was criminally prosecuted and sentenced for charges including theft.[222]

Westpac acknowledged that $2.75 million has been paid to 1,996 impacted customers as a result of advice fees paid between 1998 and 2012 for BT 'Investment Wrap' or 'SuperWrap' products that may have been higher than the maximum fee ranges noted in some disclosure documents.[223]

6 What the case studies show

Clients of financial advisers or financial advice licensees being charged fees for services not provided to them is now rightly recognised to have been a large and endemic problem in the industry.

What is said at the start of this chapter should be repeated. **Charging for doing what you do not do is dishonest. No-one needs legal advice to**

[220] NAB, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry NAB Group's Response dated 29 January 2018 to the Commission's Letter dated 15 December 2017*, 29 January 2018, item 21.

[221] Westpac, *Response of Westpac Banking Corporation*, 29 January 2018, 32.

[222] Westpac, *Response of Westpac Banking Corporation*, 29 January 2018, 31.

[223] Westpac, *Response of Westpac Banking Corporation*, 29 January 2018, 34.

tell them that. The root cause for what happened was greed; the greed of both licensees and advisers:

- **Licensees treated the *provision* of ongoing services as a matter of no concern to them. Provision of the services was treated as a matter between only the client and the adviser.** At least when an adviser left the licensee, and the client became an 'orphan client', the licensee knew that that adviser would *not* be providing ongoing services to that client. But the licensees did nothing in response. They simply continued to take the money that was deducted from the client's investments in payment of the ongoing service fee.
- **Advisers often treated ongoing service arrangements as though they were nothing but trail commissions for the advice that had already been given.** The fees were both a steady source of income (for little or no effort) and an important element that would contribute to the capital value of the adviser's business. In some cases, advisers continued to charge ongoing service fees even though the client was dead and had died years earlier.[224] Even in those cases, the licensee did not terminate the adviser's contract for dishonesty; the licensee simply 'warned' the adviser not to continue the conduct.
- **Clients seldom complained about being charged for nothing. They did not complain because the fees they paid were charged invisibly.**
- **Whether the conduct is said to have been moved by 'greed', 'avarice', or 'the pursuit of profit', it is conduct that ignored the most basic standards of honesty.**
- **The licensees did nothing to stop it and they took the proceeds.**
- **The conduct of licensees and advisers was inexcusable and no-one has since tried to excuse it.**
- **No-one has been subjected to any formal public process of investigation, finding and punishment for this conduct. Only at the last minute before the hearings began, did enforceable**

[224] Transcript, Marianne Perkovic, 19 April 2018, 1340–1, describing cases identified in the business of Count Financial Ltd; see also Exhibit 2.90, December 2015, Count Risk & Compliance Forum, 25.

undertakings yield public (and then very limited) formal acknowledgment from entities that ASIC had 'concerns' about their conduct and that those concerns were 'reasonably held'.

- **Even when the Commission was taking evidence about the issue, the licensees had not made good their defaults by compensating all their affected clients.**

As already noted, the four largest banks and AMP all acknowledged in their initial submissions to the Commission that they or their associated entities had charged clients fees for personal financial advice that had not been provided.[225] In most cases, the client had made an 'ongoing service agreement' with a licensee for the provision of personal advice and other services and had been allocated an adviser. The adviser did not provide the ongoing service and the licensee did not ensure that the service was provided. Typically, the fees were deducted automatically from the client's investment account balance.[226]

The nature and extent of the 'fees for no service' issue was described in the evidence of Mr Kell, Deputy Chair of ASIC. At 31 January 2018, AMP, ANZ, CBA, NAB and Westpac had paid, or agreed to pay, to almost 306,000 customers, combined compensation of more than $216 million.[227] Three of those entities, ANZ, CBA and NAB, had reported to ASIC that they estimated that further compensation of at least $2.5 million would be paid;[228]

[225] AMP, AMP Group Submission, 29 January 2018, 10–13 [5.4.1]–[5.4.23]; ANZ, ANZ Submission in Response to the Commission's Letters of 15 December 2017, 29 January 2018, 7–8 [5.8]–[5.17], 12–13 [5.31]–[5.35]; ANZ, ANZ Response to the Commission's Letter of 2 February 2018, 13 February 2018, items 1, 92–5; CBA, Submission, 29 January 2018, 11–13 [39]–[45]; NAB, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry NAB Group's Response dated 29 January 2018 to the Commission's Letter dated 15 December 2017, 29 January 2018, items 11–12; Westpac, Response of Westpac Banking Corporation, 29 January 2018, 29, 31.

[226] See generally Exhibit 2.1, Witness statement of Peter Kell, 12 April 2018, 1–2 [7]–[11].

[227] Exhibit 2.1, Witness statement of Peter Kell, 12 April 2018, Exhibit PK- 3 [ASIC.0902.0001.3370 at .3370].

[228] Being ANZ, CBA and NAB, Exhibit 2.1, Witness statement of Peter Kell, 12 April 2018, Exhibit PK-3 [ASIC.0902.0001.3370 at.3370].

Westpac had told ASIC that the amount of future compensation was not likely to be material;[229] the last, AMP, provided no estimate.[230]

In 2014, ASIC started its 'Wealth Management Project', a major project focusing upon the financial advice businesses conducted by ANZ, CBA, NAB, Macquarie, Westpac and AMP. In April 2015, ASIC announced that it was 'investigating multiple instances of licensees charging clients for financial advice, including annual advice reviews, where the advice was not provided'.[231] ASIC said that it would 'consider all regulatory options, including enforcement action' where it found evidence of breaches of the law and that it would 'look to ensure that advice licensees follow a proper process of customer remediation and reimbursement of fees where such breaches have occurred'.[232] As events turned out, however, until immediately before the time the Commission began taking evidence about fees for no service, ASIC had undertaken some investigations and had pursued remediation, but had taken no enforcement action.[233] Rather, as Mr Kell said, '[m]ost of ASIC's work in the [Fees for no Service] project [had] focused on remediation'.[234] And it was not until a few days before the hearings began that ASIC announced first, that it had agreed with ANZ that ANZ would give an enforceable undertaking and then, a few days later, that it had agreed with CBA that two of CBA's financial advice licensees (CFPL and Bankwest Financial Advice [BWFA], a CBA licensee that ceased to provide advice in 2016) would give an enforceable undertaking in relation to the charging of fees for no service.

In October 2016, ASIC reported that AMP, ANZ, CBA and NAB had all identified systemic issues in relation to the charging of ongoing service fees;

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229 Being Westpac, Witness statement of Peter Kell, 12 April 2018, Exhibit PK-3 [ASIC.0902.0001.3370 at .3370]

230 Being AMP, Exhibit 2.1, Witness statement of Peter Kell, 12 April 2018, Exhibit PK-3 [ASIC.0902.0001.3370 at .3370].

231 Exhibit 2.1, Witness statement of Peter Kell, 12 April 2018, Exhibit PK-2 [ASIC.0902.0001.0941].

232 Exhibit 2.1, Witness statement of Peter Kell, 12 April 2018, Exhibit PK-2 [ASIC.0902.0001.0941].

233 Exhibit 2.1, Witness statement of Peter Kell, 12 April 2018, Exhibit PK-4 [ASIC.0902.0001.3189].

234 Exhibit 2.1, Witness statement of Peter Kell, 12 April 2018, 11 [42].

Westpac had identified a systemic issue 'in relation to one adviser only'; Macquarie had not identified any systemic failures in respect of fees for no service.[235] ASIC said that '[m]ost of the systemic failures identified' had occurred before the FoFA reforms, which came into effect on 1 July 2013.[236] But the report also revealed that, as at 31 August 2016, compensation arising from fees for no service was estimated to be more than $178 million in respect of about 200,000 customers,[237] and that, by 31 August 2016, about $23.7 million and had been paid, or agreed to be paid to over 27,000 customers. Between 31 August 2016 and 31 January 2018, the total compensation paid or agreed to be paid and the number of customers affected increased markedly, to the figures given by Mr Kell in his evidence: more than $216 million and more than 305,000. And, contrary to the tenor of ASIC's 2016 report, the evidence to the Commission showed that there had been some significant systemic failures after the FoFA reforms. The most notable of those failures examined in evidence related to AMP and its conduct of continuing to charge fees to clients whose advisers had sold their businesses to AMP as the 'buyer of last resort'.

No doubt the advice licensees would say that undertaking remediation programs for clients who had been charged fees for no services constituted their acknowledgment of wrongdoing. But there has been no formal public condemnation of what occurred. The only formal and public steps that have been taken with respect to this issue, beyond ASIC issuing its reports and Press Releases, was ASIC's acceptance, very soon before the Commission began its hearings about fees for no service, of the ANZ and CBA enforceable undertakings.[238] The undertakings went no further than to record ASIC's 'concerns' and that the relevant entities acknowledge that those concerns are 'reasonably held'.

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235 ASIC, *Report 499: Financial Advice: Fees for No Service*, October 2016, 5 [7].

236 ASIC, *Report 499: Financial Advice: Fees for No Service*, October 2016, 6 [16].

237 ASIC, *Report 499: Financial Advice: Fees for No Service*, October 2016, 7.

238 ASIC, *Enforceable Undertaking,* 29 March 2018, 5 pt 3; ASIC, 'ASIC Accepts Enforceable Undertaking from ANZ for Fees for No Service Conduct' (Media Release, 18-092MR, 6 April 2018); ASIC, *Enforceable Undertaking,* 9 April 2018, 9 [3.5.5]; ASIC, 'ASIC Accepts Enforceable Undertaking from Commonwealth Bank Subsidiaries for Fees for No Service Conduct' (Media Release, 18-102MR, 13 April 2018).

This is well short of a full and frank acknowledgment by the entities that what they had done was wrong. No doubt ANZ and CBA would point to their having each agreed to 'make a community benefit payment' of $3 million. But if paying that negotiated amount is to be understood as some form of penalty marking the public denunciation of the licensees' conduct, it seems small compared with the amounts of money that the remediation programs show have been needed to make good the damage done to clients: nearly $90 million in the case of the CBA licensees and nearly $50 million in ANZ's case.

Several separate groups of issue arise from clients having been charged for advice services that were not provided.

- **How and why did these events occur?**
- **Why were these events not prevented from occurring?**
- **Why were they not detected sooner?**
- **How effective have been the remediation processes?**

Those issues can be described as issues about: causes, prevention, detection and remediation. As will be explained, issues of prevention and detection are closely connected with the issues about causes.

7 Fees for no service

7.1 Causes

In its 2016 report, ASIC reported that, during the time fees were being charged for no service:

- **The financial advice industry had a culture of reliance on automatic periodic payments such as sales commissions and adviser service fees;**
- **Some advice licensees prioritised advice revenue and fee generation over ensuring that they delivered the required services;**
- **Some licensees and advisers did not keep adequate records to enable monitoring and analysis; and**

- **Some licensees did not develop and enforce effective monitoring and checking procedures to prevent systemic failures.**[239]

No doubt these observations were then, and remain, accurate. But, as expressed, they are observations that do not go far beyond the proposition that fees were charged for no service. Several further points must be made.

The first is obvious. As said above, **charging for doing what you do not do is wrong**. No doubt, as Mr Regan, AMP's Group Executive, Advice and New Zealand, pointed out, fees were charged for no service at times that saw great legal and regulatory change. But contrary to Mr Regan's evidence, neither the pace nor the extent of regulatory change made any contribution to the occurrence of these events.[240] As Mr Regan himself accepted, charging fees for no service is obviously wrong.[241]

Second, and equally obviously, **making an ongoing service arrangement gives the adviser a financial advantage**. The adviser stands to earn, and to continue to earn, annual amounts from the client. The less the adviser does before the fee is paid, the greater the financial advantage. And, as ASIC noted in its 2016 report, licensees did not have systems in place to ensure that *any* services were provided in return for the fees being charged, but licensees did have systems that recorded incoming revenue.[242]

Third, **licensees did nothing to prevent advisers having more customers on their books than they could monitor or advise annually**. Often, the advisers had 'acquired' (or 'inherited') those clients from some other adviser.[243] And licensees, like AMP and its associated entities, that have provided, and continue to provide, 'buyer of last resort' arrangements for advisers who wish to leave the business not only facilitate, but actively encourage, the treatment of client books as a tradeable asset to be valued

[239] ASIC, *Report 499: Financial Advice: Fees for No Service*, October 2016, 8 Table 1.

[240] cf Exhibit 2.13, Witness statement of Anthony George Regan, 11 April 2018, 54.

[241] Transcript, Anthony George Regan, 16 April 2018, 1072–3.

[242] ASIC, *Report 499: Financial Advice: Fees for No Service*, October 2016, 39–40 [191].

[243] ASIC, *Report 499: Financial advice: Fees for No Service*, October 2016, 40 [191(b)].

as a multiple of annual income earned. Annual income consists of commissions and fees paid by clients.[244]

Fourth, **the services to be provided under ongoing service arrangements were, and still are, often neither well-defined nor onerous**. Witness evidence showed how the services to be provided under ongoing service arrangements may not only be very loosely defined but also defined in a way that has little or no substantive content beyond a promise to speak with the client once each year. Describing the services (as Mr Michael Wright, the national head of BT Financial Advice did) as 'strategic advice and reassurance' may encourage both adviser and client to see providing the ongoing services as a matter of form rather than substance and as not a matter of any immediate or pressing moment or value. What exactly was, or is, to be provided in an 'annual review'? What is meant when it is said that the client may 'have access' to the adviser? Was (or is) the only promise made to 'offer' an annual review? And some advisers have in the past charged fees for services that ASIC said had 'limited' (I would say no) value such as maintaining records that the law required the advisers to maintain and retain.[245]

As ASIC pointed out in its submissions, the promised services, even if provided, may not give the client a benefit commensurate with their cost. If, as each of Ms Marianne Perkovic (on behalf of CBA), Mr Regan (on behalf of AMP) and Mr Darren Williams (on behalf of ANZ) said may be the case, the future advice fee is fixed as a percentage of the 'funds under advice' (rather than as a fixed dollar sum), the question of value for money is all the more evident. Ms Perkovic said that the maximum fee charged by CFPL, under its Legacy package, was 0.94% of funds under advice;[246] Mr Regan produced an example of an agreement between an adviser at Hillross and a client where the ongoing service fee was fixed at 0.6% of funds under advice;[247] Mr Williams said that some ongoing service fees were calculated

[244] Transcript, Anthony George Regan, 16 April 2018, 1062.

[245] ASIC, *Report 499: Financial Advice: Fees for No Service*, October 2016, 40.

[246] Exhibit 2.73, Witness statement of Marianne Perkovic, 3 April 2018, 5 [29].

[247] Exhibit 2.13, Witness statement of Anthony George Regan, 11 April 2018, Exhibit AGR-1 [AMP.6000.0020.0234]; see also Transcript, Anthony George Regan, 16 April 2018, 1059.

as a percentage of the fees under advice but that other such fees were fixed as a flat dollar amount.[248]

When asked to describe what was generally provided under ongoing advice arrangements, Mr Wright said, that 'before FoFA, the conversation was much more around performance.' Post-FoFA, and particularly now in our business, the conversation is much more around *strategic advice and reassurance*.'[249] Mr Wright spoke also of now using the 'conversation' to reflect on statutory changes, and ensuring that strategic advice was going to meet the client's goals and aspirations by, if needs be, 'rebalanc[ing] or reposition[ing]' to meet those goals.[250]

Subject to one important qualification, the description that Ms Perkovic, Mr Regan and Mr Williams gave of ongoing services was not substantially different from the description given by Mr Wright. The qualification that must be noted is that Ms Perkovic described the 'core component of ongoing services' as an annual review[251] but, according to Ms Perkovic, at least in the case of BWFA, the mere offer of an annual review was sufficient for the fee to be charged.[252]

If done properly, an annual review might require the application of a deal of time, skill and judgment. Whether it did would depend not only upon the skill and diligence of the adviser but also upon what investments the client had, whether the client's circumstances had changed and whether investment conditions had changed either generally or in relation to one or more of the products in which the client had invested. Absent extraordinary external events or radical change in the client's personal position, it would be very easy to provide the service with little time and little effort. And, as pointed out above, the less the work that is done, the greater the financial advantage to the adviser.

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[248] Exhibit 2.92, Witness statement of Darren John Williams, 13 April 2018, 10–11.

[249] Transcript, Michael Wright, 20 April 2018, 1450 (emphasis added).

[250] Transcript, Michael Wright, 20 April 2018, 1450.

[251] Provided in the past, by one CBA licensee, BWFA, by telephone. See Exhibit 2.73, Witness statement of Marianne Perkovic, 3 April 2018, 4 [24], 9 [62].

[252] Transcript, Marianne Perkovic, 18 April 2018, 1289–92.

The fifth consideration to notice is that **the fees charged under ongoing service arrangements were, and still are, often charged 'invisibly': by being deducted from the client's investment accounts**. If there is no recognition of a pressing need for the services and the charge is deducted automatically against funds under investment, neither adviser nor client may think about whether the services promised have been or should be provided. A line in a periodic investment statement recording the payment will draw the matter to attention *only* if the client is attentive enough to look beyond the total given at the foot of the statement. And there are many who will not do that. Whether a fee disclosure statement draws the matter to the client's attention may depend upon what emphasis the adviser gives when presenting the statement to how beneficial the adviser's past advice has been, and how well the client's investments have proved or are proving to be.

Sixth, **before the FoFA reforms required advisers to obtain client agreement every two years for the provision of ongoing services, the client may have made the agreement for ongoing services at the time advice was first provided and neither then nor thereafter adverted to, or been reminded of, the adviser's obligation**.

Seventh, **income from trail commissions was, and remains, an important part of the revenue earned from the provision of financial advice**. This is consistent with ASIC's observation of an industry culture that relies on automatic periodic payments from customers.[253] The highest source of revenue for financial advisers providing advice on behalf of three out of AMP's four advice licensees for every year between 2008 and 2018 (for which AMP had records)[254] was ongoing or trail commissions.[255] And for the fourth of those advice licensees, where fees for service were the largest source of revenue for advisers, the advisers were employees of the licensee.

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253 ASIC, *Report 499: Financial Advice: Fees for No Service*, October 2016, 8.

254 AMP did not have records about revenue sources for two entities (Charter and iPac) for 2008–2011 because those entities were not then part of AMP. See Exhibit 2.171, Witness statement of Anthony George Regan, 11 April 2018, 21 [78].

255 Exhibit 2.171, Witness statement of Anthony George Regan, 11 April 2018, 19–21 [77]–[78].

Yet Mr Wright gave evidence that, despite clients not coming to an adviser asking for ongoing advice,[256] most clients of authorised representatives of the financial advice businesses conducted by Westpac's advice licensees, (Magnitude and Securitor) would be on an ongoing advice arrangement.[257] (He said that fewer clients of Westpac's *employed* financial advisers would have ongoing arrangements. Even so, it is to be noted that one of the case studies showed that Mr Mahadevan, an adviser employed by Westpac, signed Mr and Mrs McDowall up for ongoing advice at a fee of $3,000 per annum.[258] The point not having been explored in evidence, one can only wonder what the purpose of that ongoing advice might have been thought to be.)

Taken together, these considerations, and those identified by ASIC in its 2016 report, point firmly towards the simple conclusions that the root cause of the fees for no service conduct was greed: greed by licensees; greed by advisers.

7.2 Prevention and detection

As the remediation figures show, **the large entities did not prevent fees being charged for no service. They had neither the systems nor the processes to know whether their authorised representatives were delivering what had been promised. Hence the failure to provide services could not be detected. And how and why the events occurred show why they did not come to light sooner.**

As already noted, the licensees did not have systems or processes that allowed the licensee to monitor whether the adviser was delivering whatever services had been promised.[259] One of the elements of the ANZ and CBA enforceable undertakings was to have senior management attest that the relevant licensee's compliance systems and processes were (at the time of the undertaking) reasonably adequate to track the licensee's contractual obligations to its ongoing service clients. ANZ's attestation was to be

[256] Transcript, Michael Wright, 20 April 2018, 1451.

[257] Transcript, Michael Wright, 20 April 2018, 1449–50.

[258] Exhibit 2.98, Witness statement of Jacqueline McDowall, 4 April 2018, Exhibit JM-2 [WIT.0900.0001.0037 at .0059].

[259] ASIC, *Report 499: Financial Advice: Fees for No Service*, October 2016, 39–41.

'audited';[260] the attestation relating to CFPL (BWFA having ceased to carry on advice business) was to be 'supported by an expert report'.[261]

In its 2016 report, ASIC recorded the changes that some licensees – AMP, ANZ, CBA and NAB – had made to their systems to prevent a recurrence of charging fees for no service. Those changes varied from changing system controls,[262] to altering record keeping and oversight.[263]

But some at least of the chief causes of the issue remained, not least the enticing call of profit, the uncertain content of what was promised and the capacity to deduct the fees invisibly.

The uncertainty of the content of what is promised is not an issue to be solved by regulation. It is, and must be, a matter for client and adviser to decide what if any services will be provided after the provision of initial advice. It is, and must be, a matter for client and adviser to decide how those services are defined. But it is consistent with the policies that underpinned the FoFA reforms to consider first, how long a contract for future services can be made and second, what responsibility any entity asking for payment of fees for future services should have for verifying that the client has authorised the payment.

Under existing law, advisers cannot charge for the provision of ongoing advice unless the client has positively renewed the instruction to provide ongoing advice during a 30-day renewal period that commences no later than two years after making or renewing the ongoing fees arrangement.[264] Should that period be reduced? **Should the adviser and client have to renegotiate an ongoing service arrangement annually?**

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[260] ASIC, *Enforceable Undertaking,* 29 March 2018, 5 pt 3; see also ASIC, 'ASIC Accepts Enforceable Undertaking from ANZ for Fees for No Service Conduct' (Media Release, 18-092MR, 6 April 2018).

[261] ASIC, *Enforceable Undertaking,* 9 April 2018, 9 [3.5.5]; see also ASIC, 'ASIC Accepts Enforceable Undertaking from Commonwealth Bank Subsidiaries for Fees for No Service Conduct' (Media Release, 18-102MR, 13 April 2018).

[262] ASIC, *Report 499: Financial Advice: Fees for No Service*, October 2016, 35–8.

[263] ASIC, *Report 499: Financial Advice: Fees for No Service*, October 2016, 36–8.

[264] Corporations Act pt 7.7A div 3 ss 962A–962Q, see especially ss 962K, 962L.

Often, clients will invest funds through platform or other arrangements conducted by entities associated with the adviser's **financial services licensee**. Whether or not those investment entities are associated with the adviser or the adviser's licensee, **should the investment entity deduct amounts that are to be paid to the licensee, the adviser or both, without express authority from the client? Should that authority operate for only the period fixed by the ongoing service arrangement made between adviser and client in accordance with the ongoing fees provisions of the Corporations Act?**

7.3 Remediation

In September 2016, ASIC published Regulatory Guide 256: Client Review and Remediation Conducted by Advice Licensees (RG 256). The central premise for the guide is that a financial services licensee's general obligation to 'do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly'[265] requires licensees to take 'responsibility for the consequences of their actions if things go wrong when financial services are provided and clients suffer loss or detriment'.[266] And because the licensee is responsible for the conduct of its representative,[267] the regulatory guide goes on to say that the licensee's obligations include 'remediating clients who have suffered loss or detriment as a result of misconduct or other compliance failure by the licensee or its current or former representatives'.[268]

No person who gave evidence to the Commission sought to dispute that the obligation to provide services 'efficiently, fairly and honestly' entails that the licensee must identify and compensate clients who have, in the words of RG 256, 'suffered loss or detriment as a result of misconduct or other compliance failure by the licensee or its current or former representatives'. The focus for debate in both the submissions and the evidence given to the Commission was about the ways in which the obligation was being

[265] Corporations Act s 912A(1)(a).

[266] ASIC, Regulatory Guide 256: Client Review and Remediation Conducted by Advice Licensees, September 2016, 6 reg 256.14.

[267] Corporations Act s 917B.

[268] ASIC, Regulatory Guide 256: Client Review and Remediation Conducted by Advice Licensees, September 2016, 6–7 reg 256.14.

performed. In particular, there was a deal of debate about how quickly a licensee should move if, for example, it became aware of one of its authorised representatives having given inappropriate advice.

Many clients who paid fees for no service have now received compensation, but even ASIC could not give a complete estimate of the amount in April 2018. AMP had not then given ASIC an estimate of how much more it expected to pay as compensation to clients who had been charged fees for no service. As is recorded, in connection with the case studies concerning inappropriate advice given by representatives of AMP licensees, Ms Britt gave evidence that AMP's remediation program for those clients was moving very slowly. Not giving ASIC an estimate of the amount expected to be paid to remaining clients who had been charged fees for no service is consistent with the fact that **the remediation program was moving too slowly**.

What emerged from the case studies was that there were many cases in which **licensees had not moved promptly**.

8 Platform fees

The second subject of evidence examined in the Commission's hearings about financial advice concerned platform fees. The evidence given about platform fees showed practices that have features redolent of both the conduct constituted by charging fees for no service and the provision of inappropriate advice.

There are several forms of platform product. They were described by Mr Keating, the head of platform products at AMP, as including 'investor directed portfolio services' (or IDPS) that are non-superannuation products in the name of the customer, IDPS-like products (another form of non-superannuation product in the name of the customer, but provided by a responsible entity) and superannuation funds.[269] Mr Keating described the operation of the non-superannuation platforms as an investor investing an amount of money in the platform and the money then being invested in products made available through the platform and identified in an approved

[269] Transcript, John Patrick Keating, 18 April 2018, 1211; Exhibit 2.69, Witness statement of John Patrick Keating, 9 April 2018, 2.

products list.[270] The customer is the beneficial owner of the investments (held in the name of the platform operator) but, on some but not all platforms operated by AMP, the customer can transfer the assets held on behalf of the customer to another platform.[271] (Mr Keating explained this facility not being available on some AMP platforms as a product of history and said that there was no technical barrier to it being made available on all of AMP's platforms.)

The charging of platform fees evoked comparisons with fees for no service because the default setting seemed too often to be 'set and forget'. Charging platform fees evoked comparison with inappropriate advice because, very often, the platform that an adviser recommended the client use was a platform provided by an entity associated with the licensee with which the adviser was aligned or by which the adviser was employed and the arrangements were allowed to stay in operation despite the platform not remaining cost-competitive. Both the practice of 'set and forget' and the ways in which fees for, and services provided by, platforms could remain unaltered over time show that customers using platform services exert little or no effective competitive pressure on platform operators.

Two other particular issues emerged from the evidence given about the charging of platform fees. First, **platform operators have routinely deducted, and continue to deduct, ongoing service fees from clients' accounts and have remitted, and continue to remit, the fees to advice licensees without having any authority beyond the licensee's claim to be entitled to payment**. (If the client's account has insufficient cash to make the payment, assets are liquidated to realise sufficient cash.) To pay away money held on behalf of another on the request of the party who claims payment is a distinctly unusual arrangement.

Second, the evidence was that **it is general industry practice for platform operators to charge fees calculated by reference to the amount of funds under administration and not as a fixed fee**. This method of charging appears to owe much more to history than any other reason and its persistence suggests that there are not strong competitive pressures

[270] Transcript, John Patrick Keating, 18 April 2018, 1213.

[271] Transcript, John Patrick Keating, 18 April 2018, 1214.

at work. Be this as it may, in 2017, Colonial First State (CBA's fund management entity) launched a product that charges a flat fee.[272]

Further weight may be given to there being an absence of effective competitive pressure, by the evidence showing that two platforms operated by Colonial First State have charged, and continue to charge, fees that are calculated in part as an administration fee and in part as an investment fee. The investment fee charged is greater than the investment fee charged to the platform by the underlying manager actually responsible for making the investments. Not only that, the overall amount charged to clients is calculated in a way that makes an allowance against the possibility that the calculation is wrong.[273] For an entity to be able to charge a higher price to protect itself against the consequences of its own mistake is also unusual.

Finally, the evidence also showed that **platform operators continue to receive remuneration that, but for 'grandfathering', would be conflicted remuneration**.

As will be further explained in connection with inappropriate advice, licensees may and often do include third party manufacturers of products on their approved product lists (including the approved product lists maintained by platforms) but, much more often than not, advisers recommend that clients use products that are manufactured by entities associated with the advice licensee with which the adviser works.

Mr Keating of AMP said that, between July 2013 and October 2016, AMP had supplied benchmarking information to its advisers about AMP's platforms that showed whether the platforms were considered cost-competitive for investors.[274] The information available to advisers gave separate results for different amounts being invested. The results were given in four bands ranging from Tier 1 (competitive on price alone for the

[272] Transcript, Linda Elkins, 18 April 2018, 1248.

[273] Transcript, Linda Elkins, 18 April 2018, 1246.

[274] Transcript, John Patrick Keating, 18 April 2018, 1233.

client at the relevant investment level)[275] to Tier 4 (the AMP product is more than 15% more costly than comparable products).[276]

In 2015 and 2016, two of AMP's platforms were assessed as Tier 4 products: that is they were assessed as at least 15% more expensive than comparable products. In 2016, the two platforms that had been assessed as Tier 4 products were 'placed on hold' in the sense that advisers could not place new customers in the platforms without seeking permission to do that. By far the majority of the clients invested through the two platforms were clients of AMP affiliated advisers.

The relevant AMP advice licensees did not tell existing customers that the platforms they were using were judged to be markedly more expensive than other comparable products. The AMP advice licensees did not try to identify who were the advisers who had recommended investment through the platforms. The AMP advice licensees did not themselves ask customers whether they wished to move. As said earlier, it was a case of 'set and forget'.

Not only were investors left where they were, AMP took no step to make the platforms cost-competitive. Instead, as Mr Keating said, AMP 'focused on the more contemporary offers in terms of pricing changes' rather than consider the position of existing clients in the relevant products.[277] AMP preferred its own financial interests over the interests of the investors (by continuing to charge the investors fees that were more than 15% above market rates).

AMP could act in this way because existing clients using the platforms had neither the occasion nor the ability to find out that they were being charged more than market rates.

Since 2016, AMP has not provided its advisers with benchmarking information about platform products. That is advisers do not have access to information that allows advisers to consider whether a platform is

[275] Transcript, John Patrick Keating, 18 April 2018, 1224; Exhibit 2.69, Witness statement of John Patrick Keating, 9 April 2018, Exhibit JPK-1 [AMP.6000.0043.0379 at .0387].

[276] Transcript, John Patrick Keating, 18 April 2018, 1225; Exhibit 2.69, Witness statement of John Patrick Keating, 9 April 2018, Exhibit JPK-1 [AMP.6000.0043.0379 at .0387].

[277] Transcript, John Patrick Keating, 18 April 2018, 1232.

cost-competitive. How, then, can an adviser decide which platform it would be in the best interests of the client to use? How can an adviser tell a client that it may be time to change platform?

If a client wants to change platforms, or an adviser suggests that the client change, does the platform permit in specie transfer? If it does not, must the client choose between staying with the platform and realising the investments (with whatever capital gains consequences may follow from that event)?

The evidence about platform fees (and service provision) thus invited attention to some fundamental questions about aspects of the structure of the financial advice industry. In particular, it invited attention to **how the vertical integration of the industry may harm clients by protecting platform entities associated with advice licensees from competitive pressures. Clients end up paying more for platform services than other providers would charge for the same service**.

9 Inappropriate advice

The third subject of evidence was inappropriate advice.

It is important to begin with some points that cannot be ignored.

Hindsight will always show that some advice an adviser gives a client turns out to have been wrong. Advice that is given about financial products or investment will not always turn out for the best.

Not all advisers (financial or other) are equally skilled or diligent. In some cases reasonable advisers may form radically different views about what should be done.

Nothing can be done to change these outcomes. But recognising that there will be unforeseen and unwanted outcomes and recognising that some advisers will not be as skilled or diligent as others cannot be permitted to obscure some large and deep-seated issues examined in the course of the Commission's inquiries.

The cases of 'inappropriate' advice considered in the course of the Commission's work called attention to **four recurring points:**

- **advisers proposing actions that benefited the adviser;**
- **advisers proposing actions that benefited the licensee either with whom adviser was aligned or by whom the adviser was employed;**
- **advisers lacking skill and judgment; and**
- **licensees being unwilling to find out whether poor advice had been given and, if it had, to take timely steps to put it right.**

Whether, and to what extent, the first two points about the financial interests of advisers and licensees are properly seen as causing or contributing to the provision of bad advice will be considered first. Whether, and to what extent, providing 'inappropriate' advice might have amounted to misconduct or was conduct that fell below community standards and expectations directs attention to some basic issues that will be considered separately.

9.1 Causes

It is necessary to begin by making two simple points.

- **So long as advisers stand to benefit financially from clients acting on the advice that is given, the adviser's interests conflict with the client's interests.**
- **So long as licensees stand to benefit financially from clients acting on the advice that is given, the licensee's interests conflict with the client's interests.**

The client's interests require consideration of whether to take any step, and only then consideration of what steps to take. If steps are to be taken, the client's interests are to take whatever steps are best for the client (best both in the sense of achieving the best outcome for the client, but best also in the sense of achieving that outcome most efficiently at the best available price). The adviser's and licensee's interests are to have the client buy a product or make an investment that will give the adviser, the licensee, or both, a financial benefit.

The premise for the FoFA reforms was that conflicts of the kind described exist, must be recognised and should be regulated. The legislative response made by the FoFA reforms did not seek to eliminate the conflicts. Instead, the reforms sought to ameliorate the consequences of the conflicts. The legislation sought to do this by imposing on advisers the best interests

obligation[278] with the associated requirements that the adviser provide appropriate advice[279] and give priority to the client's interests.[280] Those provisions were supplemented by the prohibitions on conflicted remuneration[281] and by adding to the general obligation of all financial licensees, to do all things necessary to ensure that the financial services covered by a financial services licence are provided efficiently, honestly and fairly,[282] the further requirement that licensees have in place adequate arrangements for the management of conflicts of interest that may arise in relation to activities undertaken by the licensee or a representative.[283]

As amplified in the legislation, and as implemented in practice, the best interests duty and associated obligations are more in the nature of obligations to 'do no harm' to the client than 'do what is best'.

The legislative provisions emphasise process rather than outcome. Although the fundamental obligation is cast as a '*best* interests duty' there is no explicit reference in the legislation to making comparisons of a kind that would merit the use of the superlative 'best' in the collocation 'best interests'. Instead, the Corporations Act provides that the best interests obligation will be met if an adviser follows the steps described in Section 961B(2).[284] It is convenient to focus on one step identified in Section 961B(2). The best interests duty will be met if, among other things, an adviser considering recommending a financial product has conducted 'a reasonable investigation' into the products that might achieve the relevant objectives of the client.[285] In practice this requires the adviser to make little or no independent inquiry into or assessment of products. Instead, in most cases advisers and licensees act on the basis that the obligation to conduct

278 Corporations Act s 961B(1).

279 Corporations Act s 961G.

280 Corporations Act s 961J.

281 Corporations Act ss 963E–963L.

282 Corporations Act s 912A(1)(a).

283 Corporations Act s 912A(1)(aa).

284 Section 961B(3) of the Corporations Act deals separately with satisfaction of the best interests duty when advice is given by Australian ADIs.

285 Corporations Act s 961B(2).

a reasonable investigation is met by choosing a product from the licensee's 'approved products list'.

It is necessary, then, to consider how approved product lists were and continue to be used in practice. In that regard, ASIC's January 2018 report *Financial Advice: Vertically Integrated Institutions and Conflicts of Interest* is important.[286]

ASIC's 2018 report showed that the approved products lists maintained by advice licensees controlled by the five largest banking and financial institutions included products manufactured by third parties and that third party products made up nearly 80% of the lists.[287] But the report also showed that, overall, more than two-thirds (by value) of the investments made by clients were made in in-house products.[288] (At the level of individual licensees the proportion varied from 31% to 88% invested in in-house products.[289] By product type, the proportions invested in in-house products varied: 91% for platforms; 69% for superannuation and pensions; 65% for insurance; and 53% for investments. But taken as a whole, the report shows that advisers favour in-house products.)

The result is not surprising. Advisers may be expected to know more about the products manufactured by the licensee with which the advisers are associated than they know about a rival licensee's products. Advisers will often be readily persuaded that the products 'their' licensee offers are as good as, if not better than, those of a rivals. And when those views align with the adviser's personal financial interests, advising the client to use an in-house product will much more often than not follow as the night follows day.

The particular case studies examined in evidence reinforce these conclusions. So, for example, the advice given to Mr and Mrs McDowall

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[286] ASIC, *Report 562: Financial Advice: Vertically Integrated Institutions and Conflicts of Interest,* January 2018.

[287] ASIC, *Report 562: Financial Advice: Vertically Integrated Institutions and Conflicts of Interest,* January 2018, 27 Figure 2.

[288] ASIC, *Report 562: Financial Advice: Vertically Integrated Institutions and Conflicts of Interest,* January 2018, 27 [223].

[289] ASIC, *Report 562: Financial Advice: Vertically Integrated Institutions and Conflicts of Interest,* January 2018, 29.

was to invest in in-house products. Investing in in-house products gave an immediate and direct financial benefit to the adviser in the form of commissions and bonuses. And the same observation can be made in respect of the other cases of poor advice that were examined in evidence.

The general point that emerges and must be examined is what these observations show about the working of the FoFA reforms.

As noted earlier, the basic premise for the FoFA reforms was that there are conflicts of interests between clients on the one hand and advisers and licensees on the other. The legislative solution adopted was not to eliminate the conflicts but regulate them. Has this solution been successful? Is it the right solution?

10 Post-hearing responses

After the Commission had finished the second round of evidence, ANZ announced that it would begin to implement several changes 'to help improve the quality of financial planning, and customer remediation when things go wrong'.[290]

One of the changes proposed was to '[r]emove all sales incentives for bonuses and only assess performance on customer satisfaction, ANZ values and risk and compliance standards'.[291]

Two other changes proposed were described as:

- 'Quickly identify and remove planners that provide inappropriate advice – two audit fails and their contract will be terminated'; and
- 'Commit to completing compensation on about 9,000 current inappropriate advice cases by the end of [2018]'.[292]

The first of the changes that ANZ announced points firmly away from a notion that underpinned at least some other submissions that sales-based

[290] ANZ, 'ANZ Unveils Plan to Improve Financial Planning' (News Release, 7 May 2018).

[291] ANZ, 'ANZ Unveils Plan to Improve Financial Planning' (News Release, 7 May 2018).

[292] ANZ, 'ANZ Unveils Plan to Improve Financial Planning' (News Release, 7 May 2018).

financial incentives are essential to the efficient (and profitable) conduct of a financial advice business. The second change points to what is a simple, readily understood and easily adopted means of encouraging the provision of appropriate advice: fail two audits and your contract will be terminated. The third demonstrated a determination to remedy outstanding defaults.

All three changes invite close examination of claims that sales-based incentives cannot, or should not, be removed, that it is difficult to encourage good advice, or that remediation is an intrinsically protracted process.

In addition to ANZ announcing these particular changes, NAB and CBA each announced proposals to dispose of their advice businesses.[293] By contrast, Westpac announced its intention to retain the advice business it conducts under the BT name.[294]

11 Improper conduct and discipline

Questions about improper conduct and discipline can be dealt with under three headings: prevention; detection; and consequences.

11.1 Prevention

Prevention of improper conduct (like prevention of poor advice) begins with education and training.

It is by education and training that advisers (and staff more generally) are made aware of *why* certain procedures are to be followed. In some cases the procedures may reflect legal requirements; in others they may reflect the particular requirements of the relevant licensee. But in

[293] CBA, 'CBA Announces Intention to Demerge Wealth Management and Mortgage Broking Businesses' (Media Release, 25 June 2018) <www.commbank.com.au/guidance/newsroom/demerger-of-wealth-and-mortgage-broking-businesses-201806.html>; Andrew Thorburn and Gary Lennon, 'Half Year Results 2018: Investor Presentation' (Presentation, 3 May 2018) <www.nab.com.au/content/dam/nabrwd/documents/reports/corporate/2018-half-year-results-investor-presentation.pdf>.

[294] Westpac Group, 'BT Announces Significant Cuts to Platform Pricing; Launches BT Open Services' (Media Release, 23 July 2018) <www.asx.com.au/asxpdf/20180723/pdf/43wpgx0t4v9g34.pdf>.

every case, those who know why the step is required are more likely to take it than those who know only that the relevant manual requires it.

The practice that developed in NAB (and was examined in evidence) of signing as a witness to a client's signature without having seen the client sign is a good example of the need to train and educate financial advisers (and staff more generally). When spelled out, the requirement is self-evident: do not sign as a witness if you have not seen the person sign the document. But what appeared not to be evident to the many who 'witnessed' a signature after the event was why it was important. They appeared not to recognise that saying (wrongly) that you witnessed a signature may affect the validity of the document and might mean that the client's expressed wishes were not carried into effect. What happened showed the need for education and training.

Preventing improper conduct (and promoting desirable conduct) is a central task of management, at every level in an entity: from the most junior supervisor to the most senior executives and the board. APRA's April 2018 report into CBA[295] illustrates the issues and difficulties that can arise in managing operational compliance and conduct risks. Not least among those issues is striking a balance between what the report referred to as:

> financial discipline and shareholder value considerations (the 'voice of finance') … considerations of risk management, including aspects of a conduct and reputational nature (the 'voice of risk'), and … good customer outcomes (the 'customer' voice).[296]

When an entity provides financial advice, whether it provides the advice by its employees or by an authorised representative, it is the voice of risk and the customer voice that must dominate. When considering the prevention of improper conduct and the promotion of desirable conduct it is those voices that must guide the entity. In the case of fees for no service, however, it was the siren song in the voice of finance that dominated. It is the siren song of finance (for the entity and the individual adviser) that leads to misaligned incentives. Far too often it has led to advisers preferring their own interests to the interests of the client.

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[295] APRA, *Prudential Inquiry into the Commonwealth Bank of Australia*, 30 April 2018.

[296] APRA, *Prudential Inquiry into the Commonwealth Bank of Australia*, 30 April 2018, 47 [6.1].

And too often, pursuit of the adviser's interests has seen the giving of inappropriate advice.

Prevention can only go so far. To make prevention effective, it must be joined with detection.

11.2 Detection

The chief means of detecting both improper conduct and poor advice remains regular and random auditing of advisers' files.

The efficacy of the audit depends first upon there being a complete and accurate file recording the dealings between adviser and client. As the examples studied in evidence show, there can be no effective audit if the adviser keeps control of the file and will not release it to the licensee.

Next, the audit must be designed to reveal significant defaults. For too long, AMP maintained an audit system in which issues of high importance (such as not pursuing the client's best interests) could be treated as 'immaterial' when forming the overall audit grading. How can a departure from the central duty of an adviser ever be 'immaterial'?

Too often, bad audit results have had no, or no significant, consequences for the adviser. For too long, Westpac maintained a consequence management scheme under which point deductions for poor audit results were erased before the next audit would fall due. A system of that kind did nothing to penalise bad work and it did nothing to encourage better work.

11.3 Consequences: Regulatory

11.3.1 Civil penalty

Financial services licensees that breach those sections of the Corporations Act that impose the best interests duty (Section 961B), oblige the provision of appropriate advice (Section 961G), warn of incomplete or inaccurate advice (Section 961H), and require giving priority to the client's interests (Section 961J) are liable to civil penalty.[297] Licensees must take reasonable steps to ensure that representatives of the licensee comply with those

[297] Corporations Act s 961K.

sections (Sections 961B, 961G, 961H and 961J).[298] Authorised representatives are themselves liable to civil penalty for contravention of any of those Sections.[299] Clients who suffer loss or damage because of a breach of the Sections can recover compensation,[300] and the Court dealing with an action under that Section can make any of several other kinds of order.[301]

These civil penalty provisions have seldom been invoked. No civil penalty proceedings had been instigated in the five years before Ms Louise Macaulay (Senior Executive Leader of ASIC's Financial Advisers team) gave her evidence about these issues.[302] Ms Macaulay said of civil penalty proceedings generally, that they 'are time-consuming and resource intensive for ASIC', that 'their outcome is not proximate to the time of the misconduct' and that '[t]heir deterrent effect is limited by the (currently modest) size of the available penalty.'[303] More particularly, in the context of financial advice, she pointed out that a civil penalty order could not include a banning order. These observations about civil penalty proceedings must be weighed against whether other ways in which breaches of the provisions may be dealt with are speedier, less time-consuming or more effective in deterring similar conduct.

11.3.2 Notice of breach

Some, but by no means all, breaches of the Corporations Act provisions about financial advice that have been mentioned earlier may come to the attention of ASIC through the breach notification procedures established by Section 912D. As the provisions now stand,[304] a financial services licensee must lodge with ASIC a written report of the breach or the likely breach, of any of certain specified obligations. The breach, or likely breach, must be

298 Corporations Act s 961L.

299 Corporations Act s 961Q.

300 Corporations Act s 961M.

301 Corporations Act s 961N.

302 Transcript, Louise Anne Macaulay, 27 April 2018, 1915.

303 Exhibit 2.247, Witness statement of Louise Anne Macaulay, 25 April 2018, 16 [51].

304 The ASIC Enforcement Review has recommended changes. Those changes are described in Chapter 8.

'significant', having regard to a number of stated criteria. Not every breach must be notified.[305]

Notification of a breach must be given to ASIC 'as soon as practicable, and in any case within 10 business days after becoming aware of the breach or likely breach'.[306] Failure to comply with the notification requirements is an offence.[307]

For present purposes, the most relevant of the obligations of which breach or likely breach must be reported are those identified in Section 912A(1).[308] Those obligations include not only the general obligation to do all things necessary 'to ensure that the financial services covered by the licence are delivered efficiently, honestly and fairly',[309] but also the obligations to have adequate arrangements in place to manage conflicts of interest,[310] to take reasonable steps to ensure that the licensee's representatives comply with the financial services laws,[311] and to take reasonable steps to ensure that the licensee's representatives are adequately trained and competent to provide the relevant services.[312]

ASIC was advised by senior counsel that Section 912D, in its present form, presented difficulties in its application.

But even on the view adopted by ASIC, the case studies examined in the course of the Commission's hearings show that, on more than one occasion, entities lodged Section 912D notices well beyond the time fixed by the Section's requirement to lodge a written report as 'as soon as

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[305] As first enacted, the breach notification provisions required notification of every breach: see *Financial Services Reform Act 2001* (Cth) sch 1. This was found to be unwieldy and was amended in 2003: see *Financial Services Reform Amendment Act 2003* (Cth) sch 2.

[306] Corporations Act s 912D(1B).

[307] Corporations Act s 1311(1).

[308] Corporations Act ss 912D(1), 912D(1B).

[309] Corporations Act s 912A(1)(a).

[310] Corporations Act s 912A(1)(aa).

[311] Corporations Act s 912A(1)(ca). The expression 'financial services law' is defined in s 761A to include a large number of statutory provisions, including the provisions of Chapter 7 of the Corporations Act.

[312] Corporations Act s 912A(1)(f).

practicable and in any case within 10 business days after becoming aware of the breach or likely breach'. **ASIC has taken no step to prosecute any licensee for contravention of Section 912D.**

11.3.3 Banning orders

The chief regulatory tool ASIC has used in connection with financial advice has been the power to make a banning order prohibiting a person from providing any, or any specified, financial services either permanently or for a specified period.[313] Since 2008, ASIC has made 350 banning orders, of which 229 were made in relation to financial advisers.[314] Just under half of those banning orders were permanent orders.[315]

As Ms Macaulay explained, the process of making a banning order takes time. The time between ASIC becoming aware of the conduct that might warrant making a banning order and deciding to investigate the matter may vary from 'a couple of months' to 'any length of time up to a year'.[316] It may take six to twelve months to get a brief to the delegate and the delegate may take five months to make the decision.[317] Add to those times any appeal to the Administrative Appeals Tribunal or any proceedings for judicial review and the whole process may take anything up to two years before its final conclusion.

No doubt, as Ms Macaulay said, **banning orders serve a purpose of protecting the public. But a regulator's choice of regulatory steps should not be treated as requiring exercise of only one form of power.** There are cases where more than one power can and should be exercised. The process of making a banning order may be every bit as long as the pursuit of civil penalties. Court processes may prove to be more costly, if the action is fought. But chosen wisely, cases pursuing civil penalty may be

313 Corporations Act s 920A–920B.

314 Exhibit 2.247, Witness statement of Louise Anne Macaulay, 25 April 2018, 5; see also Transcript, Louise Anne Macaulay, 27 April 2018, 1914. The figures given in Exhibit 2.247 were said not to include banning orders made by a Court in civil proceedings or undertakings not to provide financial services given pursuant to enforceable undertakings.

315 Transcript, Louise Anne Macaulay, 27 April 2018, 1914.

316 Transcript, Louise Anne Macaulay, 27 April 2018, 1911.

317 Transcript, Louise Anne Macaulay, 27 April 2018, 1911.

prosecuted to conclusions that lead to a public denunciation of conduct that has breached the law. And public denunciation of unlawful conduct is a deterrent and educative tool that is important to the proper regulation of the whole of the relevant regulated community (here financial advisers and advice licensees).

ASIC's emphasis on the use of banning orders invited attention to a more basic issue about regulatory structure. Should advisers be individually licensed? As noted earlier, the present regulatory structure permits holders of a financial services licence to authorise a person to provide a specified financial service or services on behalf of the licensee.[318] The licensee must notify ASIC of the authorisation.[319] As between the licensee and the client, the licensee is responsible for the conduct of an authorised representative,[320] and that responsibility extends to loss or damage suffered by the client.[321]

What is gained by having this structure? Would there be advantage in providing for the licensing of authorised representatives, thus bringing them under the direct supervision of ASIC?

11.4 Consequences: Industry

The general weight of the evidence given to the Commission was that the practice of giving financial advice is not yet a profession. Some said it is on the cusp; others were, perhaps, more cautious.

As noted elsewhere, recent legislation[322] seeks to advance the 'professionalism' of financial advice: by requiring higher education and training standards,[323] by establishing FASEA[324] and requiring compliance[325]

[318] Corporations Act s 916A.

[319] Corporations Act s 916F.

[320] Corporations Act ss 917B–917C.

[321] Corporations Act ss 917E–917F.

[322] *Corporations Amendment (Professional Standards of Financial Advisers) Act 2017* (Cth).

[323] Corporations Act pt 7.6 div 8A ss 921B–921D.

[324] Corporations Act s 921X.

[325] Corporations Act s 921E.

with a Code of Ethics to be prepared by FASEA[326] and monitored by a 'monitoring body'.[327]

Both the Financial Planning Association of Australia (the FPA) and the Association of Financial Advisers (the AFA) seek to advance the cause of financial planners generally. Each seeks to promote the creation and growth of financial planning and advice as a profession. Each seeks to become a monitoring body under the new statutory arrangements.

Both FPA and AFA now have processes and systems for disciplining members. But the evidence before the Commission did not show that either the FPA or the AFA now plays any significant role in maintaining or enforcing proper standards of conduct by financial advisers.

Advice licensees do not look to the associations for that purpose. Licensees may encourage advisers to join a professional association. But licensees do not routinely tell either association of misconduct by advisers.

The FPA's treatment of the complaint made to it about the conduct of Mr Henderson in connection with Ms McKenna (examined as one of the case studies) did not encourage great confidence in FPA's disciplinary arrangements, at least as they stood when the Commission took evidence about the matter. The process described in evidence was prolonged, opaque and directed more to settling an agreed outcome to the complaint than imposing proper standards of conduct by members. And Mr Henderson chose not to renew his membership of FPA when he did not get his preferred outcome. The chief executive of the FPA said that the failure to pay membership dues does not terminate the membership of a member against whom a complaint remains outstanding. Even if that is so, and even if FPA were to expel the member concerned, it seems that the expulsion would be of little or no moment to a self-employed financial adviser.

Financial advisers are not currently required to belong to an association, and though some employers of employed financial advisers require it, few if any specify which. Advisers are free to switch between associations at any time, or, as Mr Hagger put it, 'go down the road to another association' if

[326] Corporations Act s 921U.

[327] Corporations Act ss 921G–921T.

they are expelled.[328] The FPA and AFA therefore actively engage in recruitment of members from the industry and, to some necessary extent, from each other. Membership fees are their chief source of revenue.

Representatives of each association said that promoting the profession was one of its key functions.[329] These characteristics sit uncomfortably with those of effective discipline that include objectivity, consistency and compulsion, and the tension was clearly borne out in the case of Mr Henderson and the FPA.

Mr De Gori, the chief executive officer of the FPA, gave evidence that the only compulsory sanction available to the FPA is to expel members. To encourage members to comply with disciplinary decisions, the association may threaten to publicly name them as the subject of its proceedings. Generally, names are kept confidential. The AFA has undertaken only two disciplinary matters since 2013, both of which resulted in a reprimand.[330]

The Code of Ethics being developed by FASEA will come into force in January 2020.

If, as both FPA and AFA hope, industry associations become monitoring bodies under the Corporations Act, much will depend upon how they perform those tasks. The monitoring bodies will play an important part in setting the tone and the culture of those who act as financial planners.

11.5 Operation of the disciplinary system

The disciplinary system (or systems) supervising financial advisers now consists of a number of bodies. Each is directed at regulating different, though related, norms of behaviour, and each is geared to different outcomes. The question is whether this segmentation imposes a satisfactory standard of behaviour on what is, as numerous witnesses noted, an aspiring profession.

Submissions from the parties generally agreed that the relevant disciplinary bodies were ASIC, professional associations and the employing licensee,

[328] Transcript, Andrew Paul Hagger, 24 Apr 2018, 1671.

[329] Transcript, Dante Giuseppe De Gori, 26 April 2018, 1819; Transcript, Philip Houston Kewin, 26 April 2018, 1828.

[330] Exhibit 2.230, Witness statement of Philip Michael Kewin, undated, 14–15.

with an adjunct role for **external dispute resolution** schemes. ASIC's submission was that, as a regulator, its role is to oversee compliance by advisers with the law and not to supervise or monitor their work.[331] Primary responsibility for discipline lies with licensees, who are responsible under the law for the conduct of their advisers.[332] That is undoubtedly correct. In my view, however, ASIC's enforcement of the law with regard to individual advisers is an important part of the disciplinary system. It is for that reason that a robust approach to enforcement is critical.

According to ASIC it would be inaccurate to suggest there are gaps in this system. Rather, each body 'has its own distinct, overlapping role to play'.[333] The other submissions did not share this view. Many of the gaps they identified can be ascribed to a lack of information sharing between ASIC, licensees and disciplinary bodies.

First, licensees are not doing enough to communicate between themselves about the backgrounds of prospective employees. The Australian Bankers' Association reference checking protocol is limited to signatories and not consistently applied.[334] Licensees also frequently fail to respond adequately to requests for references regarding their previous employees.[335] Nor do they always take the information delivered to them seriously enough. The result is that financial advisers facing disciplinary action from their employer can shop for another licensee to employ them. Dover Financial Advisers, for example, authorised three people as its representatives before conducting background checks and after those people themselves disclosed to Dover that other entities held serious concerns about their ability to provide financial advice. The AFA submission

[331] ASIC, *Submissions of the Australian Securities and Investments Commission Round 2: Financial Advice*, 7 May 2018, 16.

[332] ASIC, *Submissions of the Australian Securities and Investments Commission Round 2: Financial Advice*, 7 May 2018, 15–16.

[333] ASIC, *Submissions of the Australian Securities and Investments Commission Round 2: Financial Advice*, 7 May 2018, 15 [77].

[334] Exhibit 2.248, ABA Financial Advice – Recruitment and Termination Reference Checking and Information Sharing Protocol; Transcript, Louise Ann Macaulay. 27 April 2018, 1918–19.

[335] ASIC, *Submissions of the Australian Securities and Investments Commission Round 2: Financial Advice*, 7 May 2018, 13 [64].

discussed the view that some licensees are considered by advisers with poor track records as 'licensees of last resort'.[336]

Second, licensees and ASIC are not sufficiently sharing information about advisers. Licensees may fail to report, or report late, their concerns about an adviser's conduct, which obviously impedes ASIC's ability to enforce disciplinary sanctions on those that have breached the law. That is so even though, as Mr Hagger of NAB noted, licensees themselves depend on ASIC's Financial Adviser Register for a definitive listing of banned advisers to indicate whether an adviser has a poor history.[337] ASIC, however, noted that it 'rarely if ever' uses its power under Section 916G of the Corporations Act to disclose information about an adviser to a licensee.[338] The licensee may therefore lack information necessary for it to determine how to supervise or monitor the adviser properly.

Third, neither ASIC nor licensees are sharing information with industry associations. Both the AFA and the FPA find out about members under ASIC investigation from media releases and news stories. Licensees almost never report their concerns about advisers to industry associations. The two associations do not share disciplinary information between them. Members of the public are generally unaware that the AFA and FPA exist, and are more likely to take their complaint to a dispute resolution body than report advisers to the industry bodies. The result is that industry bodies now have little basis on which to play any effective disciplinary role.

11.6 The new regulatory provisions

When the amended regulatory provisions come into effect, all advisers will be required to become members of a code monitoring body. Advisers will be prohibited from changing associations while under investigation by a monitoring body, and all breaches of the code will have to be reported to ASIC and the adviser's licensee. Breaches of the code and any sanctions will be listed on the Financial Adviser Register.[339]

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[336] AFA, *AFA Response: Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, 7 May 2018, 19.

[337] Transcript, Andrew Paul Hagger, 24 Apr 2018, 1672.

[338] Exhibit 2.247, Witness statement of Louise Anne Macaulay, 25 April 2018, 13 [34].

[339] Treasury, *Submission Hearings on Financial Advice*, undated, 15 [94].

In these ways, the new scheme will deal directly with several of the issues raised above. The requirement to share information is welcome. The restriction on advisers changing schemes mid-investigation should limit the evasion of disciplinary processes that is otherwise possible in a system where multiple bodies administer one code of ethics. However, advisers not under investigation but looking for a lighter touch will still be free to switch monitoring bodies. **The consistency between various code monitoring bodies in enforcing discipline will therefore be important.**

It is important to recognise the proper place of the proposed Code of Ethics. Professional codes are not laws. Codes of ethics are important to fostering public confidence and practitioner integrity in a profession. They are composed by industry practitioners according to agreed industry processes. Laws, by contrast, are the product of a public process conducted under the authority of democratic institutions. It is laws, and not codes of ethics, that are the proper repositories for basic norms of conduct. This qualitative disparity mandates a difference in approach to contraventions of each.

While codes of ethics have a part to play in setting professional standards of behaviour, the industry must be conscious of their boundaries. The **investigation and punishment of breaches of law should not be outsourced to private bodies. Licensees and industry bodies should not try to resolve breaches of law by advisers internally, but must notify ASIC or other appropriate authorities.** A breach of the code of ethics must not be allowed to obscure, or be treated as more significant than, a breach of the law.

Though laws and professional codes serve different normative purposes the discipline they impose can have similar objectives. Both ASIC and the FPA emphasised the protection of the public as their overriding disciplinary aim. For that reason, they may not take action, for example, against an unscrupulous adviser who has ceased to practice.

Disciplinary powers do have a protective aspect. In some cases protecting the public will be a critical aspect of disciplinary action. But the imposition of discipline in a civil or even a professional setting usually, by analogy with criminal sentencing, serves multiple and sometimes contradictory purposes. Among those purposes will ordinarily be purposes of punishment, denunciation, and the identification of conduct that breaches applicable norms. To characterise disciplinary action as serving *only* to protect the public is wrong. Not only is the characterisation wrong, it is a fallacy that

hides the need for regulatory bodies to give proper weight to the other purposes that are to be achieved by taking regulatory action.

12 Issues that have emerged

The issues that emerged in connection with financial advice related to:

- culture and incentives;
- conflicts of interest and duty, and confusion of roles; and
- regulator effectiveness.

The first of those themes, culture and incentives, includes issues about the culture of particular parts of the financial services industry, such as **mortgage brokers**, financial advisers, and point of sale agents for consumer lending. But it also includes more specific issues about the culture created and maintained by particular entities. And running through all of those issues are questions about how industry participants are paid (including how bonuses and other incentives are calculated).

The second theme, conflict of interest and duty, and confusion of roles, is closely related to the first. It includes issues about FoFA's treatment of conflicts of interest as conflicts that can, and should be, 'managed' (by advisers and licensees meeting the 'best interests duty' and giving the client's interests priority over the interests of the adviser and licensee). The second theme goes further, however, and requires consideration of structural considerations. In particular, the second theme draws attention to consequences that appear to be related to, if not stem from, some entities being vertically integrated, in the sense that the entity manufactures and sells **financial products** while, at the same time, advising clients which products to use or buy. And the second theme also embraces the issues that emerged in the first round of hearings about the confusion of roles and responsibilities of, for example, mortgage brokers and **mortgage aggregators**.

The third theme, regulator effectiveness, directs attention to what responses regulators can make, and what responses regulators should make, to conduct of the kinds examined in the Commission's hearings. A necessary part of the second branch of that inquiry (what responses regulators should

make) is to consider whether (with all the benefit of hindsight) the responses that were made have proved to be satisfactory.

The particular issues can be further identified as including:

- How does a financial adviser's employer encourage provision of sound advice (including, where appropriate, telling the client to do nothing)?
- How do advice licensees encourage advisers aligned with the licensee to provide sound advice (including, where appropriate, telling the client to do nothing)?
- Can conflicts of interest and duty be managed?
- How far can, and how far should, there be separation between providing financial advice and manufacture or sale of financial products?
- Should financial product manufacturers be permitted to provide financial advice?
  - At all?
  - To retail clients?
- Should financial product sellers be permitted to provide financial advice?
  - At all?
  - To retail clients?
- Should an authorised representative be permitted to recommend a financial product manufactured or sold by the advice licensee (or a related entity of the licensee) with which the representative is associated?
  - At all?
  - Only on written demonstration that the product is better for the client than comparable third party products?

- Should the grandfathered exceptions to the **conflicted remuneration** provisions now be changed?
  - How far should they be changed?
  - If they should be changed, when should the change or changes take effect?
- Should the life risk exceptions to the conflicted remuneration provisions now be changed?
  - How far should they be changed?
  - If they should be changed, when should the change or changes take effect?
- Should any part of the remuneration of financial advisers be dependent on value or volume of sales?
- Should all financial advisers (including those who now act as authorised representatives of an advice licensee) be licensed by ASIC?
- Are current product and interests disclosure requirements sufficient to allow customers to make fully informed choices?
- Should the period after which a client must positively review an ongoing fee arrangement be reduced from two years to one?
- Should platform operators be permitted to deduct fees on behalf of licensees without the express authority of the client of the platform operator?
- When an employee or authorised representative is terminated for fraud or other misconduct, should a licensee inform their clients of the reason for termination?
- When an employee or authorised representative is terminated for fraud or other misconduct, should a licensee review all the files or clients of that employee or intermediary for incidents of misconduct?

- Should negotiation and settlement be the main approach for a regulator?
- Should there be greater focus on general deterrence in regulatory strategy?
- Should a component of **enforceable undertakings** be the acknowledgment of specific wrongs?
- Should self-reported breaches of the Corporations Act generally attract legal sanctions unless some special circumstances exist?
- Should banning orders continue to be preferred to civil penalty proceedings in case of licensee/adviser misconduct?
- Should ASIC make more use of its Section 916G power to give a licensee information about a person who is or will be a representative of the licensee?
- Does Section 916G need to be amended so as to be more effective?
- Should there be more focus on criminal proceedings against licensees rather than individual advisers?

4. Small and medium enterprises

Introduction

Round 3 of the Commission's hearings looked at some issues arising from banks dealings with small and medium enterprises (SMEs).

Small and medium enterprises are very important to Australia's economy. Most businesses in Australia are small businesses, no matter which definition of that term is used. Small businesses represent about 97.5% of all businesses operating in Australia[1] and employ about 44% of people in the private, non-financial sector.[2] Those statistics reflect the number of businesses, not their size. And most small businesses are indeed very small. The majority employ no one at all; those that do, generally employ fewer than four people.[3]

1 What is an SME?

I say 'no matter which definition … is used' because there are many definitions of what is a small business. Definitions differ between, and even within, statutes. They differ between government and industry entities.

The *Corporations Act 2001* (Cth) (the Corporations Act)[4] and Section 12BC of the *Australian Securities and Investments Commission Act 2001* (Cth) (the ASIC Act) apply certain protections to small businesses, defined as

1 FSRC, *FSRC Background Paper No. 12: Financial Services and Small and Medium-Sized Enterprises*, 14 May 2018, 7.

2 FSRC, *FSRC Background Paper No. 12: Financial Services and Small and Medium-Sized Enterprises*, 14 May 2018, 9.

3 FSRC, *FSRC Background Paper No. 12: Financial Services and Small and Medium-Sized Enterprises*, 14 May 2018, 8.

4 Corporations Act s 761G.

those employing fewer than 20 employees, or if manufacturing businesses, fewer than 100. But Section 12BF of the ASIC Act and the *Competition and Consumer Act 2010* (Cth),[5] providing unfair contracts protections, define a small business as one with fewer than 20 employees and a contract with an upfront price of less than $300,000, or if the contract lasts more than 12 months, a price of no more than $1 million. The *Australian Small Business and Family Enterprise Ombudsman Act 2015* (Cth) gives the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) jurisdiction over small businesses employing fewer than 100 people or taking in less than $5 million yearly in revenue.[6] The *Fair Work Act 2009* (Cth) provides different unfair dismissal provisions for businesses employing fewer than 15 people.[7] The *Income Tax Assessment Act 1997* (Cth) provides access to certain concessional treatment in the tax laws for entities that have a turnover of less than $10 million.[8] The Australian Bureau of Statistics collects information about small businesses defined as those employing fewer than 20 people.[9] The Australian Financial Complaints Authority (AFCA) will apply a definition of 100 or fewer employees.

Then there are definitions applied by the banking industry. The 2013 Code of Banking Practice (the Code) defines small business as a business having fewer than 20 employees, or 100 employees if it is a manufacturing business. It provides that if the banking service provided is a **financial product** or service regulated under Chapter 7 of the Corporations Act, the Code only applies to 'retail clients' within the meaning of the Corporations Act.[10] The 2019 Code will define a small business as one having three characteristics: an annual turnover of less than $10 million in the previous financial year; fewer than 100 full time equivalent employees; and, less than $3 million total debt to all credit providers (including amounts undrawn, all loans applied for and the debt of all related entities that are businesses).[11]

5 ASIC Act s 12BF; *Competition and Consumer Act 2010* (Cth) sch 2 s 23.

6 *Australian Small Business and Family Enterprise Ombudsman Act 2015* (Cth) s 5.

7 *Fair Work Act 2009* (Cth) s 23.

8 *Income Tax Assessment Act 1997* (Cth) s 328-110.

9 ABS, *8155.0 – Australian Industry, 2016–17* (25 May 2018) ABS <www.abs.gov.au/AUSSTATS/abs@.nsf/Latestproducts/8155.0Glossary12016-17?opendocument>.

10 2013 Code cl 42.

11 2019 Code cl 1.

Practice within banks varies. CBA adopts the 2013 Code definition for the purposes of lending.[12] ANZ lending to small business is subsumed into its 'commercial lending' category, which also includes medium sized business and generally goes up to loans of $10 million.[13] Westpac's business bank includes an SME business unit that distinguishes between 'Micro SMEs', which employ four or fewer employees and borrow up to $250,000, and 'SMEs', which have business turnover of less than $5 million and lending requirements of up to $3 million.[14] NAB generally categorises SME lending as up to $50 million, and segments those customers based on various characteristics relating to the complexity of their requirements and business structures.[15] Bank of Queensland (BOQ) and Bankwest both define small businesses as those borrowing up to $1 million.[16]

1.1 Harmonise the definitions?

There appears to be little appetite to choose one or two of these definitions and apply it or them more generally. The Productivity Commission has said that a single definition is not desirable, as it may lead to inflexibility and higher costs.[17] And even if that were not so, there may be little point in seeking uniformity for its own sake.

Even so, two general points should be made. First, no matter what definition is adopted for use in a particular context it should be cast in terms that will enable the proper pursuit of the relevant policy objectives. That is, the definition that is adopted should identify the field of operation of the relevant provisions in a way that is appropriate to the purposes being pursued by those provisions. It is not immediately apparent to me that all the different definitions that have been used in legislation or other instruments reflect clear identification of the reason or reasons that have led to drawing the boundary of operation of the relevant provisions at the particular points

12 Exhibit 3.130, Witness statement of Joanna Charlene White, 8 May 2018, 3 [16].

13 Exhibit 3.129, Witness statement of Isaac James Christian Rankin, 8 May 2018, 3 [12].

14 Exhibit 3.132, Witness statement of Alastair Derek Dawson Welsh, 8 May 2018, 3 [12].

15 Exhibit 3.131, Statement of Howard William Silby, 23 May 2018, 4–5 [10]–[11].

16 Exhibit 3.133, Witness statement of Douglass Robert Snell, 8 May 2018, 6; Exhibit 3.134, Witness statement of Sinead Taylor, 8 May 2018, 3 [17].

17 Productivity Commission, *Regulator Engagement with Small Business,* September 2013, 14.

chosen. Second, as explained in Chapter 8, legislative complexity can lead to difficulties in supervision and enforcement. It can cause the regulated community to lose sight of what the law is intending to achieve and instead see the law as no more than a series of hurdles to be jumped or compliance boxes to be ticked. Whatever definition of small business is chosen, someone will be able to point to a case that lies at the edge of the definition. Lines must therefore be drawn. But the fewer the lines, the easier the law is to administer and the easier it is for the regulated community to understand when particular provisions of the law are engaged.

1.2 Why treat small businesses differently?

Small businesses can be seen to resemble consumers in several ways. Like consumers, small businesses lack the bargaining power and resources of larger entities. They may only have limited access to legal and financial advice. The financial dealings of the business and the business owner's understanding of finance may be relatively unsophisticated. There may be substantial overlap between the finances of the small business and the personal finances of its owner, most commonly because personal assets are offered as security for a business loan. In the case of sole traders, who constitute many of Australia's small businesses, there is no legal distinction between the sole trader and the business, and the owner is personally responsible for the business's debts. And small businesses, like consumers, accept the services of banks largely on the basis of standard form contracts, which typically have strongly favoured the interests of banks.

What then is the current legal framework?

2 The current framework

The responsible lending provisions of the *National Consumer Credit Protection Act 2009* (Cth) (the NCCP Act) do not apply to lending for business purposes. In particular, the provisions of Section 128 of the NCCP Act prohibiting an Australian credit licensee from entering a credit contract with a consumer without making an assessment that the credit contract will not be unsuitable for the consumer does not apply. The hardship, pre-contractual disclosure, price regulation, and enforcement provisions of the National Credit Code (NCC) do not apply. Financial services entities that are not engaged wholly or predominantly in personal, domestic or household

credit or credit for investment in residential property are not required to hold an **Australian Credit Licence** (ACL). It follows that entities providing credit only for business purposes need not conform with the ACL requirement to be a member of an approved **external dispute resolution** (EDR) scheme. But about 80% of small business lending is provided by the major banks, who do hold licences.[18]

The policy choices that have been made to limit the application of these statutory regimes reflect recognition of the need to ensure small businesses have access to reasonably affordable and available credit. The extension of protections has been judged likely to restrict the circumstances in which banks may lend and likely to limit the banks' capacity to reduce credit risk when they do lend, thus restricting the supply of credit and increasing its cost. This has been seen as especially the case where credit is sought for a new business (for which there can be no trading records) and the lender seeks security for the loan either from the principals of the business or from a **third party guarantor**, or, often enough, both.[19] There has been reluctance, therefore, not least on the part of small business owners themselves, to take up proposals for increased protections. And the small business representatives consulted in the course of the Khoury Review of the Code of Banking Practice (discussed in Section 2.1, below) said that they did not have concerns about irresponsible lending to small businesses.[20]

There are important provisions that do apply to lending to small businesses. In particular, some provisions of the ASIC Act that apply to consumers apply also to lending to small businesses. The ASIC Act prohibits misleading conduct in relation to financial services.[21] It prohibits unconscionable conduct in connection with the supply or possible supply of financial services to a person other than a listed public company.[22] The ASIC Act also implies a number of terms into contracts for the supply of financial services where the services under the contract were acquired for use or

[18] Treasury, *FSRC Background Paper No. 11: Request for Information Reforms to Small Business Lending*, 9 May 2018, 5.

[19] Phil Khoury, *Independent Review Code of Banking Practice,* 31 January 2017, 49 [8.4.2].

[20] Phil Khoury, *Independent Review Code of Banking Practice,* 31 January 2017, 49 [8.4.2].

[21] ASIC Act ss 12DA, 12DB, 12DC, 12DF.

[22] ASIC Act ss 12CA, 12CB.

consumption in connection with a small business.[23] The implied terms warrant that services will be rendered with 'due care and skill'[24] and will be reasonably fit for any purpose made known to the supplier.[25]

Since November 2015, the ASIC Act has provided that unfair terms in standard form small business contracts for financial services and financial products are void.[26] The provisions apply where at least one party is a business employing fewer than 20 people and the upfront price of the contract is no more than $300,000, or if the contract has a duration of longer than 12 months, $1 million.

Eight months after these provisions commenced operation, and following reviews by ASIC and ASBFEO of small business loan contracts offered by the four major banks, those banks agreed to remove a number of standard clauses considered 'unfair'. Clauses removed included entire agreement clauses; broad indemnification clauses; unilateral variation clauses; and, except in respect of certain specialised industries, financial indicator covenants.

It is also necessary to recall that general law principles may be engaged in the relationship between small businesses and their banks. A contract will almost always govern the parties' relationships. Equitable doctrines may operate in cases where there has been an abuse of power, other doctrines may apply to require lenders to perform their services with reasonable care. In rare circumstances, a bank might be found to have undertaken some fiduciary duties to its customer.

The evidence and submissions provided to the Commission did not reveal any great appetite to change the legal framework. In particular, I did not understand there to be substantial support for changing the legal framework in ways that would bring some or all SMEs within the application of the NCCP Act.

The chief protection for small business borrowers, however, has been, and remains, the Code. And, as will later be seen, the chief focus of attention in

23 ASIC Act s 12ED, read with the definition of 'small business' in s 12BC(2).

24 ASIC Act s 12ED(1).

25 ASIC Act s 12ED(2).

26 ASIC Act s 12BF.

the case studies in this round of hearings was upon the application of the Code and its requirement that a bank considering making a loan will exercise the care and skill of a diligent and prudent banker. In considering what emerged from those case studies it is, therefore, necessary to begin by saying something about the Code.

2.1 The Code of Banking Practice

The Code is prepared and published by the Australian Banking Association (ABA). The ABA is a voluntary association of 24 banks that carry on business in Australia. The Association says that it 'works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry'.[27]

The Association first published a code of banking practice in 1993. The Association did not require its members to apply the code, but many members, including the four largest banks, said publicly that they would comply with its provisions. From time to time, the code was amended. A new edition of the code was published in 2013.

In 2016, as part of its 'banking reform program', the association appointed Mr Philip Khoury to review the Code.[28] (The Sedgwick Review was conducted as part of the same program.[29]) Mr Khoury told the Commission that he was asked to review the Code from the perspective of what stakeholders wanted from banks and what would help restore trust in the banking industry. Mr Khoury rightly described the Code as a document that sets out the promises the industry makes to its customers. He said that, in his view, the Code as it stood when he began his review 'was really written from the point of view of the banks' and 'was not accessible for consumers because, in many cases, it was not clear what the promise was'.[30]
Mr Khoury said that he understood his task in reviewing the Code as being to make significant 'transformational' changes to the Code that would help

[27] ABA, The Australian Banking Association's Role <www.ausbanking.org.au/About-Us/The-ABA>.

[28] Transcript, Anna Maria Bligh, 31 May 2018, 2912–3.

[29] Transcript, Anna Maria Bligh, 31 May 2018, 2913.

[30] Transcript, Philip George Khoury, 21 May 2018, 2023.

restore trust in the banking industry.[31] Mr Khoury gave the association his final draft of the Code in early February 2018.[32]

Section 1101A of the Corporations Act permits ASIC to approve codes of conduct that relate to any aspect of the activities of financial services licensees, authorised representatives of **financial services licensees** or issuers of financial products 'being activities in relation to which ASIC has a regulatory responsibility'. Although Section 1101A was inserted in the Corporations Act in 2001,[33] the ABA did not seek ASIC's approval of any of the several versions of the Code published by the Association before Mr Khoury's review.

The Chief Executive Officer of the ABA, Ms Anna Bligh, told the Commission that, over a number of months before and after Mr Khoury submitted his report, members of the Association gave consideration to submitting the Code to ASIC, for its approval.[34] The Association decided to submit the Code for approval by ASIC because 'providing the code … to a body outside the industry, in this case a regulator, may well add public reassurance that this code was a code that would be of benefit to customers, that it had been assessed, and that it had been developed in accordance with appropriate regulatory guidelines'.[35] (Ms Bligh's reference to 'regulatory guidelines' was to ASIC's Regulatory Guide 183: Approval of Financial Services Sector Codes of Conduct. It is enough to notice that it states, as 'key criteria for code approval' that, among other things, the code should provide 'effective and independent code administration'; it should be 'enforceable against subscribers'; it should provide that 'compliance is monitored and enforced'; it should have 'appropriate remedies and sanctions'; and, there should be a 'mandatory three-year review of code'.[36])

Having received Mr Khoury's draft of the Code, the ABA made some changes to the draft and submitted the revised draft to ASIC for its approval.

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31 Transcript, Philip George Khoury, 21 May 2018, 2023.

32 Transcript, Anna Maria Bligh, 31 May 2018, 2913.

33 *Financial Services Reform Act 2001* (Cth).

34 Transcript, Anna Maria Bligh, 31 May 2018, 2914.

35 Transcript, Anna Maria Bligh, 31 May 2018, 2914.

36 ASIC, Regulatory Guide 183: Approval of Financial Services Sector Codes of Conduct, March 2013, 6 [183.12].

ASIC and the association had not completed their discussions about the revised draft when the Commission took evidence during its third round of hearings.

Ms Bligh identified the chief point of debate between the ABA and ASIC as being the Code's proposed definition of a 'small business'. As already noted, the ABA proposed to define a small business as one that, at the time it obtained the relevant banking service met three criteria: annual turnover of less than $10 million in the previous financial year; fewer than 100 full-time employees; and, less than $3 million total debt to all credit providers (including amounts undrawn under existing loans, any loan being applied for and the debt of all of its related entities that are businesses).

Mr Khoury had proposed that it would be both simpler and better to have the Code govern loans to any business where the loan being applied for was less than $5 million. He said, in evidence, that the test he proposed would be simpler for customers (and banks) to apply and that, adopting that test rather than the three-part test now proposed by the ABA would have a relatively small effect, extending the coverage of the provisions to an additional 10,000 or 20,000 businesses.[37]

In July 2018, ASIC approved the draft that the ABA submitted. The new code is to commence on 1 July 2019 and is called 'The Banking Code of Practice'. It defines 'small business' in the manner proposed by the ABA.

Four points underpin any consideration of the Code. First, it is a document that has been written for the industry to put forward as a statement of a voluntary code of its practice. Second, the Code proceeds from the premise that the rules it sets out are consistent with, but go beyond the requirements of, the applicable law. Third, the Code sets out rules and principles that signatories to the Code identify as precepts that those who deal with banks can expect banks to follow. That is, the Code sets out standards of behaviour that the banks accept members of the community can expect banks to follow. Fourth, intermediate courts of appeal have held that relevant provisions of the Code can be incorporated in, and form part of, a contract of guarantee between a bank and a third party guarantor and, it may be assumed, can therefore be incorporated in, and form part of, the

[37] Transcript, Philip George Khoury, 21 May 2018, 2024–9.

loan contract between the bank and its customer.[38] (And the 2019 Code will expressly provide that the terms and conditions for banking services and guarantees to which the Code applies will include a statement to the effect that the relevant provisions of the Code apply to the service or guarantee.)[39] Chapter 17 (Clauses 49–61) of the 2019 Code is entitled 'A responsible approach to lending'. Clause 49 says that '[i]f we are considering providing you with a new loan, or an increase in a loan limit, we will exercise the care and skill of a diligent and prudent banker'. Clause 51 provides that '[i]f you are a small business, when assessing whether you can repay the loan we will do so by considering the appropriate circumstances reasonably known to us about (a) your financial position; or (b) your account conduct'. And Clause 52 provides that '[w]e also owe an obligation to any guarantor of the loan to comply with the above paragraph in assessing the borrower's ability to repay the loan'. (This last obligation, like the provisions of Clause 49 about exercising the care and skill of a diligent and prudent banker, must be understood in light of the Code's definition of the words 'you' and 'your', as including a guarantor, or a prospective guarantor.)

The 2019 Code (like earlier versions) thus requires a bank considering the provision of a new loan or an increase in loan limit to exercise the care and skill of a diligent and prudent banker. This imposes on a bank a duty that the law would not otherwise impose. Ordinarily, parties negotiating a new contract must not mislead or deceive or act unconscionably, but neither party to the negotiation owes a duty to consider the interests of the counterparty when deciding whether to make the contract. In particular, neither party makes any promise that it has assessed whether the counterparty can perform the obligations that it assumes by making the contract.

By adopting the Code, banks recognise that failing to act as a diligent and prudent banker would act when deciding whether to make a new or increased loan will have consequences for the customer and any guarantor of the customer's obligations. And, as noted above, intermediate courts of appeal have decided that the promises that banks make in the Code may be enforced as terms of the contract ultimately struck between the bank and a

[38] *Brighton v Australia and New Zealand Banking Group Ltd* [2011] NSWCA 152; *Doggett v Commonwealth Bank of Australia* (2015) 47 VR 302; [2015] VSCA 351.

[39] 2019 Code cl 2.

guarantor of the customer's obligations. That is, the obligations voluntarily assumed by the banks by their subscribing to the Code have been given legal effect.

When considering a loan proposal, a diligent and prudent banker will consider whether the borrower is likely to be able to comply with the terms and conditions of the loan. If periodical payments are required, can the borrower make those payments? If the loan is for a term, is it likely that the borrower will be able to repay on time? There is, however, always a risk of default. It is for the diligent and prudent banker to decide what the risk is and whether that is a risk that the bank is willing to undertake.

It seems to me to follow from providing that a bank owes to the borrower and any prospective guarantor a duty to exercise the care and skill of a diligent and prudent banker, that the content of the duty is formed in an important respect by what the hypothetical banker would regard as an acceptable level of risk. And that is not necessarily identical in every respect with a particular lender's appetite for risk. In many, probably most, cases, there would be no relevant difference between the objectively determined level of acceptable risk and the risk appetite of a particular entity. But that may not always be so. I say that because, in the past, there have been cases where particular banks have pursued certain kinds of lending more aggressively than other market participants. In such a case there may be some room for debate about whether the hypothetical diligent and prudent banker would have approved the relevant transaction.

That a borrower defaults in performing the loan agreement does not, without more, show that the lender did not act as a diligent and prudent banker. When a loan is provided to allow the borrower to start a new enterprise, there will always be a risk that the business does not prosper and that the borrower may default.

It is, therefore, unsurprising, that banks lending to SMEs seek security for the debt. If the borrower has no satisfactory security to offer, it is unsurprising that the bank will seek not only third-party support for the loan from a guarantor of the principal debtor's obligations but also security for the guarantor's performance of his or her obligations as guarantor. When the borrower is a small or medium enterprise, the borrower may have no security to offer other than the principal's family home. If the bank seeks third-party support, beyond the immediate participants in the enterprise, the guarantor will often be related to the principal of the enterprise that is

to borrow. If the guarantor is a parent of the principal of the enterprise, and the guarantee is to be secured, the security may be the parent's residence. If the venture fails, and the loan cannot be repaid, realisation of the security provided by the principal of the business or by a relative of the principal will have very serious consequences for whomever provided that security.

Unsurprisingly, there was, therefore, a deal of attention paid in both evidence and submissions to whether any change should be made to law or practice relating to voluntary guarantees with respect to SME lending. These issues are considered later. Before doing that, it is important to record what the entities told the Commission about their conduct in connection with SME lending.

3 Conduct acknowledged by the entities

As previously noted, a large number of entities were asked, at the start of the Commission's work, to provide submissions setting out misconduct and conduct falling short of community standards and expectations they had identified as occurring during the previous 10 years. Before the Round 3 hearings, a further request, specific to small businesses, was sent to ANZ, BOQ, CBA, Macquarie Bank, NAB and Westpac asking whether there was any feature of their earlier responses that those entities wished to point to as relating to SME lending, and inviting those entities to add to their responses specifically in relation to SME lending. The entities made the following disclosures.

3.1 ANZ

In its SME-specific submissions, made in April 2018, ANZ acknowledged that it has engaged in misconduct and conduct falling below community standards and expectations in relation to SME lending.

In particular, ANZ acknowledged misconduct or conduct falling below community standards and expectations in relation to applications for business loans. And ANZ identified instances where frontline staff engaged in inappropriate sales practices in an effort to increase incentive payments,

including selling or referring customers to unsuitable products, some of which involved SME lending.[40]

In addition, ANZ identified instances where its staff or representatives were involved in submitting false information in connection with loans and loan applications.[41] For example, in its first, January 2018 submissions, ANZ acknowledged that, in 2017, two ANZ business banking managers were found to have been colluding with external third parties to make 47 fraudulent loans. One was dismissed, the other resigned during the disciplinary process.[42]

In its SME-specific submissions, ANZ also acknowledged misconduct or conduct falling below community standards and expectations in cases where business loan arrangements had been varied or come to an end. It said that, in some instances, dealings between its collection team and customers breached the Code of Banking Practice and the ASIC debt collection guidelines.[43] ANZ also identified concerns raised by the Financial Ombudsman Services (FOS) of systemic issues in failing to suspend collections activity once a dispute was before the ombudsman, including in connection with SME lending.[44]

3.2 BOQ

In both its January 2018 submissions and its SME-specific submissions, BOQ acknowledged that, following the initiation of a product review program, a number of issues had been identified with respect to the incorrect charging of fees and interest that also affected business

40 ANZ, *Small-Medium Enterprise Lending ANZ Submission in Response to the Commission's Letter dated 5 April 2018*, 17 April 2018, 4–5 [22].

41 ANZ, *Small-Medium Enterprise Lending ANZ Submission in Response to the Commission's Letter dated 5 April 2018*, 17 April 2018, 4 [21].

42 ANZ, *ANZ Submission in Response to the Commission's Letters of 15 December 2017*, 29 January 2018, 32 [6.74].

43 ANZ, *Small-Medium Enterprise Lending ANZ Submission in Response to the Commission's Letter dated 5 April 2018*, 17 April 2018, 5 [26].

44 ANZ, *Small-Medium Enterprise Lending ANZ Submission in Response to the Commission's Letter dated 5 April 2018*, 17 April 2018, 5 [27].

customers.[45] BOQ said that there had been instances in which guarantees for SME loans were taken from and sought to be enforced against guarantors who claimed not to have understood the effect of the guarantee or their waiver of independent legal advice, including where guarantees were given by relatives of an SME borrower.[46] In addition, it identified instances, before some risk framework developments and enhancements were made in 2012, where complaints had been made about BOQ's assessment of the ability of an SME borrower to service an SME loan.[47]

BOQ identified circumstances where business loan arrangements had been varied or come to an end: instances in which it did not provide an extensive period of notice before taking action against a borrower in default, giving rise to complaints about the adequacy of the notice provided;[48] and instances in which it did not provide an extensive period of notice of the expiry of a small or medium enterprise facility giving rise to complaints about the adequacy of that notice.[49] In identifying these instances, BOQ emphasised that the bona fide reliance on contractual terms should not be seen as conduct falling below community standards and expectations.

In its January 2018 submission, BOQ told the Commission that about 3,200 external dispute resolution cases involving the FOS had been taken against it between 2009 and 2017.[50] In its later specific submission, BOQ elaborated that some of those cases included complaints by SME lending customers that were resolved in favour of the borrower.[51] Nevertheless,

45 BOQ, *BOQ Response to the Royal Commission's Letter dated 15 December 2017*, 29 January 2018, 10–11 [59] (a), (c), (g), (h); BOQ, *BOQ Submission in Response to the Commission's Letter dated 5 April 2018*, 17 April 2018, 2 [9].

46 BOQ, *BOQ Submission in Response to the Commission's Letter dated 5 April 2018*, 17 April 2018, 3 [17].

47 BOQ, *BOQ Submission in Response to the Commission's Letter dated 5 April 2018*, 17 April 2018, 4 [30].

48 BOQ, *BOQ Submission in Response to the Commission's Letter dated 5 April 2018*, 17 April 2018, 3 [21].

49 BOQ, *BOQ Submission in Response to the Commission's Letter dated 5 April 2018*, 17 April 2018, 4 [25].

50 BOQ, *BOQ Response to the Royal Commission's Letter dated 15 December 2017*, 29 January 2018, 23 [154].

51 BOQ, *BOQ Submission in Response to the Commission's Letter dated 5 April 2018*, 17 April 2018, 3 [12].

BOQ said that it did not consider that it had identified any systemic problems in the conduct of its SME lending business.[52]

3.3 CBA

CBA identified instances in which customers had raised concerns in relation to applications for business loans. In its SME-specific submission, CBA made particular reference to two decisions of the Supreme Court of Victoria concerning business loans the bank had made: *Doggett v Commonwealth Bank of Australia*, and *Doggett and Doggett v Commonwealth Bank of Australia*.[53] The court held, both at first instance and on appeal, that CBA had breached the then applicable provision of the Code (by not exercising the skill and care of a diligent and prudent banker) and that the guarantors of the business facility were not liable to the bank.[54]

CBA also identified in its RiskInSite data:

- 59 instances of provision of a business lending product for a potentially ineligible purpose that did not comply with a policy or business rule;
- 17 instances of inadequate or inaccurate disclosure being made to customers in relation to an SME lending product;
- 16 instances relating to loan conditions including servicing;[55]
- 5 instances in which customers have raised concerns relating to account management; and
- 25 incidents relating to fee and interest inaccuracy including some incidents that involved multiple customers.[56]

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[52] BOQ, *BOQ Submission in Response to the Commission's Letter dated 5 April 2018*, 17 April 2018, 5 [33].

[53] *Commonwealth Bank of Australia v Doggett* [2014] VSC 423; *Doggett v Commonwealth Bank of Australia* [2015] VSCA 351.

[54] CBA, *Business Lending CBA Response to the Royal Commission's Letter dated 5 April 2018*, 17 April 2018, 6 [27]–[28].

[55] CBA, *Business Lending CBA Response to the Royal Commission's Letter dated 5 April 2018*, 17 April 2018, 6–7 [29].

[56] CBA, *Business Lending CBA Response to the Royal Commission's Letter dated 5 April 2018*, 17 April 2018, 7 [31].

In connection with this last class of events, CBA pointed to a notification by FOS, on 6 October 2017, of what FOS considered to be a systemic issue in connection with the charging of interest on both business overdrafts, and what CBA called 'Simple Business Overdrafts' on business transaction accounts. FOS pointed to what it said was double debiting of interest.[57]

CBA had first identified a problem of this kind in 2013. In 2015 it paid compensation to customers and made what it thought to be a sufficient change to its computer systems. But the change did not wholly solve the problem. And this became apparent from the dispute in FOS that lay behind FOS's notification of a systemic issue. Additional cases of double debiting interest were identified.

The double debiting of interest was the subject of one of the case studies in the third round of hearings.

CBA also notified the Commission of an incident, shortly before the Round 3 hearings, in which it identified that CBA and Bankwest merchant customers may have been charged fees for merchant facilities provided to them despite the customers not using or ceasing to use those facilities. CBA said that it had notified ASIC of the issue and was continuing to investigate it.[58]

CBA's SME-specific submissions showed that, since 2010, CBA had had 196 cases in FOS relating to business financial or SME lending issues with FOS having a view adverse to CBA in 86 of those cases.[59] More particularly, CBA acknowledged concerns where business loan arrangements had been varied or come to an end and gave details of 24 cases where FOS had a view adverse to CBA, including business customers experiencing financial difficulty.[60] CBA acknowledged that the experience of one customer, who had made a submission to the loan

[57] CBA, *Commonwealth Bank of Australia and Its Associated Australian Entities (Group) – Revised Table (1)*, 22 March 2018, 57 [307].

[58] Letter from Jane Couchman, CBA, to Chris Green, ASIC, 15 May 2018.

[59] CBA, *Business Lending CBA Response to the Royal Commission's Letter dated 5 April 2018*, 17 April 2018, 8 [40].

[60] CBA, *Business Lending CBA Response to the Royal Commission's Letter dated 5 April 2018*, 17 April 2018, 9 [40] (f).

impairment inquiry conducted by the Parliamentary Joint Committee, had been poor.[61]

3.4 Macquarie Bank

Macquarie Bank's SME-specific submissions identified 23 complaints, from 16 business banking customers, since 1 January 2012, relating to:

- unsuitable lending (2 complaints);
- financial hardship or proposed enforcement action (15 complaints); and
- declined applications and guarantees (6 complaints).[62]

Macquarie Bank also identified 679 complaints from customers of its Macquarie Leasing Pty Ltd and Macquarie Equipment Rentals Pty Ltd entities, of which:

- 29 complaints were identified by customers as relating to 'maladministration';
- 217 related to 'financial difficulty'; and
- 75 related to 'processes'.[63]

One of the instances relating to maladministration concerned a man's complaint about Macquarie Leasing's provision of finance for a purchase by his son of a luxury imported vehicle for business purposes, on the basis that his son had psychological issues that prevented him from making sound financial decisions at the time. Macquarie Leasing resolved the complaint by taking back the vehicle and waiving the shortfall.[64]

3.5 NAB

NAB did not aggregate instances of misconduct or conduct falling below community standards and expectations in relation to SME lending, instead

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61 CBA, *Business Lending CBA Response to the Royal Commission's Letter dated 5 April 2018*, 17 April 2018, 8 [33].

62 Macquarie Group, *SME Lending Request*, 17 April 2018, 5 [14].

63 Macquarie Group, *SME Lending Request*, 17 April 2018, 6 [16]–[17].

64 Macquarie Group, *SME Lending Request*, 17 April 2018, 6 [19] (b).

identifying 180 events recorded in their internal risk reports relevant to business lending. A review of the events identified by NAB showed that there were four recurring issues:

- first, incorrect disclosure of interest rates and interest calculated incorrectly resulting in clients being over charged;
- second, duplication of or incorrect disclosure of fees;
- third, defects with the provision of customers and guarantor consent, including consent forms missing from files or being provided after a loan had been granted or consent received after application; and
- fourth, failures to complete credit checks.

In its January 2018 submission, NAB acknowledged some specific instances of misconduct in relation to SME lending. It referred, in particular, to litigation in the Supreme Court of Victoria (*NAB v Rice*[65] and *NAB v Rose*[66]) in which the court found, in 2015, that NAB had failed to give a customer prominent notice of certain matters before execution of the guarantees, including, in particular, that the customer should seek independent legal and financial advice.[67]

As part of a program to review Code compliance, NAB identified in 2016/2017, that it may not be able to demonstrate that appropriate warnings and disclosures had been made to guarantors in compliance with Clause 31 of the Code. This matter was reported by NAB to the Code Compliance and Monitoring Committee in its annual compliance statements. The committee found that NAB had breached the Code when procuring guarantees prior to 2016.[68]

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65 *National Australia Bank Ltd v Rice* [2015] VSC 10.

66 *National Australia Bank Ltd v Rose* [2016] VSCA 169.

67 NAB, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry NAB Group's Response dated 29 January 2018 to the Commission's Letter dated 15 December 2017*, 29 January 2018, 6 [2]; see also *National Australia Bank Ltd v Smith* [2014] NSWSC 1605.

68 NAB, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry NAB Group's Response dated 29 January 2018 to the Commission's Letter dated 15 December 2017*, 29 January 2018, 6 [2].

3.6 Suncorp

Suncorp's submissions to the Commission acknowledged instances of conduct falling below community standards and expectations, of which two related to business banking. Suncorp acknowledged in its January 2018 submission that between 14 November 2015 and 10 March 2016, it failed to issue approximately 54,000 system-generated letters to retail and small business loan customers due to human error. This affected about 31,000 individual accounts. Suncorp reported this to ASIC as a breach of the National Consumer Credit Code. In December 2016, Suncorp and ASIC agreed to resolve the matter by ASIC issuing 20 infringement notices with a non-negotiable penalty of $270,000.[69]

The second matter acknowledged by Suncorp was an error, identified in 2015, in relation to Suncorp's systems and controls with respect to margin call facilities that had exposed borrowers to incorrect margin calls totalling about $4 million.[70]

3.7 Westpac

Westpac provides business lending under several different brand names: Westpac, St George, Bank SA, Bank of Melbourne and Capital Financial Australia.

In relation to applications for business loans, Westpac said in its SME-specific submission that it had identified examples where business bank customers may have been offered customer loans for personal purposes but the loan had been assessed as a business loan when it should have been offered and assessed as a loan within the scope of the NCCP Act. At the time of the Round 3 hearings, Westpac had told ASIC about the issue and was still in the process of identifying its scope.[71]

Westpac acknowledged a number of matters relating to business loans being varied or coming to an end. It referred to issues relating to collection

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69 Suncorp, *Submission to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, 29 January 2018, 8–9 [1.3].

70 Suncorp, *Submission to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, 29 January 2018, 10 [1.7].

71 Westpac, *Response of Westpac Banking Corporation Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, 20 April 2018, 14 [88].

functions performed by Westpac and third parties on Westpac's behalf, including three instances of inappropriate enforcement action being taken against borrowers.[72] It identified incidents where it did not verify the customer's financial information, did not appropriately test serviceability, did not follow appropriate process in meeting the customer face-to-face, or made errors in the origination of loans in the incorrect stream.[73] It referred to several FOS cases in which it had failed properly to consider or respond to a customer's notification to the bank about their financial distress with the consequence that it had continued with enforcement action rather than working with the customer.[74]

Over all, Westpac identified 98 instances of matters being referred to EDR in relation to business banking.

4 The voluntary guarantor

Because third party guarantees are commonly taken in support of loans to small or medium enterprises, the general law principles that affect whether the guarantee is enforceable are important.

The **general law has always been careful of the position of the volunteer**: the person who enters a transaction from which he or she stands to gain no benefit. Some guarantees of SME loans are given by volunteers, often enough by a person related to the principal of the business.

In certain circumstances, well-established principles of law and equity will prevent a creditor enforcing a guarantee signed by a volunteer (a voluntary guarantor). In *Commercial Bank of Australia Ltd v Amadio* the High Court held it would be unconscionable to allow the bank to enforce a

[72] Westpac, *Response of Westpac Banking Corporation Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, 20 April 2018, 13 [85] (a).

[73] Westpac, *Response of Westpac Banking Corporation Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, 20 April 2018, 13–14 [85] (f).

[74] Westpac, *Response of Westpac Banking Corporation Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, 20 April 2018, 15 [90] (d).

guarantee given by the parents of a borrower because the bank's employee had shut his eyes to the misconduct by which the son had procured his parents to give the guarantee.[75] In *Garcia v National Australia Bank Ltd* the High Court held that it would be unconscionable to allow the bank to enforce a guarantee of a company's obligations given by the wife of the principal of the company when the bank had not taken steps to explain its content and effect or have a third party do so.[76] Though the wife was both a shareholder and director of the company, her participation was nominal rather than substantial and she was, therefore, treated as a volunteer.

Echoes of those decisions sounded loudly in Westpac's lending policy documents explored during the evidence given in connection with one of the case studies undertaken in this round of evidence (concerning a guarantee given to Westpac by Ms Carolyn Flanagan). The policy placed much emphasis on whether a prospective guarantor stood to benefit from the transaction being considered and on the need for the guarantor to receive independent legal advice. The case itself raised a number of separate but related issues about whether there are cases where a volunteer cannot given an enforceable guarantee, and if there are, how those cases would be defined. Those issues are identified more fully at the end of this chapter.

5 Responsible lending

The Commission considered several different case studies about responsible lending. The chief general issue that emerged from those case studies can be identified as being what inquiries a diligent and prudent banker should make when deciding to lend to an SME. More particularly, to what extent may the banker take the business case presented by the loan applicant at face value? Is the banker to do more than conduct such checks and stress testing of assumptions made in the business case as the lender's policies require?

[75] *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447.

[76] *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395.

6 More general issues

The most general issue that was raised by the whole of the hearings about SME lending is whether there should be any change to the present legal framework governing those loans. I have said already that I did not understand there to be substantial support for changing the legal framework in ways that would bring some or all SMEs within the application of the NCCP Act. But I mention that matter again in case there are those who seek to persuade me to the contrary.

Three further issues did arise.

The first can be described as an issue about power and communication. Much of the dissatisfaction that SME borrowers have expressed (in the course of evidence and submissions in the Commission and more generally) about their dealings with lenders can be traced to two related sources: one about power; the other about communication. Borrowers came to recognise, both during the life of the loan and later, that the lender had what they saw as 'all the power' and they had none. And borrowers did not understand, and were not told, why the lender took the steps that it did when bringing the loan to an end.

The second issue can be described as a competition between regulation and self-regulation. Are the issues that arise when a loan is brought to an end to be resolved by reference only to the terms of the agreement that was made when the loan was made or renewed? Apart from existing rules prohibiting unconscionable conduct and rendering unfair contract terms void, should there be some additional rules that govern what a lender can or cannot do before it brings a loan to an end or it seeks to enforce repayment?

The third issue is narrower. If a lender makes a loan that a prudent and diligent lender would not have made, what should an EDR like FOS (now the Australian Financial Complaints Authority – AFCA) direct the borrower and the lender to do?

Again, each of these issues arose out of, and were well-illustrated by the case studies undertaken in the hearings. The issues about power and communication were examined in the cases of Bank of Melbourne and Mr Bradley Wallis and NAB and Mr Ross Dillon. They were issues that ran

through all of the four Bankwest case studies about loans to entities associated with Mr Michael Kelly, Mr Stephen Weller, Mr Michael Doherty and Mr Brendan Stanford.

Many of the case studies, especially those relating to Bankwest, raised issues about how a lender may bring a loan to an end or enforce repayment. My sense of the evidence and submissions, however, was that there was no substantial support for changing the legal framework in a way that would prevent a lender enforcing its rights under a loan agreement or in a way that would oblige a lender to make some fresh loan after an existing loan has expired. For some time there has been debate about lenders relying on non-monetary defaults to bring about the termination of a loan contract. But the 2019 Code will set limits on the use of provisions of that kind. Assuming that the contractual terms relied on are not unenforceable under the unfair contract terms provisions of the ASIC Act, and assuming further that reliance on the terms is not affected by the 2019 Code, are there any circumstances in which termination and renewal of a loan contract should be governed except by the general law of contract?

Whether the reach of either the unfair contract terms provisions or the small business provisions of the 2019 Code should be extended is an altogether separate issue. Given the nature and extent of the debate that appears to have been had between ABA and ASIC about the definition of small business in the 2019 Code, is the debate to be regarded as now closed? The evidence led in the Commission fell short of persuading me that the simpler definition that had been put forward by Mr Khoury (with a monetary limit of $5 million, not $3 million) should not be preferred. And that view was reinforced by the case studies looked at in connection with business lending to agricultural enterprises.

The third set of issues was illustrated by the case study about the Lows and BOQ. One of several loans made by BOQ was found by FOS to have not been made responsibly. The loan was for a term of years. The borrower had had the use of the money. Despite the conclusion that the loan should not have been made, was the loan to be allowed to run its course? If it was to be repaid sooner, how long should the borrower have to repay?

7 Issues that have emerged

The most general issues emerging from consideration of lending to small and medium enterprises can be identified as being:

- **Should there be any change to the legal framework governing small and medium enterprise (SME) lending?**
- **In particular, should any lending to SMEs come within the reach of the *National Consumer Credit Protection Act 2009* (Cth) (the NCCP Act)?**

The other issues calling for consideration can be described by reference to the following themes:

- **the content of Code of Banking Practice obligations;**
- **third party guarantors; and**
- **dispute resolution approaches by the Financial Ombudsman Service (FOS) and the Australian Financial Complaints Authority (AFCA).**

The first of these themes, the content of Code of Banking Practice obligations, concerns the meaning in particular of two obligations set out in the Code: first, the requirement that a bank providing a loan or limit increase will do so exercising the care and skill of a diligent and prudent banker, and second, the requirement that a bank assess whether a small business customer can repay a loan based on their financial position and account conduct. Submissions in response to this round of hearings demonstrated disagreement about the bounds and content of these obligations. That is significant given that they are the obligations that provide most practical protection to small businesses seeking funding from subscribing banks.

The second theme, **third party guarantors**, draws into sharp focus the disconnect between how the law, and lenders, may treat third party guarantors (as interested, or at least, rationally motivated actors) and the reality of the role played by many if not most guarantors of small business (family members assisting their loved ones in their plans). The questions raised here attempt to balance these inconsistent models, a task made more difficult by the central and perhaps irreplaceable role played by

guarantors in securing funding for small businesses and the particular vulnerability of small businesses to failure.

The third theme, dispute resolution approaches by FOS and AFCA, relates to the outcomes available to consumers who successfully seek intervention by a dispute resolution body. This round of hearings demonstrated that customers who were wholly or partly successful in their claims nonetheless sometimes struggled to achieve what they believed was a satisfactory outcome. If those beliefs were unrealistic, it is important to explore why. This theme encompasses the approach both of FOS and, necessarily, the approach of banks to the resolution of claims.

The issues can be amplified as follows:

7.1 Code of Banking Practice

- What inquiries should a diligent and prudent banker make when deciding whether to lend to an SME?
- Does 'forming an opinion about the customer's ability to repay the loan facility' as required by Clause 51 of the 2019 Code involve bringing critical analysis to the cash flow forecasts and other business plan documents presented by customers?
- If so, what level of analysis is acceptable?
- Is it enough that the lender satisfy itself the borrower can repay the loan and that the business plan is not obviously flawed?
- Is the standard set out in Clause 51 of the 2019 Code, which requires a bank to determine whether a customer can repay a loan based on their financial position and account conduct, a sufficient standard?

7.2 Guarantees

- If established principles of judge-made law and statutory provisions about unconscionability would not relieve a guarantor of responsibility under a guarantee, and if, further, a bank's voluntary undertaking to a potential guarantor to exercise the care and skill of a diligent and prudent banker has not been breached, are there circumstances in which the law should nevertheless hold that the guarantee may not be enforced?
- What would those circumstances be?
- Would they be defined by reference to what the lender did or did not do, by reference to what the guarantor was or was not told or by reference to some combination of factors of those kinds?
- Is there a reason to shift the boundaries of established principles, existing law and the industry code of conduct?
- If the guarantor is a volunteer, and if further, the guarantor is aware of the nature and extent of the obligations undertaken by executing the guarantee, is there some additional requirement that must be shown to have been met before the guarantee was given if it is to be an **enforceable undertaking**?
- Should lenders give potential guarantors more information about the borrower or the proposed loan? What information could be given with respect to a new business?

7.3 External dispute resolution

- Should AFCA adopt FOS's approach of putting the borrower back in the position they would be in if the loan had not been made, but not awarding compensation for losses or harm caused?
- Are there circumstances in which AFCA should waive a customer's debt?

5. Bankwest and CBA

Introduction

Before the third round of hearings began, the Commission had received 43 public submissions from former customers of Bankwest. Taken together, the submissions alleged that, after CBA acquired Bankwest in December 2008, it had acted improperly by terminating, not renewing, or in some cases not increasing, performing business loan facilities that Bankwest had granted. It was said that the premature termination of performing loans was 'engineered'.

The complaints are not new. They have been made in litigation between Bankwest and borrowers and the courts have rejected the allegations. They have been made in other forums. CBA has always denied that it acted improperly. The complainants sought to re-agitate their complaints in the Commission.

1 The complainants' conundrum

Most of those who complained about CBA's conduct had suffered significant loss when the business loans they had obtained from Bankwest came to an end. They complained about how they had been treated. But in support of their individual complaints they pointed to how many other Bankwest business loans had been dealt with in ways that they suggested revealed a pattern of improper conduct. In particular they said that the losses inflicted on individual customers could be judged by how many loans CBA defaulted and how many millions of dollars of loans CBA wrote off after the Bankwest acquisition.

But there is a conundrum at the heart of the allegations.

The complaints that are made all proceed from the premise that, contrary to the judgments that CBA made at the time, and contrary to the facts as they unfolded, the individual loans were all sound. But, as will be seen, the loans, in fact, were not sound and were not all well-secured. Both CBA and HBOS

accepted at the time of the sale that there were problems with the Bankwest business loan book, as a result of which the sale price was discounted. For the purposes of the sale price adjustment mechanism, Ernst & Young (EY) concluded that the loan provisions should be increased (potentially leading to a price decrease), although other countervailing adjustments resulted in a small increase to the purchase price. Over time, CBA had to increase the provisions it made for impairments, including over loans that had been performing at the time of the takeover. CBA's auditors considered the increase of the provisions to be prudent. Eventually, in terms of the quantum, CBA wrote off more on the Bankwest commercial loans that were in place at the time of the takeover than it benefited from through the discount to the price.[1]

So if, contrary to the facts as they unfolded, the loans were sound and well-secured, why would CBA deliberately set out to bring the loans to an end? **What motive could it have for 'engineering' default or not extending a loan if the borrower was meeting what was due and the loan was well-secured?** What motive could CBA have to act in ways that would not maximise its profit from the transaction?

Over the course of the years since CBA acquired Bankwest, several theories have emerged as suggested answers to these questions. First to emerge was the clawback theory. It was said that CBA did what it did to reduce the amount it had to pay for Bankwest. Sometimes, it was said that loans were defaulted to give CBA a claim against HBOS plc, a UK bank, for breach of warranties given in the sale and purchase agreement. More recently, a '**Tier 1 Capital** Ratio theory' has emerged. It is said that CBA did what it did because doing so improved its Tier 1 Capital Ratio (or its 'economic capital' generally) or because doing so somehow helped CBA meet some unspecified 'regulatory' or 'prudential' requirements. And even more recently it has been suggested that CBA acted as it did because, having bought Bankwest cheaply, it could afford to write down the value of the loan book it thus acquired. That is, having paid less than the face value of the loans it acquired, writing off the loans it did still left CBA profiting from the acquisition.

The clawback theory (and its variant about claiming on warranties) is demonstrably false. So too, the Tier 1 Capital Ratio theory (and its variants

[1] Exhibit 3.2, 10 November 2015, Letter from CBA, 3.

referring generally to 'economic capital' or 'regulatory' or 'prudential' requirements) are demonstrably false. And common to those, and the 'CBA got a bargain' theory is the fact that each theory would prove too much. Each theory asserts, expressly or implicitly, that CBA did what it did to inflict harm on itself. That is, each theory asserts that CBA did not make the decisions it made about individual loans by reference to the circumstances affecting *that* loan; instead, CBA decided not to renew that loan, and others, or decided to enforce that loan, and others, so that CBA could derive some other advantage either by sustaining a loss in respect of the loans it brought to an end or by making less profit.

None of the theories, if true, would make commercial sense. The conundrum remains unanswered.

To explain why the theories are false it is necessary to say something about the acquisition of Bankwest, then something about earlier inquiries and consideration of these issues and finally deal directly with why the theories are false.

2 The Bankwest acquisition

Bankwest, formerly called the Bank of Western Australia Ltd, was the State Bank of Western Australia. In 2003, a subsidiary of the UK bank, HBOS plc, acquired Bankwest.

In the years that followed, Bankwest was heavily dependent on funding from its UK parent. But, like many other European and American banks, HBOS was badly affected by the Global Financial Crisis (GFC). In mid-September 2008, Lloyds TSB announced a proposal to acquire HBOS and, soon after the sale of HBOS, the UK Government took a 40% stake in the merged entity. HBOS decided to sell Bankwest.

The sale took place at a time of great fear about the global financial system. There had been a crisis in the United States sub-prime market in 2007. Lehman Brothers collapsed in September 2008. The GFC was upon us.

CBA agreed to buy Bankwest. There was no time for any prolonged due diligence. The sale agreement was made on 8 October 2008 and it provided for an initial purchase price of $2.1 billion to be paid on 19 December 2008.[2]

The sale was subject to regulatory approval. Approval was granted by the Australian Competition and Consumer Commission (ACCC) on 10 December 2008.[3] The Treasurer of the Commonwealth approved the sale on 18 December 2008.[4]

The principal asset of Bankwest was its loan book. The initial purchase price reflected a significant discount on the net assets of Bankwest. The inescapable conclusion is that both the vendor and purchaser regarded the true value of the business loan book as being much less than the face value and so accepted that there were issues with the 'quality' of the business loans that had been written by Bankwest. As will be seen, this assessment by the two parties to the transaction was correct, although eventually CBA wrote off more on the Bankwest business loans in place at the time of the takeover than the value of the discount to the price it paid for the loans.

The sale agreement provided a mechanism for adjustment of the initial purchase price. The adjustment was to be made by reference to the financial accounts of Bankwest as at the settlement date of 19 December 2008. HBOS was to provide its calculation of the adjustments necessary and, in the absence of agreement, the sale agreement provided a mechanism for resolution of the dispute and finalisation of the amount of the adjustment by expert determination.

On 19 February 2009, HBOS gave CBA a draft completion balance sheet for Bankwest as at 19 December 2008. The draft completion balance sheet was accompanied by price adjustment calculations and by an unqualified audit report by KPMG. CBA was required to give notice by 20 April 2009 whether it agreed or disagreed with the content of the draft completion

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2 Exhibit 3.200, 8 October 2008, Share Sale Deed, 20 [4.1]; CBA, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Submission*, 29 January 2018, 32 [181].

3 See ACCC, *Public Competition Assessment: Commonwealth Bank of Australia – Proposed Acquisition of Bankwest and St Andrew's Australia*, 10 December 2008, 1[1].

4 See Wayne Swan, Deputy Prime Minister and Treasurer, 'Proposed Acquisition of Bank of Western Australia and St Andrew's by the Commonwealth Bank of Australia' (Media Release, No. 144, 18 December 2008).

balance sheet and the price adjustment calculations. CBA gave notice that it disagreed with 22 items in the draft completion balance sheet.

HBOS and CBA tried to resolve the differences by negotiation and some were agreed. On 5 June 2009 the parties instructed EY to determine the remaining disputed items. EY completed its determination on 7 July 2009. The result was an increase of $26.1 million in the price payable by CBA. That is, the final price paid by CBA was $2,126.10 million. The figure of $26.1 million was the balance resulting from increases and decreases that reflected EY's determination of the several disputed items.[5] Of those disputed items, two related to impairment of loans. One related to the amount that should be allowed as *specific* provisions in respect of particular loans; the other related to the level of *general* provision that should be made in respect of some classes of loans. Taken together, the two items relating to impairment of loans accounted for a $156.45 million price decrease,[6] but they were more than netted out by other disputed items that EY determined required increasing the price. The amount of the adjustment ($26.1 million) was much less than the provision ($328 million) that CBA had made in its 31 December 2008 half yearly accounts for the outcome of the price adjustment mechanism.[7]

What then happened in connection with Bankwest's business loans must be understood bearing three dates at the forefront of consideration:

- First, the critical date in the purchase agreement was 19 December 2008. That was the settlement date. The financial accounts used to determine price adjustments were Bankwest's financial accounts as at 19 December 2008. Those accounts were prepared by Bankwest and audited by Bankwest's auditors. EY's expert determination decided, among other things, what specific provisions and what general provisions should be made *as at that date* for impaired loans.

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5 Exhibit 3.186, 7 July 2009, Expert Determination Report Pursuant to the Share Deed dated 8 October 2008 (as amended) Commonwealth Bank of Australia and HBOS Australia Pty Ltd, 11 [14], 118 [Part D].

6 Exhibit 3.186, 7 July 2009, Expert Determination Report Pursuant to the Share Deed dated 8 October 2008 (as amended) Commonwealth Bank of Australia and HBOS Australia Pty Ltd, 10 [2], [3].

7 Exhibit 3.187, 11 February 2009, CBA, Profit Announcement for the Half Year Ended 31 December 2008, 47.

- EY made its determination on 7 July 2009 but that was a determination of what it considered to be true and fair accounts of Bankwest as at 19 December 2008.
- CBA began its review of Bankwest's business loan book – called 'Project Magellan' – in about April 2010.[8] Planning for the review seems to have begun in about February of that year.

3 Previous inquiries

As already noted, there have been several inquiries into CBA's actions in connection with Bankwest business loans. Those inquiries have included:

- the Senate Economics References Committee Inquiry during 2012 into 'The Post-GFC Banking Sector';
- the Inquiry by the Parliamentary Joint Committee on Corporations and Financial Services Inquiry on 'Impairment of Customer Loans';
- the Australian Securities and Investment Commission's (ASIC's) inquiries into allegations of misconduct in relation to commercial loans and engineered defaults; and
- the Australian Small Business and Family Enterprise Ombudsman's (ASBFEO's) Inquiry into Small Business Loans.

Parliamentary privilege precludes me from canvassing what was said to, or decided by, either of the Parliamentary inquiries.

In the course of preparing for the third round of the Commission's hearings, counsel and solicitors assisting the Commission considered documents produced by ASIC in response to notices to produce and they consulted with senior members of ASIC's Deposit Takers, Credit and Insurers team about reports of misconduct that ASIC had received and considered in relation to commercial loans. About half of the matters related to loan

[8] Exhibit 3.111, Witness statement of David Cohen, 17 May 2018, 32 [137(c)]. There were other overlapping projects, including Project Sonic, which sought to implement a lower risk strategy with a preference for what was described by CBA as 'straightforward' banking.

defaults occurring in the 2009/2010 or 2010/2011 financial years. ASIC considered that concerns that banks had imposed unfair terms or used their strong bargaining position to disadvantage debtors could not be made out on the evidence presented. It described the number of reports of alleged misconduct in relation to commercial lending involving 'engineered' defaults as negligible. ASIC considered two particular cases where Bankwest had made loans and the borrowers alleged that CBA had acted wrongly after it acquired Bankwest. ASIC decided not to pursue regulatory or enforcement action in relation to any of the matters reported to, or considered by it because it concluded that there was not sufficient evidence of misconduct to take further action.

In September 2016, the Minister for Small Business asked the ASBFEO to inquire into small business loans. Among other things, ASBFEO considered 23 particular cases and conducted a 'deep dive' review of eight selected cases. Of those eight cases, only two concerned business loans by Bankwest. Both related to property development. One of the two Bankwest business loans examined by ASBFEO was for more than $170 million. During the inquiry the ASBFEO consulted business owners and stakeholders, including business owners in the case studies being reviewed, customer advocates of the four major banks, and regulators. The ASBFEO conducted a number of hearings. Documents relating to those reviews were produced to the Commission in accordance with notices to produce. They were considered in the course of preparing for the hearing at which the issue of the takeover of Bankwest by CBA was ventilated.

The ASBFEO's report recorded that the Ombudsman considered that some of the cases examined raised 'very real issues where bank conduct is unacceptable and possibly unconscionable'.[9] But, as Senior Counsel Assisting the Commission pointed out when opening the third round of the hearings, the Ombudsman told the Commission that, contrary to what may have been thought to be countenanced by her report, she considered that the so-called 'clawback' theory was false.[10]

I agree.

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[9] ASBFEO, *Inquiry into Small Business Loans,* 12 December 2016, 6.

[10] Exhibit 3.188, ASBFEO, *The Need for Further Inquiry into BWA/CBA's Treatment of Corporate and SME Customers Post Acquisition of BWA*, undated, 4 [9.1].

Other, more particular, criticisms made of CBA's conduct in relation to the particular loans the ASBFEO examined are better considered in connection with the case studies that the Commission undertook.

In the courts, borrowers have made complaints of the same general kind as were made to the Commission. Some of those cases were settled. A class action remains pending in the Supreme Court of New South Wales. Two cases that have gone to judgment raised the clawback theory.[11]

In the first case that went to judgment (*International Skin Care*) the borrower made allegations that amounted to a form of the clawback theory. The borrower alleged that the borrower's facilities, though not in fact impaired, had been classified as impaired so that CBA could obtain a reduction in the purchase price for Bankwest. These allegations were abandoned at trial. Nonetheless, the trial judge, Hammerschlag J, considered the allegations and said of them that there was no proper basis for the charges of dishonesty that had originally been levelled at CBA and its officers, but then abandoned.[12] It is not to the point that the allegations were abandoned by the plaintiff at trial, and their resolution was not necessary to the quelling of the plaintiff's dispute. Having all of the relevant evidence, Hammerschlag J decided that '[t]here was no evidence that impairment of any of [the relevant facilities] could, let alone did, have any downward effect on the price paid' by CBA for Bankwest.[13]

In the second case, the borrower initially had sought to advance the clawback argument that had been made in *International Skin Care* but had been abandoned during the trial of that action. The trial judge in this second case (again Hammerschlag J) recorded that, once *International Skin Care* was decided, the borrower in the second case, Mr Neale, had accepted that

11 *International Skin Care Suppliers Pty Ltd v Commonwealth Bank of Australia* [2013] NSWC 1768; *Neale v Bank of Western Australia Ltd* [2014] NSWSC 315 and, on appeal, [2015] NSWCA 272.

12 *International Skin Care Suppliers Pty Ltd v Commonwealth Bank of Australia* [2013] NSWC 1768 [605].

13 *International Skin Care Suppliers Pty Ltd v Commonwealth Bank of Australia* [2013] NSWC 1768 [602].

the clawback argument was not correct.[14] Instead the borrower sought to advance an argument that 'once the Commonwealth Bank had taken over Bankwest, it set out on a deliberate course of targeting Bankwest's customers, including himself, with the intention of harming them by fraudulently forcing them into default and selling them up at an undervalue'.[15] Despite what Hammerschlag J said[16] was the borrower's 'describing himself as a doctor who had to push to the front of the queue to help other victims of the Commonwealth Bank's behaviour, of a Senate inquiry which had failed to provide an avenue for redress, and of the failure of the fraud squad to react to his complaints', his Honour refused the borrower leave to amend his pleadings to raise these arguments. Among other things, Hammerschlag J said that 'no rational basis was given why [CBA] would, to its own detriment, seek destruction of its subsidiary's assets'.[17] The borrower's appeal to the Court of Appeal against the decision of Hammerschlag J was dismissed.[18]

Together the decisions show that the theories advanced in those cases were abandoned (but said by the judge to be unsupported by evidence) or found by the judge to be so insubstantial ('no rational basis was given …') that permission to raise the allegation was refused.

4 Analysis of the various theories

CBA has long asserted that it acted for sound commercial reasons. In its profit announcement for the year ended 30 June 2010 CBA said that:

> [CBA] identified many pre-acquisition loans [made by Bankwest] reflecting poor asset quality, high loan to value ratios and insufficient covenant coverage. This resulted in significant risk grade reassessments and

[14] *Neale v Bank of Western Australia Ltd* [2014] NSWSC 315 [31]. Mr Neale has since told the Commission, more than once, that he considers that the clawback theory has no foundation.

[15] *Neale v Bank of Western Australia Ltd* [2014] NSWSC 315 [24].

[16] *Neale v Bank of Western Australia Ltd* [2014] NSWSC 315 [32].

[17] *Neale v Bank of Western Australia Ltd* [2014] NSWSC 315 [40].

[18] *Neale v Commonwealth Bank of Australia Ltd (t/as Bank of Western Australia)* [2015] NSWCA 272.

> security revaluations with loan impairment expenses increasing $304 million. These loans are confined to the pre-acquisition business banking book.[19]

This observation captures the central elements of CBA's answer to allegations that what it did in connection with Bankwest's business loan book was improper. CBA says that Bankwest's business loan book had loans of poor quality; that 'Project Magellan' was directed to identifying what loans were poor and what provisions should be made; and that 'Project Magellan' was conducted as it was, when it was, to allow CBA to prepare true and fair accounts as at 30 June 2010. In addition, as will be considered more closely in connection with particular case studies undertaken in the course of the third round of hearings, CBA says that it acted in individual cases in the prudent exercise of its contractual powers, albeit on occasion attended by conduct that it now concedes falls short of community standards and expectations.

As already noted, those who complain about CBA's conduct in connection with Bankwest describe CBA's conduct in different ways, but the central uniting thread is that CBA 'engineered' the default of 'performing' loans. The notion of 'engineering' default of an otherwise 'performing' loan calls for close and careful consideration. In some cases, the complaint is not that a loan was brought to a premature end, but that a term loan, having reached its expiry, was not renewed. In one case (to which I will return below) the complaint is that the loan, though then in default, was not only not renewed but was not increased by a further $19 million. In other cases, the loan was 'performing' in the sense that the borrower was making repayments as and when due, but other provisions of the loan agreement (in particular, financial indicator covenants) were not being met.

Care must be exercised lest words like 'engineered' and 'performing' are used in ways that convey more than the underlying facts will support.

The importance of unpacking the expressions is emphasised by asking the question that has already been identified. Why would CBA 'engineer' default of otherwise 'performing' loans? If the loan was sound, adequately secured, and being serviced, why bring it to an end? Why do that if the probable,

[19] Exhibit 3.189, 11 August 2010, CBA, Profit Announcement for the Full Year Ended 30 June 2010, 30.

even inevitable, consequence of doing so was that CBA would itself suffer loss?

As has already been said, several explanations have been offered. The explanations are not consistent one with another. Common to all has been an attempt to identify a reason for CBA systematically to default loans for a reason or reasons that are unconnected with CBA's judgment of the risks associated with the particular loan. That is, as Senior Counsel said in the course of opening this aspect of the third round of hearings, those who complain about CBA's conduct say that CBA acted with some ulterior motive.

The clawback theory has been described. It asserts that after acquiring Bankwest CBA acted deliberately to impair some loans so that it could 'clawback' the amount of the impairment from HBOS under the price adjustment mechanism.

There are at least four reasons to reject the allegation. As has already been emphasised, the price adjustment mechanism in the sale agreement directed attention to the state of Bankwest's accounts as at 19 December 2008. If an adjustment was to be made to the purchase price because a loan was impaired, that provision had to be one that ought to have been made in Bankwest's account as at 19 December 2008. That is, the loans relevant to the price adjustment mechanism were ones in respect of which provision should have been made immediately *before* CBA acquired Bankwest. CBA's conduct *after* acquisition was irrelevant to whether the loan was impaired at the relevant date.

Second, the suggestion that CBA defaulted loans after 19 December 2008 in order to render them 'impaired' as at 19 December 2008 fails to recognise the real and radical distinction between a loan being 'impaired' and a loan being in default. A loan is impaired if the lender concludes that there is doubt about whether the lender will recover the full amount lent. A loan may be impaired even if the borrower is not in default. And, conversely, a borrower may be in default but, if the bank has sufficient security to cover both the amount of the loan and the costs of recovery, the loan may not be impaired. If the loan is impaired, the lender should make a provision in its accounts to cover the expected shortfall. The lender may make specific provisions in respect of particular loans; the lender with a large book may make a general provision against the risk of non-performance of the book taken as a whole.

Third, nearly all of the complaints by Bankwest customers that the Commission has considered are directed to events occurring well after 7 July 2009. For the most part, the complaints concern events in 2010 or later. (The case of Mr Rory O'Brien, to which I refer below, is a notable exception.) EY had completed its expert determination under the price adjustment mechanism by 7 July 2009. Nothing done after that date, could have, or did have, any effect on that determination. The price adjustment mechanism had done its work. Subsequent events were irrelevant to the price adjustment process.

Fourth, the Commission's review of what was done in connection with the price adjustment mechanism lends no support to the clawback theory. EY made its own determination about whether loans in respect of which CBA said the accounts should make specific provision as at 19 December 2008 were properly regarded as impaired.

The Commission reviewed the submissions made by CBA to EY in respect of each of the loans that it submitted should be the subject of specific provision in the HBOS balance sheet as at 19 December 2008. The review showed no evidence consistent with CBA having taken any action in respect of any of the relevant loans in order to bolster its argument that provision should be made. Indeed, the fact that HBOS sought to decrease the relevant adjustment, by its draft completion balance sheet, provided on 19 February 2009, and CBA sought, by its response provided on 20 April 2009, to increase the provision is hardly surprising. The parties had directly opposed commercial interests. That was why it was necessary for EY to resolve the difference, as the sale agreement contemplated. In the event, EY concluded that the provisions should be increased, although other adjustments resulted in a price increase.

The clawback theory is untenable.

Likewise, it cannot be said that CBA acted as it did so that it could make some claim on warranties given by HBOS in the sale agreement. The short answer to the allegation is that CBA made no warranty claims that related to the loan provisioning.[20] This theory, too, is untenable.

[20] The warranty claims related to other matters, including technology licences and other information technology issues and in relation to various basis swap trades.

As has been noted, a different explanation for what is alleged to have been CBA's deliberate engineering of defaults in otherwise performing loans has emerged more recently. It is suggested that CBA took the steps it did in order to improve its Tier 1 Capital Ratio.

Again, the argument takes several different forms. The most common form suggested that the Board of CBA decided, in early 2009, to lift its internal Tier 1 Capital Ratio target to more than 7%. This decision is said to have created pressure on CBA management to improve the bank's Tier 1 Capital Ratio and it is suggested that, because CBA did not wish to raise capital, CBA had an incentive to impair or write off loans to improve its capital ratio. And describing the argument more generally, as CBA acting as it did to meet unspecified 'prudential' or 'regulatory' requirements, simply hides the substance of the allegation that is being made.

The Tier 1 Capital Ratio theory has several fatal flaws.

First, at December 2008 CBA had a Tier 1 Capital Ratio of 8.4%, the highest of the big four banks. If, as most versions of the Tier 1 Capital Theory have it, CBA was looking to raise its Tier 1 Capital Ratio above 7%, CBA was already well above that figure at the time it acquired Bankwest and CBA's Tier 1 Capital Ratio did not drop below 8.1% at any time thereafter. After the acquisition, CBA's Tier 1 Capital Ratio was 8.3% at March 2009, 8.1% at June 2009, 8.2% at September 2009 and thereafter was always greater than 9%.[21]

Second, at the relevant times, CBA was not avoiding raising capital. In March and September 2009, CBA issued $405 million and $688 million of ordinary shares to satisfy its dividend re-investment plans. In March 2009, it issued $865 million ordinary shares with respect to a share purchase plan. In October 2009 CBA issued $2 billion of PERLS V securities of which $1.6 billion qualified as Tier 1 capital.[22] Third, and most importantly, neither impairing a loan nor making a provision for impairment improves a bank's

[21] Exhibit 3.1, undated, Attachment A: Tier 1 Capital Ratios, 2.

[22] Exhibit 3.190, CBA, Basel II Pillar 3 – Capital Adequacy and Risk Disclosures: Quarterly Update as at 31 March 2009, 1; Exhibit 3.191, CBA, Basel II Pillar 3 – Capital Adequacy and Risk Disclosures: Quarterly Update as at 30 September 2009, 1; Exhibit 3.192, CBA, Basel II Pillar 3 – Capital Adequacy and Risk Disclosures as at 31 December 2009, 5. See also Exhibit 3.193, 11 August 2010, CBA, Annual Report 2010, 3, 45, 47, 161.

Tier 1 Capital Ratio: it reduces the bank's Tier 1 Capital Ratio.[23] Thus the consequence of systematically impairing loans would be to reduce the Tier 1 Capital Ratio, not improve it. Likewise, writing off a loan does not improve a bank's capital ratio.[24] And, CBA's write-offs in 2009 and 2010 were markedly smaller than in the years between 2011 and 2015.

Fourth, there is nothing in any of the material that CBA produced to the Commission that shows any connection between CBA's conduct in relation to the Bankwest commercial loan book and CBA's capital management of its Tier 1 Capital Ratio.

Finally, the maintenance by a bank of the prescribed Tier 1 Capital Ratio is a regulatory requirement. CBA could not be criticised for seeking to comply with this requirement. There is nothing 'ulterior' in such a motive; it is required by the regulator.

Putting the argument in some more general and abstract form, by saying that CBA acted as it did to improve its 'economic capital' (by reducing its exposure to risky loans) or to meet some unspecified 'prudential' or 'regulatory' requirements, makes the argument worse, not better.

In the context of banking, economic capital refers to the capital that a bank needs to protect against future losses. Economic capital is a measure of risk (whereas regulatory capital [Tier 1] is a measure of capital). It is used as a means of managing risk across different lines of business.[25] It follows that saying that a bank is motivated by improving economic capital consumption (by reducing risk) is akin to saying that the bank is motivated by managing

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[23] APRA, *FSRC Background Paper No. 9: The Regulatory Framework for Authorised Deposit-Taking Institutions (ADIs),* 27 April 2018; APRA, *FSRC Background Paper No. 13: The Regulatory Capital Framework: Impairment, Provisioning and Enforcing Security*, 18 May 2018; see also APRA, *Prudential Standard APS 220 Credit Quality,* January 2015.

[24] APRA, *FSRC Background Paper No. 13: The Regulatory Capital Framework – Impairment, Provisioning and Enforcing Security*, 18 May 2018.

[25] The Basel Committee on Banking Supervision, 'Range of Practices and Issues in Economic Capital Frameworks', March 2009, 8, defined economic capital as 'the methods or practices that allow financial institutions to consistently assess risk and to attribute capital to cover the economic effects of risk-taking activities'.

its risk. This is eminently prudent and so again, there is nothing 'ulterior' about such a motive.

The theory that CBA bought Bankwest for a bargain (one submission quantified it as CBA buying each dollar of loans for 73 cents in the dollar) and so could afford to write off loans is also untenable. There are two reasons.

First, unless it is assumed that CBA was irrational, there is no logical connection between the price CBA paid for Bankwest and how it managed loans after acquisition. I would expect that CBA managed loans after its acquisition of Bankwest for its commercial benefit. If it thought that it would achieve a better outcome by extending a loan then it would do so. If it thought that it would likely achieve a worse outcome if it extended a loan (for example because the value of an asset was likely to continue to deteriorate) then it would not extend the loan. The price it had paid for Bankwest was a sunk cost. Whether it had obtained a bargain or not did not affect future outcomes.

Second, the argument misunderstands the facts as they occurred. CBA eventually wrote off $2.77 billion of the commercial loans held at 19 December 2008. Of that, $630 million was accounted for in the loan impairment provisions as at 19 December 2008 (as allowed by EY).[26] The balance of $2.14 billion was an additional loss not accounted for in the purchase price.

None of the several different reasons that have been advanced in support of the allegation that CBA deliberately engineered defaults of business loans made by Bankwest holds water. The complainants' conundrum remains unsolved.

Why then did CBA act as it did? Mr David Cohen, Chief Risk Officer of CBA, gave evidence to the Commission about these matters. He said that CBA acted as it did for a combination of reasons reflecting four heads of concern:

- the overall quality of the loan book;
- there was an undue concentration of lending;

[26] Exhibit 3.2, 10 November 2015, Letter from CBA, 3.

- the quality of loan management; and
- the adequacy of provisioning.

First, it became apparent to CBA, soon after it acquired Bankwest, that there were problems with the quality of the business loan book. It must be borne in mind that, given the urgency with which the sale and purchase was made, CBA had no opportunity to conduct extensive due diligence inquiries. The vendor had to sell and sell quickly. CBA paid less than book value for Bankwest and took Bankwest as it found it. The vendor got the best price it could for what both vendor and purchaser evidently regarded as a poor loan book.

By March 2009, there had been a notable increase in the concentration of troublesome assets.[27] (CBA and Bankwest distinguished between 'impaired' assets and 'troublesome' assets. An impaired asset is a loan where the bank does not expect to recover the full proceeds of the loan and expects to make a loss. A troublesome asset is an asset that is not an impaired asset but where there is a concern about the health of the loan and 'derives from a view that the likelihood of loss from that loan has increased'.[28]) During 2009, Bankwest increased its provisions for losses in its business loan portfolio. Mr Cohen said that 'these increases had not been anticipated by Bankwest or flagged to CBA in advance'.[29]

Second, soon after CBA acquired Bankwest it learned that Bankwest had adopted a very aggressive strategy in lending with respect to commercial property, particularly in the eastern states.[30] At the time of CBA's acquisition of Bankwest, 50% of Bankwest's 'non-retail exposures' were 'commercial property related'.[31] CBA's internal documents, particularly papers put to CBA's Executive Risk Committee, showed, unsurprisingly, that the CBA group sought to manage, and limit, the Group's exposure to commercial property lending. I say that is 'unsurprising' because, as Mr Cohen

27 Transcript, David Antony Keith Cohen, 29 May 2018, 2726–7.

28 Transcript, David Antony Keith Cohen, 29 May 2018, 2727.

29 Exhibit 3.111, Witness statement of David Antony Keith Cohen, 17 May 2018, 28 [120].

30 Transcript, David Antony Keith Cohen, 29 May 2018, 2738–9.

31 Exhibit 3.116, 11 September 2009, Memorandum to Executive Risk Committee CBA, 1–2 [3.5].

explained, banks seek to mitigate risk by diversification, limiting concentration in lending to particular industries and particular geographic areas.[32] To that end, CBA's Executive Risk Committee decided in December 2009 to introduce exposure caps for commercial property lending and to reduce Bankwest's property exposures.[33]

Third, in light of the increases in provisions that were made during 2009, and the number of times increases were being made, CBA and Bankwest became concerned about three aspects of the management of Bankwest's business loans:

- the effectiveness of Bankwest's collective provisioning models and processes;
- the extent of monitoring and awareness of the health of the Bankwest business loan portfolios; and
- whether the Bankwest business loan portfolio was being credit rated and managed in accordance with CBA's standards.[34]

Mr Cohen explained the third of these points as a concern first, that the credit ratings used by Bankwest when it was rating particular business loans were not being as diligently applied as CBA applied credit ratings and, second, that the day-to-day management of a loan by business relationship managers was not as active as it should have been.[35]

A fourth concern arose out of the issues that had emerged about risk rating and loan management. Was there proper collective provisioning?[36] The amount allowed as a collective provision was calculated in a way that depended upon (among other things) the credit risk rating that was given to each particular loan in the portfolio. Hence, if the risk rating was not determined diligently and business relationship managers did not monitor

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32 Transcript, David Antony Keith Cohen, 29 May 2018, 2731.

33 Exhibit 3.116, 11 September 2009, Memorandum to Executive Risk Committee CBA, 2 [4.2].

34 Exhibit 3.111, Witness statement of David Antony Keith Cohen, 17 May 2018, 28 [121].

35 Transcript, David Antony Keith Cohen, 29 May 2018, 2734.

36 Transcript, David Antony Keith Cohen, 29 May 2018, 2735.

the health of outstanding loans, the amount to be allowed as a collective provision may be incorrectly assessed.

CBA responded to the issues that had emerged during 2009 in a number of ways. First, it added more resources to, and improved the operating procedures of, the 'Credit Asset Management' team within Bankwest. The Credit Asset Management team (often referred to as 'CAM') was the group that looked after troublesome and impaired loans. (In 2012 Bankwest's CAM team became part of CBA's 'group credit structuring' or GCS team.[37])

Second, in about April or May 2009, Bankwest introduced, for the first time, a 'watch list' of loans for which the 'credit health' had started to deteriorate and cause concern, but not to the point where the loan had become a troublesome or impaired asset.[38] An important purpose of the watch list was to try to prevent loans on the list reaching the point of being rated as troublesome or impaired.

Third, by September 2009, Bankwest had put in place revised caps on commercial property exposure. It was reported to the CBA Executive Risk Committee that Bankwest had committed to reducing its commercial property exposure from $14.8 billion to $14.25 billion by 31 December 2009 and to capping the exposure at that level through to December 2010. Bankwest also committed to reducing the level of non-retail assets that property services and construction then represented from 50.5% at 31st July 2009, to 45% by 31st December 2009 and to 40% by 31st December 2010.[39] Mr Cohen's evidence was that looking back, the introduction of these caps was a prudent response to Bankwest's over exposure to commercial property.[40] The commercial property exposure cap was reduced to $13 billion in August 2011, and to $12 billion in November 2012.[41]

In March 2013, it was reported that Bankwest's commercial property exposure had fallen from a peak of $14.8 billion in July 2009, to $9.8 billion

37 Transcript, David Antony Keith Cohen, 29 May 2018, 2735.

38 Transcript, David Antony Keith Cohen, 29 May 2018, 2736.

39 Exhibit 3.116, 11 September 2009, Memorandum to Executive Risk Committee, 2 [4.2].

40 Transcript, David Antony Keith Cohen, 29 May 2018, 2733.

41 Exhibit 3.120, 5 March 2013, Report to the CBA Executive Risk Committee, 1 [3.1].

at 31 December 2012.[42] Most of that reduction had occurred by January 2011.[43]

Between July 2009 and February 2010, 250 loans with a value of $1.4 billion were transferred into CAM because they had been identified as being troublesome or impaired. CAM's task was to manage the loan to the point where either its credit rating improved such that it was no longer classified as troublesome or impaired (when the loan would be returned to the relevant business unit for continued management in the ordinary way) or, as Mr Cohen put it, to 'work with the customer to end the relationship in a normal way, such as when a loan matures, when it reaches expiry or through repayment by re-financing for example … or if none of those were available then through enforcing as a last resort'.[44]

In about February 2010, CBA began to plan a systematic review of the rest of Bankwest's business loan book. The project was called 'Project Magellan'. Project Magellan and its consequences lie at the heart of many of the complaints that former Bankwest customers make about CBA's conduct. One of the first steps that the Commission took when considering how to identify and deal with the allegations that have been made about CBA's conduct with respect to Bankwest was to require CBA to produce documents relating to Project Magellan. Counsel and solicitors assisting the Commission examined many thousands of documents relating to Project Magellan produced by CBA in response to notices to produce.

Project Magellan was a review of what was described as the 'good book' from Bankwest's business portfolio. The 'good book' was that part of Bankwest's business loan portfolio that had not been classified as troublesome or impaired. The purpose of the review was to determine whether the loans had been properly classified (as neither troublesome nor impaired) and to determine whether there should be an adjustment to the

42 Exhibit 3.120, 5 March 2013, Report to the CBA Executive Risk Committee, 1 [3.1], 4 [Figure 1].

43 Exhibit 3.120, 5 March 2013, Report to the CBA Executive Risk Committee, 4 [Figure 1].

44 Transcript, David Antony Keith Cohen, 29 May 2018, 2736–7; see also Exhibit 3.117, March 2010, Bankwest Business Watch List, Troublesome and Impaired Accounts Update.

amount of collective provision that should be made in respect of the 'good book'.[45]

Accurate provisioning for impaired loans was then, and remains, important for two simple but compelling reasons. First, proper provisioning is necessary to satisfy prudential obligations. Second, proper provisioning is necessary to allow calculation of the loan impairment expense that should be taken into account in determining the amount of the profit to be recorded in the bank's financial statements and reported to the market.[46] At that time, the second requirement assumed significance; the end of the 2009/2010 financial year was fast approaching. Despite it being said in one submission that this urgency demonstrates some ulterior purpose, the need to prepare the bank's financial statements, and comply with its legal and other obligations, explains the urgency that attached to the review process being undertaken by the bank.

The files reviewed in Project Magellan met one or more of a long list of criteria. The criteria required review of accounts for all hotels and pubs, most exposures classified as property in Bankwest's commercial business, many accounts relating to aged care (including retirement villages), and land bank and property development businesses.[47] There were other criteria that, if met, required loans to be included in the Project Magellan reviews but their detail need not be noticed. For present purposes it is enough to notice that all hotels and pubs and many property loans were to be examined.

Project Magellan reviewed more than 1,100 customer groups. Exactly what proportion of Bankwest's business book was reviewed may be open to some doubt. Mr Cohen believed that it was more than half and may be as much as 60%. The exact percentage does not matter.[48] Many files were reviewed.

45 Transcript, David Antony Keith Cohen, 29 May 2018, 2740–1.

46 Transcript, David Antony Keith Cohen, 29 May 2018, 2741.

47 Exhibit 3.111, Witness statement of David Antony Keith Cohen, 17 May 2018, 29–30 [125].

48 Exhibit 3.111, Witness statement of David Antony Keith Cohen, 17 May 2018, 31 [133]–[134]; Transcript, David Antony Keith Cohen, 29 May 2018, 2740.

Project Magellan proceeded in three steps. First, relationship managers provided basic information about loans to be reviewed. The second step was taken by about 42 business credit specialists. Those specialists included CBA and Bankwest staff but also included staff from four external firms: Grant Thornton, Ferrier Hodgson, KordaMentha and PPB Advisory. These specialists reviewed the file, provided a risk assessment and risk grade and made a recommendation about future action.[49]

At this second step, files were divided into those that were judged not to be high risk ('green') and those judged to be high risk ('red' or 'double red'). Files that were judged not to be high risk were not reviewed further. But those that were deemed to be high risk were reviewed by one of two review panels that could accept, reject or modify the recommendations made in the file review.[50]

As a result of the reviews, 161 customer group files (about 15% of the files reviewed) were downgraded to the status of troublesome or impaired asset. These files were transferred to CAM.[51] Of the files that were transferred to CAM, 31 were rehabilitated and returned to the relevant business unit; 37 were terminated by enforcement action of one kind or another; the remaining 124 files continued on the same or different terms. Of this last group of 124 files, 31 continued on the same terms; 93 continued on different terms. In cases where the loan continued, but on different terms, the changes made included extending the term of the loan, changing the pricing and changing the repayment arrangements. In some cases CBA increased the funding provided; in others the borrower agreed to sell assets.[52]

As just noted, 37 of the files transferred into CAM were subsequently terminated by enforcement action. Of those 37 files, 10 were first in default of a monetary term; the remaining 27 were first in default of a non-monetary

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[49] Exhibit 3.111, Witness statement of David Antony Keith Cohen, 17 May 2018, 33 [139]–[140].

[50] Transcript, David Antony Keith Cohen, 29 May 2018, 2743; Exhibit 3.111, Witness statement of David Antony Keith Cohen, 17 May 2018, 33 [139].

[51] Exhibit 3.112, Supplementary witness statement of David Antony Keith Cohen, 17 May 2018, 2 [8].

[52] Exhibit 3.112, Supplementary witness statement of David Antony Keith Cohen, 17 May 2018, 2–3 [8]–[11].

term (a description covering terms about insolvency events, as well as financial ratio requirements like loan-to-value ratios, interest cover or debt service ratios or minimum levels of earnings before interest, taxes, depreciation and amortisation [EBITDA]).[53] As Mr Cohen rightly said, breach of financial ratio requirements often indicate that a borrower's financial circumstances are deteriorating.

The statistics about Project Magellan do not support the contention that the reviews then undertaken were the first step along a path towards 'manufacturing' defaults of 'performing' loans. The 161 files transferred into CAM were only about 15% of the files reviewed. Only 37 of the 161 files transferred ended in enforcement action; 124 continued on the same or different terms.

PwC was Bankwest's auditor and reviewed and reported on the findings of Project Magellan. In particular, PwC reported to Bankwest's audit committee that, in increasing total provisions to $2,089 million at 30 June 2010 (from $1,281 million at 30 June 2009), management had 'applied a prudent approach in calculating loan loss provisions'.[54] PwC said in its report that the increase was 'largely a result of the outcome of Project Magellan and the continued deterioration in the Business Portfolio'.[55]

What was done in Project Magellan is consistent with responding properly to legitimate concerns about the quality of Bankwest's business banking loan book. The repeated, and unforeseen, increases in provisions during 2009 warranted close attention to the quality of those loans that had not been classified as troublesome or impaired. Of course it may be observed that the reviews included loans for purposes that CBA had decided should not form so large a part of the combined CBA Bankwest business loan book as they then did. But it must also be recognised that Project Magellan was not confined to loans of those kinds and that Bankwest's auditors concluded that management had 'applied a prudent approach' in calculating loan provisions. In forming that view, PwC considered what had been done in

53 Exhibit 3.112, Supplementary witness statement of David Antony Keith Cohen, 17 May 2018, 3 [12].

54 Exhibit 3.111, Witness statement of David Antony Keith Cohen, 17 May 2018, Exhibit DC-69 [CBA.0002.1566.7527 at .7531].

55 Exhibit 3.111, Witness statement of David Antony Keith Cohen, 17 May 2018, Exhibit DC-69 [CBA.0002.1566.7527 at .7531].

Project Magellan and dealt separately with collective provisions and individually assessed provisions. The process adopted in Project Magellan was described as 'robust with a prudent outlook taken in light of recent experience'.[56]

In respect of collective provisions, PwC noted that the revised risk grades and collateral values identified in Project Magellan had caused a significant increase in collective provisions but that the additional confidence gained in underlying data had allowed some changes in the method of calculating the amount to be allowed.[57] Tellingly, PwC noted that the amount of individually assessed provisions for Bankwest had continued to increase from $620 million at 30 June 2009 to $956 million at 30 June 2010. This was said to be 'primarily due to the ongoing deterioration in the quality of the corporate portfolio'.[58] The reasons for deterioration had been revealed by Project Magellan.

Project Magellan found (among other things) that Bankwest had had aggressive risk appetite settings between 2006 and 2008, 'with poor quality business written on the east coast and with a lack of ongoing management of files'.[59] It found that Bankwest had 'relied on independent valuations, without due diligence, to support the business written at or near the top of the cycle in 2006–2008'.[60] It found that Bankwest had 'placed heavy reliance on going concern valuations (based on future maintainable earnings) where businesses had not performed according to expectations and [on] security lending with an absence of identified servicing sources for property loans, especially land bank'.[61] Nothing in the material the

[56] Exhibit 3.111, Witness statement of David Antony Keith Cohen, 17 May 2018, Exhibit DC-69 [CBA.0002.1566.7527 at .7532].

[57] Exhibit 3.111, Witness statement of David Antony Keith Cohen, 17 May 2018, Exhibit DC-69 [CBA.0002.1566.7527 at .7533].

[58] Exhibit 3.111, Witness statement of David Antony Keith Cohen, 17 May 2018, Exhibit DC-69 [CBA.0002.1566.7527 at .7533].

[59] Exhibit 3.111, Witness statement of David Antony Keith Cohen, 17 May 2018, 33 [143(a)].

[60] Exhibit 3.111, Witness statement of David Antony Keith Cohen, 17 May 2018, 33 [143(c)].

[61] Exhibit 3.111, Witness statement of David Antony Keith Cohen, 17 May 2018, 33 [143(d)].

Commission has examined shows any challenge to, let alone reason to doubt, these conclusions. It is then unsurprising that the quality of the 'corporate portfolio' or business loan book deteriorated.

There can be no doubt that CBA took steps to alter the structure of the business loan book that it acquired by taking over Bankwest. Nor can there be any doubt that, consistent with its intention to alter the structure of its business loan book, CBA chose not to renew some loans that had expired even where the borrower had not defaulted in performance of the expired loan. Some of those borrowers could not refinance. As the case study concerning Mr Michael Kelly, Wildlines Pty Ltd and Silversun Corporation Pty Ltd showed, even if CBA did not demand immediate repayment and the borrower was eventually able to refinance, the pressure to refinance, coupled with the price at which funds were made available, left the borrower feeling aggrieved.

Nor can there be any doubt that CBA did give notice of default to some borrowers and thereafter set about seeking to enforce its securities and recover the debt. Almost always the borrower and CBA both suffered loss. More often than not the effect of the loss was devastating for the borrower. And rarely, if ever, could the borrower accept that the optimism with which the borrower had embarked on the venture had proven to be misplaced. Almost always, the borrower looked for reasons beyond the immediate state of the business. And almost always, the borrower will blame the lender for not having let the business last just that little bit longer until it turned the corner towards success. And this borrower, too, will feel aggrieved.

In these circumstances, it should not be surprising that the sense of individual grievance, joined with the grievances of others, should spark allegations that the lender did not act according to the lender's judgments about the risks of continuing the loan to a particular borrower, but acted according to some overall plan that was at least improper if not unlawful. And this is what has happened with respect to CBA's conduct in relation to the Bankwest business loan book. Borrowers, seeing that others were dealt with and affected in ways that they regard as relevantly similar, have formed the unshakeable view that CBA's conduct towards them was wrong. They will not accept that CBA may have acted case by case, according to judgments made about each loan. Instead they seek to assign reasons for CBA's conduct that they say show how and why the conduct was wrong. And out of the search for improper reasons has grown first the clawback

theory and then the Tier 1 Capital Ratio Theory and their more generalised offspring. But both of the particular theories (and their offspring) are false.

Faced with demonstration that the theories are false, those who allege misconduct reframe the allegation as 'engineering' the default of 'performing' loans. Or they go so far as to reframe the allegation as an overall pattern of conduct by CBA that, seen as a whole, was 'unconscionable'. Both of these ways of framing the allegation assert wrongdoing. But **both ways of framing the allegation hide so much more than they reveal**. Each is a proposition that depends on the content that is given to the critical terms. What exactly is meant by 'engineering' or 'performing'? What are the considerations that make reliance on legal rights under the contract 'unconscionable'? Is it said that there has been some taking advantage of the borrower? How? Is there said to be some other circumstance, or combination of circumstances that made reliance on the lender's rights unconscionable? What is that circumstance, or combination of circumstances? None that has been put forward persuade me that CBA adopted an overall pattern of unconscionable conduct.

In the end, the borrowers' complaints stem from a belief that 'their' bank should have 'backed them' further than it did. The sense of grievance is acute if the borrower can say that all instalments due under a loan that was not renewed had been paid in full and on time. And it would equally be so if the borrower to whom notice of default was given could say not only that there had been no monetary default but also that the default alleged in the notice was trivial. But in none of the cases examined by the Commission, in which there had been a notice of default, could the borrower properly say that the default assigned was trivial. Financial ratio covenants provide important financial indications of the overall health of the loan.

Whenever a borrower does not comply with the terms of a loan agreement, there comes a point where the lender must judge for itself whether acting now is more prudent than waiting to see what happens. And the loans that were not rolled over or renewed were all loans for a defined term that had expired. Any further loan required the lender and the borrower to make a new contract. The borrower could not demand that the lender agree. The lender had to judge whether it wished to make the loan and, if it did, at what price it would do so.

As the case studies show, CBA did not always act towards the borrowers concerned as well as it should have acted. But the defaults

revealed in the case studies fall very well short of showing that CBA engaged in deliberate conduct of the kind that those who continue to complain about its conduct allege.

5 Further submissions

The Commission received a number of further submissions in relation to the issue of the takeover of Bankwest by CBA after the conclusion of the third round of hearings. Six people were the authors of most of those submissions. Some of these people described themselves as victims of CBA's conduct. Others presented as speaking for such victims. Some of the submissions challenged conclusions that Senior Counsel Assisting had submitted were or were not open to me. Some of those who made submissions complained that they had not had the opportunity to give evidence before the Commission and said, in effect, that their evidence would have proved that CBA had an ulterior motive. Others said that the time that the Commission spent on this issue was inadequate.

Some of the submissions appeared to me to proceed from misconceptions about the Commission's tasks. To ensure that interested persons were given the opportunity to put forward any further matters that they considered relevant, and to ensure that I had not overlooked any relevant considerations, I said, at the start of the fourth round of hearings:

> Since the conclusion of the third round of hearings, a number of persons have written to the Commission about [matters relating to CBA and Bankwest]. Some of these have suggested that insufficient time was devoted to that matter; that more case studies should have been examined. It was explained by Counsel Assisting, both in the opening and the closing of that round, [that] the work of the Commission regarding the CBA takeover of Bankwest to that date had been intensive and was not limited to consideration of the circumstances of the four witnesses who gave evidence.
>
> Some of these further communications have also proceeded from the premise that it is the Commission's role to advance the interests of those who describe themselves as Bankwest's victims. That, of course, misunderstands the role and the duty of a Royal Commissioner, which is to inquire, without fear or favour, into matters falling within the terms of reference. Neither I, nor Counsel Assisting, or the solicitors assisting the Commission, carry any brief for those who assert a grievance arising from

> the takeover of Bankwest or, indeed, any other issue. We are here to inquire.
>
> Another misconception which has appeared in many of these further communications is that findings have already been made by me. They have not. Counsel Assisting has made submissions as to the findings that they submit are open on the basis of the evidence heard during the course of the third round of hearings, but I have not yet made any findings. My findings about these matters and my reasons as to why those decisions are ultimately made are matters to be dealt with when I report in accordance with my terms of reference, a task that remains some time away, and in the meantime, the Commission continues to consider, and will keep under constant review, how best it should execute the tasks committed to it by the Letters Patent.
>
> Now, with that in mind, additional information which is received by the Commission will be carefully considered. To facilitate that process, we have indicated to those who have written to the Commission in recent weeks about the Bankwest matter that, if there are additional matters that they wish to raise with the Commission, they should do so. However, we have made clear that we will derive most assistance if those who take up this invitation focus on identifying matters which have not already been raised with us and identifying evidence, not mere assertions and conjecture, that is said to be relevant to the consideration of these matters. Of course, I will bear well in mind that any additional material raised by this process may, in turn, trigger procedural fairness obligations in favour of other persons.

After I made this statement at the commencement of the fourth round of hearings, I received further submissions from various interested persons. I have considered those submissions carefully and will say something about all of them.

The person who provided the most extensive further submissions was Mr Rory O'Brien. Mr O'Brien considers himself to be a victim of CBA's conduct. He propounds the 'clawback theory' and says that it explains CBA's conduct towards him.

As I have said, I consider that the clawback theory is false.

Mr O'Brien's complaint arises from loans Bankwest made in respect of his Whisper Bay project. He says that the project had achieved completion at the end of November 2008 and that the conduct of CBA, particularly its

appointment of receivers in April 2009, was directed to achievement of an adjustment to the purchase price CBA paid for Bankwest.

Mr O'Brien's further submissions were accompanied by a bundle of material. With the exception of a handful of emails, the Commission had already obtained all of this material before the third round of hearings. (The additional emails Mr O'Brien provided added nothing of substance to the material in hand.) In the main, the material relied upon by Mr O'Brien in support of his further submissions was material he had put before the ASBFEO.

It is important to identify some basic facts about Mr O'Brien's dealings with Bankwest and CBA.

By the end of November 2008, Mr O'Brien's company, FOB-Airlie Beach Pty Ltd had borrowed approximately $172 million from Bankwest. The term of the loan had expired. The loan was due to be repaid. FOB-Airlie did not, and could not, repay the loan on the due date. It was in default.

In December 2008, Mr O'Brien asked for more funding to complete the project. It appears from the documents that FOB-Airlie then owed Westpac money. CBA completed the acquisition of Bankwest on 19 December 2008.

Mr O'Brien complains that CBA 'stalled' on its consideration of the application for further funding that he had made in December 2008 after the term of the existing loan had expired. In fact, during December 2008, Bankwest made two additional temporary advances: one of $2.3 million and the other of $750,000 (a total of $3.05 million).[62]

Bankwest did not advance the additional $16 million that FOB-Airlie sought. The application was considered by the bank and rejected. In April 2009, Bankwest appointed receivers.

In its determination in July 2009, EY rejected CBA's argument that, on 19 December 2008, there should have been a provision of $46.05 million in respect of FOB-Airlie's loan. EY accepted that, as at 19 December 2008, the loan was impaired. EY determined that, as at 19 December 2008: (a) the borrower was in financial difficulty; (b) the borrower had breached the initial contract through delinquency in interest and principal; and (c) the

[62] Exhibit 3.194, 23 January 2009, Credit Sanctioning Increase, 5.

lender had granted the borrower a concession that the lender would not otherwise consider, being the extension of the facility and interest capitalisation.[63] But, having regard to the workout strategy then in place, EY was satisfied that no specific provision was required as at 19 December 2008.[64]

Bankwest sued Mr O'Brien (and another company associated with him, Bakota Holdings Pty Ltd) for approximately $158 million pursuant to his personal guarantee of the loans of FOB-Airlie. Mr O'Brien brought a cross-claim against Bankwest alleging, amongst other things, misleading or deceptive conduct and unconscionable conduct by the bank. He said that his cross-claim was for about $500 million. The litigation was the subject of an interlocutory dispute that reached the NSW Court of Appeal[65] but was ultimately settled.

Bankwest agreed to pay Mr O'Brien an amount representing a small proportion of CBA's estimated legal costs of running the court proceedings in full and final settlement of all of the claims made in the proceeding. That is, CBA forgave Mr O'Brien's personal liability under the guarantee he had given. A joint statement issued by CBA and Mr O'Brien recorded Mr O'Brien's acknowledgment that he would have lacked the means to satisfy the full judgment or costs order against him were CBA to have succeeded.[66]

So, the dispute was settled as it was because Bankwest, the plaintiff, thought that at the end of what would probably be prolonged litigation it would obtain a judgment that Mr O'Brien could not meet and Mr O'Brien was prepared to compromise on the basis that he would receive only a slight fraction of the amount he had claimed in his cross-claim.

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63 Exhibit 3.186, 7 July 2009, Expert Determination Report Pursuant to the Share Deed dated 8 October 2008 (as amended) Commonwealth Bank of Australia and HBOS Australia Pty Ltd, 21 [2.25].

64 Exhibit 3.198, 19 December 2008 and 23 December 2008, Letters from Bankwest and BOS International (Australia) Limited to Rory O'Brien; see also Exhibit 3.194, 23 January 2009, Credit Sanctioning Increase.

65 *O'Brien v Bank of Western Australia Ltd* (2013) 16 BPR 31,705; [2013] NSWCA 71.

66 Exhibit 3.195, 2 May 2014, CBA, Joint Statement by Commonwealth Bank and Rory O'Brien.

The dispute being quelled, and Mr O'Brien having had the benefit of that settlement, including the forgiveness of his very significant debt to the bank, further examination of the matter would serve no purpose when the central theory he propounds (based on the clawback) is false.

Mr O'Brien's case was considered by the ASBFEO. As noted above, the ASBFEO concluded that '[t]he significant and sudden change in support for the project, driven by the CBA representative, in March '09 appears consistent with CBA's intent to maximise the clawback against the purchase price of [Bankwest]'. But, later, when the ASBFEO made submissions to the Commission, she said that the hypothesis that 'losses on loans incurred post acquisition could be 'clawed back' by [Bankwest]/CBA as part of the sale process' was false. Rather, as the ASBFEO rightly explained:[67]

> There was no capacity in the Share Sale Deed for a clawback of performing loans that were present at acquisition and which post-acquisition became impaired.

Although Mr O'Brien's loan was not performing at the time of the acquisition, the underlying principle conveyed by the ASBFEO applies equally to him: the clawback clause did not allow CBA to rely on post-acquisition events to claim an adjustment. Mr O'Brien's case is a clear example of those who describe themselves as 'victims' of Bankwest and CBA proceeding from the premise that the loans about which they complain could only be regarded as sound and well-secured. The loans to the O'Brien interests, like other loans the subject of submissions, were made before the full fury of the GFC hit. They were loans made with a very aggressive risk appetite. It is entirely unsurprising that, from late 2008, others would make, and did make very different judgments about the soundness of the loans that Bankwest had made and CBA had acquired when it bought Bankwest.

Perhaps the decision that CBA made, not to lend more money to Mr O'Brien's company when it was already in default, was not the only decision open to CBA. But the decision not to lend more money was reasonably open, especially when CBA knew that Mr O'Brien had defaulted to it and owed Westpac more than $17 million. It was a matter for CBA to decide whether it would grant a new and larger loan. It chose not to do so.

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[67] Exhibit 3.188, ASBFEO, *The Need for Further Inquiry into BWA/CBA's Treatment of Corporate and SME Customers Post Acquisition of BWA*, undated, 4 [9.1].

The decision that CBA made was not directed in any way to obtaining some 'clawback' of purchase price.

In addition to the submissions made by Mr O'Brien on his own behalf, he, together with Mr Guy Goldrick, also made a number of submissions on behalf of what they called the 'Bankwest Victims Group'. Most of the points raised in these submissions are adequately addressed elsewhere. However, there are issues raised in some of the later submissions of Messrs O'Brien and Goldrick, as the representatives of the Bankwest Victims Group, with which I should deal.

Messrs O'Brien and Goldrick (and others) have advanced a further theory of premeditated foreclosures which is not easy to explain. It involved a number of steps.

The first step was to assert that 'CBA's 2009 audited accounts show Bankwest's value at $3.676 billion as at 19th Dec 2008'. This assertion is incorrect. CBA's 2009 Annual Report records the fair value of the net identifiable assets of *each of* Bankwest (consisting of retail and business banking), St Andrew's Australia Pty Ltd (consisting of insurance and wealth management services businesses) and HBOSA Group (Services) Pty Ltd (HBOSGS) (an internal administrative support entity) *as at 30 June 2009* as $3.676 billion.

The second step was to assert that '[t]he evidence shows that the price [of Bankwest, St Andrew's and HBOSGS] was reduced by $1.639 billion' rather than, as Senior Counsel Assisting explained, being increased by $26 million. This assertion is misconceived. The initial price for the acquisition of Bankwest, St Andrew's and HBOSGS was $2.1 billion; after adjustments it was increased, as we have seen, by $26.1 million. The $1.639 billion identified by the submitters is their calculation of the difference between the fair value of Bankwest, St Andrew's and HBOSGS as at 30 June 2009 (as shown in CBA's 2009 Annual Report) and the proportion of the initial price (before adjustment) as at 19 December 2008 attributable to Bankwest (as recorded in the Share Sale Deed). This calculation goes nowhere and is not informative of anything. The price agreed between CBA and HBOS for Bankwest, St Andrew's and HBOSGS was a price agreed at as part of an arm's length commercial negotiation. There is no doubt that the price paid was less than what CBA believed to be the fair value of the net assets of those entities as at 19 December 2008. That does not assist the submitters for reasons I explain at the conclusion of this chapter.

The third step was to assert that '[w]e can see a sharp rise in impairments to $1.639 billion immediately appearing on Bankwest's balance sheet as at 19th Dec 2008'. This assertion is incorrect. The Bankwest balance sheet does not record $1.639 billion of impairments as at 19 December 2008. Nor is it something that was 'immediately appearing'. The submitters have misunderstood the 31 December 2008 Annual Financial Report for Bankwest.[68] In fact, the provision for impairment losses on loans and advances as at 31 December 2008 was recorded as being $894.7 million.[69] The submitters have derived their figure of $1.639 billion 'of impairments' by rounding off the $1.6394 billion of *gross loans* that were past due or in possession and also impaired. This compared to figures for the year ending 31 December 2007 of total gross loans of $446.5 million that were past due or in possession and also impaired. The submitters say that the Commission must 'identify why $1.639 billion of impairments immediately appeared on the Bankwest balance sheet … immediately after the acquisition'. The answer is that $1.639 billion of impairments did not appear on the balance sheet as at 19 December 2008 and that the assertion to that effect is incorrect.

The fourth step, which was the culmination of the preceding three steps, was to assert that the difference between, on the one hand, the proportion of the initial price paid by CBA to HBOS and attributable to Bankwest of $2.037 billion and, on the other hand, the fair value of Bankwest and St Andrew's of $3.676 billion, is equal to the 'immediate increase in impairments exactly'. Because each of the preceding steps is wrong, this fourth step is also wrong. In fact, what the submitters have identified is that the difference between the initial price (but not the final price) attributable to Bankwest as at 19 December 2008 and the fair value of Bankwest, St Andrew's and HBOSGS as at 30 June 2009 is approximately the same as the gross value of Bankwest's loans as at 31 December 2008 that are past due, or in possession, and impaired. Further, it is wrong to treat the initial price for Bankwest as based on the value of impairments. The initial price was an arm's length commercial agreement of a price that was less than the net assets of Bankwest, HBOSGS and St Andrew's. The adjustment to the initial purchase price was to be done pursuant to the calculation stipulated in clause 4.2 of the Share Sale Deed. That clause

[68] Exhibit 3.196, 30 April 2009, Bankwest, Annual Financial Report 31 December 2008.

[69] Exhibit 3.196, 30 April 2009, Bankwest, Annual Financial Report 31 December 2008, 19.

required consideration of more than the general and specific loan provisions in the calculation of the relevant adjustment. The exercise undertaken by EY did not turn solely on determining the value of impaired loans. It is therefore wrong to try to draw a direct correlation, as Messrs O'Brien and Goldrick seek to do, between the purchase price for the businesses and impaired loans as at 19 December 2008.

The fifth step, which was said to follow from the preceding four steps, was that '[t]his means that CBA mass foreclosures were premeditated and indeed provisioned for as part of the purchase price reduction'. There are at least two problems with this fifth step. The first is that each of the preceding steps on which it depends is wrong. The second is that there is no logic by which the fifth step would follow from the preceding four steps even if they were all correct.

Messrs O'Brien and Goldrick submitted that, on the premise that the purchase price was 'discounted' by $1.639 billion for impaired loans, 'CBA were "double-dipping" by further pursuing these debts from customers'. For reasons I have just explained, the premise is wrong. But even if it were right (and it is not), there was no 'double-dipping'.

The suggestion seems to be that if CBA had paid less than net asset value for Bankwest because of the value of impaired loans it ought therefore follow that Bankwest should forgive those impaired loans and not hold the borrowers to their contractual obligations. I do not accept that suggestion. Having paid what it paid to acquire Bankwest, CBA was entitled to cause Bankwest to manage them in accordance with their terms and the prevailing economic conditions.

It follows that these submissions do not point to, let alone establish, misconduct in CBA's approach to managing the Bankwest loans. I reject the submissions.

Three of the other submissions made after the statement made at the start of the fourth round of hearings do not refer to or rely on the personal circumstances of particular borrowers. Rather, they are submissions directed to the *general* conduct of CBA after its acquisition of Bankwest.

Of these, I will deal first with the submissions made by Mr Romesh Wijeyeratne. Mr Wijeyeratne has communicated frequently with the

Commission and following the invitation made at the commencement of the fourth round of hearings, made further submissions.

Mr Wijeyeratne said that the recognition of impairments at the time of the sale demonstrates that CBA had a pre-meditated plan to foreclose the loans. The submission reflects a misunderstanding regarding the impairment of loans. As has been explained, where a bank considers that there is a risk that a borrower will default, it is obliged to make a provision, by reason of regulatory and other requirements. Doing so does not pre-determine anything. This aspect of Mr Wijeyeratne's submission must be rejected.

Another aspect of Mr Wijeyeratne's submissions relied on a footnote to a Background Paper prepared by APRA. The relevant footnote states that:[70]

> In limited circumstances, it is possible that an ADI using the IRB approach [which is a method of determining capital adequacy ratios used by the major banks such as CBA and is described in the Background Paper] might obtain a capital benefit where it purchases a loan that has already become impaired and the purchase price is significantly discounted from the loan amount.

Mr Wijeyeratne argued that the potential to obtain a capital benefit provided the motive for CBA's actions.

APRA has confirmed to the Commission that the footnote in APRA's Background Paper is referring to the fact that, because of the requirements under APS 113 imposed on an IRB bank in relation to expected losses and eligible provisions, it is possible to conceive of very limited circumstances in which an IRB bank purchases an already distressed or defaulted loan at a very significant discount to the loan amount and, if there is a shortfall in eligible provisions relative to expected losses on the IRB bank's other defaulted exposures, the effect is that there is a temporary (until the conclusion of enforcement action) improvement in the IRB bank's capital ratio (but then the capital ratio would subsequently decrease post enforcement action and that ratio would be lower than if the asset had been originally recorded as unimpaired on the IRB bank's balance sheet).There is no evidence that CBA had determined that it was possible that any of the

[70] APRA, *FSRC Background Paper No.13: The Regulatory Capital Framework – Impairment, Provisioning and Enforcing Security*, 18 May 2018, 8, n 5.

Bankwest loans in respect of which enforcement action was subsequently taken satisfied this limited circumstance. There is nothing in the internal documents of CBA reviewed by the Commission to suggest that CBA caused Bankwest to manage its loans in a particular way because it was motivated to obtain a capital benefit of this kind. I do not accept Mr Wijeyeratne's submission.

Another person who lodged a further submission was Mr Ross Waraker. Mr Waraker is not a former customer of Bankwest but has been involved in advocating on behalf of those who were. Mr Waraker made two submissions to the Commission, the second being in response to the invitation made at the start of the fourth round of hearings. He submitted that the lens through which CBA's conduct should be viewed is its adoption of a so-called 'bad bank' strategy. This is a reference to a strategy for banks to deal with risky assets, promoted by the consulting firm McKinsey and Company following the GFC, although the concept is older than that. In short, it involves quarantining 'bad' assets, such as non-performing and troublesome loans and perhaps strategically undesirable assets, into a 'bad bank' structure within the bank. The aim is then to exit systematically from those assets. This is seen as carrying a number of advantages, including lessening the bank's risk profile, improving its risk weighted assets and improving investor confidence. The assets that are left are the on-going core business of the bank.

Mr Waraker pointed to internal CBA communications to demonstrate that the bank had adopted such a strategy. He said the steps taken by the bank to give effect to this strategy included acting to reduce its consumption of economic capital, shifting away from riskier and less profitable loans, seeking to improve return on equity, ensuring credit ratings are not affected and that Tier 1 capital requirements were met. Even if CBA did adopt (formally or informally) a 'bad bank' strategy, and I am not persuaded that it did, all of the identified steps are prudent steps to take (and in the case of Tier 1 capital, required by reason of regulatory and other requirements). Mr Waraker rightly acknowledged that the adoption of a 'bad bank' strategy is not illegal and does not, in and of itself, constitute misconduct. He submitted, however, that CBA had 'crossed the line' into unconscionable conduct. The steps he suggested took the bank over the line included the bank having recourse to non-monetary covenants that the bank 'would not ordinarily rely upon alone' and refusing to roll over loans when 'in ordinary circumstances' they would have been.

The difficulty with this submission is that the circumstances that faced the bank were anything but 'ordinary' and there were very good reasons for the bank to adopt an approach that sought to reduce its exposure to risky loans. Indeed, the concerns identified by the bank in relation to the business loan book turned out to be justified, as demonstrated by the need for the bank constantly to increase provisions and eventually having to make substantial write offs when assets were sold and loans could only be partly repaid.

For the reasons already explained, I consider that Mr Waraker's reliance on economic capital is apt to mislead. Economic capital is a risk measurement and management tool. Saying the bank was motivated to reduce its economic capital consumption seeks to criticise the bank for managing its credit risk following the acquisition of Bankwest. Of course that is what it did, and it was a course reasonably open to it. That conduct does not amount to an 'unconscionable systemic plan', as Mr Waraker submitted.

Mr Peter McNamee has made a number of submissions to the Commission. He is not a former customer of Bankwest but has, over a long period of time, sought to advocate on behalf of such persons. The submission lodged by Mr McNamee after the invitation made at the beginning of the fourth round of hearings covered a range of issues, many of them policy-related. In those submissions, he drew attention to Mr O'Brien's circumstances, suggesting that the state of the Bankwest business loan book may not have been as low quality and high risk as Mr Cohen conveyed in his evidence.
Mr McNamee suggested that evidence should be taken from past Bankwest executives to 'hear the other side of the story'. But Mr McNamee's conjecture about the state of the Bankwest business loan book was no more than speculative and is inconsistent with the facts described earlier regarding the recognition by both parties to the sale that the commercial loan book was impaired (such recognition later being reinforced by EY); the need for CBA to increase its provisions, which its auditors described as prudent; and the level of write-offs that CBA ultimately was required to make on the loans. Nothing raised by Mr McNamee has caused me to alter my conclusions.

Two further submissions were provided from the perspective of the personal circumstances of the authors, each of whom was a former customer of Bankwest. But each also made broader submissions directed to identifying CBA's motives.

The first of these was lodged by Mr Jim Neale. The first point to note is that Mr Neale has, on a number of occasions, rejected the clawback theory. Second, he also dismisses the Tier 1 Capital theory, at least as it has been advanced by others. Third, he cautions against the misuse of terms relating to impaired loans. In particular, Mr Neale (rightly) notes that one should not confuse the whole value of an impaired loan with the amount of a provision made for impairment after the realisation of securities.

In summary, Mr Neale contends that it is not inimical for a bank to sell assets taken as security for the lowest price possible. He says that holds true when one bank has bought another bank for less than shareholders' funds and the securities being sold are 'secondary'. He explained that by 'secondary', he means that the loan is still fully secured by other real property or guarantees. He further contends that the maximum profit for the bank is achieved by selling the secondary property 'for nothing', by which I take him to mean for less than its true value, as this means there is no reduction in the loan amount on which penalty interest is being charged. His contention is that penalty interest earned CBA 13 times as much profit as a loan without penalty interest being charged.

He explained that another benefit to CBA in this case was that a sale at less than true value yields no surplus funds for the borrower, thereby reducing its capacity to take action against the bank. A further benefit to the bank that he identifies is that if they were sold for more than the impaired value, that would have exposed CBA to a claim by HBOS (although it is difficult to understand what that claim would be in the context of a commercial transaction where both parties agreed the price). He also said that CBA benefited from the 'destruction' of Bankwest customers whose businesses competed with the businesses of CBA customers. He cited his own property development in support of this contention, and observed that Meriton, a CBA customer, was a competing developer in the area.

Mr Neale argued that by buying Bankwest for $1.3 billion less than shareholders' funds meant that this created a reduction in Bankwest's (and so CBA's) Tier 1 capital. Added to that, he said that CBA did not disclose this provision in a prospectus to raise $2.1 billion in funds for the purchase and was forced by ASIC to withdraw the prospectus, which led to a further (albeit temporary) worsening of its Tier 1 position. While he acknowledged that impairing loans does not improve Tier 1 capital, he emphasised that calling in loans does improve the Tier 1 position as this reduces the amount

of Tier 1 capital that is required, and the position is also improved by raising capital that increases Tier 1 capital. He also noted that extra profit made from penalty interest also improves Tier 1 capital.

Lastly, Mr Neale has said that CBA bought the Bankwest loans at a discount (which he has quantified at 73 cents in the dollar) and that CBA was able to make a profit by realising the securities on the loans for 100c in the dollar.

The proposition advanced by Mr Neale regarding Tier 1 capital is addressed by my earlier comments on that topic. I address below the submission he advances (which is also advanced by others) based on the proposition that CBA bought Bankwest for a bargain. And Mr Neale's argument regarding secondary securities cannot be accepted in the face of the facts as they occurred: CBA eventually wrote off $2.77 billion of the commercial loans held at 19 December 2008 and the proceeds from realising securities that had been held did not cover the loans to that extent.

A further submission was also received from Mr Trevor Eriksson.
Mr Eriksson was a customer of Bankwest. He supported the submission made by Mr O'Brien and Mr Goldrick to the effect that CBA had accounted for the impaired loans and purchased Bankwest at a price well below the 'true value'. He argued that this meant that CBA had to default the loans or otherwise would face a claim by HBOS. It can be seen that this echoes one of the submissions made by Mr Neale. He also argued, as did Mr Neale, that CBA profited from charging penalty interest. The question he posed is whether there was any surplus from the sale of securities. There was no surplus. CBA did not recover the full amount of the loans on enforcement and it could not recover more than the full amount of the loans (plus interest and costs).

There are two final points to make.

First, it was said that the treatment of Bankwest by Counsel Assisting differed from the treatment of ANZ's acquisition of the loan and deposit books of Landmark Financial Services. I set out elsewhere the conclusions I have reached about matters arising from ANZ's acquisition of Landmark.[71]

The two acquisitions were different in many ways. They were made at different times and in different circumstances. Each acquirer made its own

[71] See Case studies: Agricultural lending, in Volume 2.

decisions and took its own path. It is unsurprising, therefore, that I should reach different conclusions about different events and circumstances. The comparisons that it was sought to draw between the two matters are simplistic and ill-founded. The only point at which the two matters intersect is that in each case a new entity acquired an existing loan book.

The second point to make is that some submitters pointed out that CBA was expecting to pay, and did pay a price for acquisition of Bankwest that was a discount to the net assets of Bankwest (and St Andrews and HBOSGS). They are correct. As at October 2008, the purchase price of $2.1 billion before adjustments was 0.8 multiplied by the 2007 book value of Bankwest, St Andrews and HBOSGS.[72] But the point goes nowhere. Whether CBA engaged in misconduct in its dealings with Bankwest borrowers after acquisition depends upon how it dealt with those borrowers. Dealings that do not otherwise constitute misconduct or conduct falling below community standards and expectations are not transformed into misconduct because CBA paid a discount to book value. Similarly, had CBA paid a price for Bankwest based on a multiplier of greater than one on the book value, that would not have somehow lessened the legal obligations that applied to it in dealing with Bankwest borrowers.

[72] Exhibit 3.197, 8 October 2008, CBA, Acquisition of Bankwest and St Andrew's Australia – A Compelling Strategic Growth Opportunity, 4.

6. Agricultural lending

Introduction

The agricultural industry is an important contributor to the Australian economy. It is the primary source of jobs in many regional and rural areas. In 2017, about 260,000 were employed in the agricultural industry.[1] In 2016, there were about 84,500 farming businesses having an estimated value of agricultural operations of $40,000 or more.[2]

All agricultural enterprises are subject to the effects of events beyond the control of the individual farmer: seasonal variation, changes in prices obtained for outputs and paid for inputs, longer-term climate events like drought, natural disasters like flood and fire, regulatory decisions of both foreign and domestic governments, and outbreaks of pest or disease. Occurrence of any of these events, let alone a combination of them, will affect cash flow and profitability and, hence, the ability to service debts. Their occurrence will often have profound personal effects on those who conduct the business.

Australia's climate is very variable. The Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) notes that Australia has a lower mean rainfall and higher rainfall variability than most other nations. As a result, agriculture in Australia is subject to more revenue volatility than almost any other country in the world. Changing seasonal conditions cause variations in agricultural production that are difficult to predict accurately beyond the current season.[3]

1 FSRC, *FSRC Background Paper No. 16: Some Features of Finance in the Agriculture, Forestry and Fishing Industry*, 15 June 2018, 4.

2 ABS, *Catalogue Number 7503.0 – Value of Agricultural Commodities Produced, Australia, 2016–17* <www.abs.gov.au/Ausstats/abs@.nsf/0/5D9BB73004B25F66CA2578A00014F415?OpenDocument>.

3 FSRC, *FSRC Background Paper No. 16: Some Features of Finance in the Agriculture, Forestry and Fishing Industry*, 15 June 2018, 16–17 [6.1].

Australian farming businesses rely heavily on debt finance.[4] There is little institutional investment in agriculture.[5] ABARES reports that 'more than 95% of farms' in the broadacre and dairy industries are family owned and operated.[6] Most Australian agricultural enterprises fund the acquisition of land on which the enterprise is to be conducted by loans secured over the land. More often than not the enterprise funds its working capital by debt. In 2015–2016, almost 85% of businesses in the agriculture, forestry and fishing sector who sought debt finance sought it from banks.[7]

At 30 June 2017, total rural debt in Australia was $71.7 billion (equivalent to about 2.3% of net loans and advances held by **authorised deposit-taking institutions** [ADIs] as assets). The share of rural debt held by banks has increased over recent years. In 2007, banks' share of rural debt was about 89%; as at 30 June 2017 banks held about $68.6 billion or 96% of all rural debt outstanding.

At 30 June 2016, more than two-thirds of the aggregate broadacre debt was held by 12% of farms.[8] Those farms produced about half of the value of broadacre farm production. In the dairy industry, one third of farms held about two thirds of the total debt.[9] For broadacre farms, the most common reason to borrow was to buy land (43%); for dairy farms, the

4 ABS, *Catalogue Number 8167.0 – Selected Characteristics of Australian Business, 2015–16* <www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/8167.02015-16?OpenDocument>.

5 FSRC, *FSRC Background Paper No. 16: Some Features of Finance in the Agriculture, Forestry and Fishing Industry*, 15 June 2018, 24 [7.2].

6 Department of Agriculture and Water Resources ABARES, *Farm Debt: Broadacre and Dairy Farms, 2014–15 to 2016–17* (18 April 2018) Department of Agriculture and Water Resources ABARES <www.agriculture.gov.au/abares/research-topics/surveys/debt>.

7 ABS, *Catalogue Number 8167.0 – Selected Characteristics of Australian Business, 2015–16* <www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/8167.02015-16?OpenDocument>.

8 FSRC, *FSRC Background Paper No. 16: Some Features of Finance in the Agriculture, Forestry and Fishing Industry*, 15 June 2018, 22 [7.1].

9 FSRC, *FSRC Background Paper No. 16: Some Features of Finance in the Agriculture, Forestry and Fishing Industry*, 15 June 2018, 22 [7.1].

most common reason to borrow was to cover operating expenses (26%) followed by to buy land (24%).[10]

At 30 June 2017, 945 farm business entities had loans more than 90 days past due.[11] The total value of loans more than 90 days past due was $630 million or 0.90% of the total value of loans.[12] By contrast, at 30 June 2013, about 3% of the total value of agriculture, fisheries and forestry sector debt was more than 90 days past due compared with about 2% of the total value of all business sector debt.[13]

Both the federal and state governments provide various forms of assistance to agricultural industry. Some assistance is to relieve against the effects of drought or other natural disasters. Some is directed to supporting productivity and exports. The detail of those programs is not examined here.[14] But there is one form of government assistance that should be explained.

The Farm Management Deposits Scheme is intended to help primary producers manage fluctuations in cash flow. Put shortly, the scheme allows producers to set aside pre-tax income in one year to be drawn on (and taken to account as taxable income) in a later year. In the tax year in which the deposit is to be made, the primary producer's income that is not from primary production must be less than $100,000. The maximum amount that can be held in a farm management deposit is $800,000. The deposit must be held for at least 12 months with an ADI. (The producer may be exempted from this requirement if the producer receives recovery assistance under

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10 FSRC, *FSRC Background Paper No.16: Some Features of Finance in the Agriculture, Forestry and Fishing Industry*, 15 June 2018, 22 [7.1].

11 Department of Agriculture and Water Resources, *FSRC Background Paper No. 17: Department of Agriculture and Water Resources*, 28 June 2018, 10.

12 Department of Agriculture and Water Resources, *FSRC Background Paper No. 17: Department of Agriculture and Water Resources*, 28 June 2018, 10.

13 ABARES, The Australian Bankers' Association and the National Farmers' Federation, *Regional Farm Debt: Northern Queensland Gulf, South West Queensland and North West New South Wales*, December 2014, 5; Department of Agriculture and Water Resources, *FSRC Background Paper No. 17: Department of Agriculture and Water Resources*, 28 June 2018, 11.

14 See generally, Department of Agriculture and Water Resources, *FSRC Background Paper No. 17: Department of Agriculture and Water Resources*, 28 June 2018, 13–21.

natural disaster relief and recovery arrangements or if affected by a rainfall deficiency for at least six consecutive months.) At 30 April 2017, there were about 49,000 farm management deposit accounts holding a total of about $5.17 billion.[15]

1 Legal and regulatory framework

1.1 General

The legal and regulatory framework within which agricultural lending occurs is the framework that applies to business lending generally. Hence, the provisions that apply to other forms of small and medium enterprises apply equally to primary producers conducting small and medium enterprises.

Some agricultural businesses are within the definition of small business in the *Australian Securities and Investments Commission Act 2001* (Cth) (the ASIC Act). The provisions of that Act prohibiting misleading or deceptive conduct and implying warranties of fitness for purpose and due care and skill will apply to the provision of financial services to those businesses. The unfair contract terms provisions of the ASIC Act will apply to standard small business contracts that those businesses make.

The Code of Banking Practice applies to dealings with agricultural businesses that are small businesses. In the 2013 Code, small business is defined to include 'a business having … less than 20 full time (or equivalent) people'. Many agricultural enterprises would meet this definition. By contrast, the 2019 Code requires a business to meet three criteria to fall within the definition of 'small business'. The criteria are turnover (less than $10 million in the previous financial year), employees (fewer than 10 full time equivalent) and total debt to all credit providers (including the amount of any loan being applied for) of less than $3 million. The reach of the 2019 Code in agricultural lending is diminished. Not all of the enterprises examined as case studies in the course of the fourth round of hearings would have met that definition.

[15] Department of Agriculture and Water Resources, *FSRC Background Paper No. 17: Department of Agriculture and Water Resources*, 28 June 2018, 18.

The 2019 Code provides for longer minimum periods of notice to small business customers about changes to loan conditions or decisions about rolling over existing facilities. It will remove material adverse change clauses and restrict the operation of non-monetary default clauses.

One important difference in the legal and regulatory framework for agricultural lending is farm debt mediation.

1.2 Farm debt mediation and rural financial counsellors

Three states, New South Wales, Victoria and Queensland, have legislated for farm debt mediation.[16] There are differences between the schemes but, essentially, each requires banks and other creditors to offer mediation to farmers before taking enforcement action against farm property, including the farm itself and farm machinery. The object is to have a neutral and independent mediator assist the farmer and the lender to try to reach an agreement about current and future debt arrangements.

ABARES estimates that the farm debt mediation schemes in New South Wales, Victoria and Queensland cover about 77% of Australia's farm businesses. In 2016/2017:

- New South Wales had 39 new cases under the *Farm Debt Mediation Act* (compared with 62 in 2015/2016) with 40 cases completed and agreement in 90% of those cases;
- Victoria had 54 new cases (56 in 2015/2016), 47 referred to mediation and 45 ending in agreement; and
- Queensland's statutory scheme began on 1 July 2017, replacing a voluntary scheme under the Queensland Farm Finance Strategy.

South Australia still uses a voluntary scheme under the South Australian Farm Finance Strategy.[17] So, too, Western Australia operates a voluntary scheme.

[16] *Farm Debt Mediation Act 1994* (NSW); *Farm Debt Mediation Act 2011* (Vic); *Farm Business Debt Mediation Act 2017* (Qld); see also Farm Debt Mediation Bill 2018 (SA).

[17] But see Farm Debt Mediation Bill 2018 (SA).

One other important element affecting lending to agricultural enterprises is the availability of rural financial counselling services. These services are funded primarily by the federal government.[18] They provide free financial counselling to farmers, fishing enterprises, forestry growers and related small businesses when the enterprise is experiencing financial hardship or difficulty.

1.3 Who are the principal lenders to agricultural businesses?

As noted earlier, most agricultural debt finance is obtained from banks.[19] Of the four major banks, ANZ, CBA and NAB have a larger presence in the sector than Westpac.

Rabobank Australia Ltd, the Australian subsidiary of a Dutch multinational bank, focuses only on agricultural lending.[20] It aspires to be the leading rural lender in Australia. Rabobank operates 61 branches in rural areas (an increase of 10 in the last 10 years). As branch numbers have increased, so too there has been an increase in the number of branch managers and relationship managers. By contrast, the four major banks have closed branches in several rural areas. ANZ, for example, closed 91 rural branches between 2008 and 2018.[21]

Rural Bank is now a wholly owned subsidiary of Bendigo and Adelaide Bank.[22] It is a 'dedicated agribusiness bank lending only in the agricultural sphere' with only a small amount of lending beyond the farm gate.[23] In 1998, Bendigo and Elders established what was then called Elders Rural

18 See generally Department of Agriculture and Water Resources, *Rural Financial Counselling Service (RFCS)* (6 August 2018) Department of Agriculture and Water Resources <www.agriculture.gov.au/ag-farm-food/drought/assistance/rural-financial-counselling-service>.

19 FSRC, *FSRC Background Paper No. 16: Some Features of Finance in the Agriculture, Forestry and Fishing Industry*, 15 June 2018, 20 [7.1].

20 Transcript, Bradley Mark James, 27 June 2018, 3341.

21 Exhibit 4.20, Witness statement of Benjamin William Steinberg, 18 June 2018, 9 [15].

22 Transcript, Alexandra Esma Maria Gartmann, 2 July 2018, 3612.

23 Transcript, Alexandra Esma Maria Gartmann, 2 July 2018, 3613.

Bank as a fifty/fifty joint venture.[24] Elders Rural Bank began trading as an ADI in June 2000 and, in May 2009, Bendigo acquired a controlling interest in Rural Bank.[25] Rural Bank became a wholly owned subsidiary of Bendigo in late 2010.[26] Rural Bank does not have its own branded branches.

In opening the fourth round of hearings, Senior Counsel Assisting described the extent of lending by the principal agricultural lenders.[27] The description that was given was based on information supplied to the Commission in response both to correspondence from the Commission and to requests for statements from the relevant entities. Most of the statistics recorded the position at 30 June 2017. Where available, more recent statistics are now given.

At 31 March 2018, ANZ had more than 19,500 agricultural clients and at 30 June 2017 held agricultural loans with total limits of $9 billion of which $7.6 billion was outstanding.[28] Bankwest (as distinct from its parent, CBA) had more than 3,500 agricultural customers at 30 June 2017. More than 90% of those customers were in Western Australia.[29] Bendigo had about 2,600 agricultural customers and Rural Bank, its wholly owned subsidiary, had more than 8,000.[30] CBA had more than 25,000 agricultural client relationships and just under 5,000 agricultural lending relationships.[31] NAB had just under 21,000 agricultural clients.[32] Rabobank had nearly 34,000 agricultural clients and over 21,000 agricultural client groups. Of those,

24 Transcript, Alexandra Esma Maria Gartmann, 2 July 2018, 3612.

25 Transcript, Alexandra Esma Maria Gartmann, 2 July 2018, 3612.

26 Transcript, Alexandra Esma Maria Gartmann, 2 July 2018, 3613.

27 Transcript, Senior Counsel Assisting, 25 June 2018, 3078–84.

28 Exhibit 4.20, Witness statement of Benjamin William Steinberg, 18 June 2018, 6 [19], 7 [23].

29 Exhibit 4.92, Witness statement of Sinead Taylor, 24 June 2018, 6-7 [17], 7 [19].

30 Exhibit 4.121, Witness statement of Alexandra Esma Maria Gartmann, 20 June 2018, 6 [27].

31 Exhibit 4.133, Witness statement of Grant Michael Cairns, 19 June 2018, 7 [12].

32 Exhibit 4.112, Witness statement of Ross Hugh McNaughton, 18 June 2018, 7 [21].

about 11,000 agricultural clients and 8,750 agricultural client groups had active loans.[33]

There have been exits from agricultural lending. The two most prominent were ANZ's acquisition, in 2010, of the loan and deposit books of Landmark Financial Services and CBA's acquisition, in 2008, of Bankwest. Issues arising out of loans made originally by Landmark and Bankwest were examined in the case studies.

What did the banks tell the Commission about past conduct relating to agricultural lending?

2 Conduct acknowledged by the entities

2.1 ANZ

ANZ accepted that there were respects in which its management of customers whose loans had been acquired from Landmark fell below community standards and expectations.[34] ANZ also acknowledged that in some cases its conduct might have breached the Code of Banking Practice obligation to act fairly and reasonably.[35] As Senior Counsel Assisting noted in her opening, it has been clear for some years that a significant number of former Landmark customers felt that they were treated unfairly by ANZ after ANZ took over their loans.[36] And, of the public submissions received by the Commission about agricultural finance, 32 related to a Landmark loan that had been acquired by ANZ.

In addition to these matters, ANZ told the Commission that:

33 Exhibit 4.33, Witness statement of Bradley Mark James, 15 June 2018, 4–5 [12]–[13].

34 ANZ, *Hearing Round 4: Experiences of Regional & Remote Communities ANZ's Submissions on Findings Concerning Case Studies Involving ANZ*, 13 July 2018, 3–5 [17].

35 ANZ, *Hearing Round 4: Experiences of Regional & Remote Communities ANZ's Submissions on Findings Concerning Case Studies Involving ANZ*, 13 July 2018, 3–5 [17].

36 Transcript, Senior Counsel Assisting, 25 June 2018, 3085.

- Between December 2013 and June 2014, the Financial Ombudsman Service (FOS) identified an instance of improper collections activity by ANZ in relation to a particular agribusiness customer.
- It had identified some system and process errors that would have affected some agribusiness customers.
- There had been instances of frontline staff engaging in inappropriate sales practices to increase incentive payments.[37]

2.2 Bendigo

Bendigo identified five examples of conduct that it said fell below community standards and expectations. One of those five examples was examined as a case study. It concerned the failure to make appropriate inquiries and verifications before approving a number of loans to customers in the Queensland cattle industry that became non-performing loans. The bank did not assess serviceability of the loans properly, relied too heavily on security values and did not manage the loans adequately.

The other examples given by Bendigo concerned:

- the bank not making its own inquiries in response to a customer notifying the bank that her signature had been forged by her husband on documents to increase an agricultural facility;
- the bank charging, in 2016, more than 2,000 customers larger fees than it should on some agricultural products and paying more than $160,000 to remedy the matter;
- the bank paying less interest on term deposits of 81 customers for as much as five years and paying more than $10,000 to remedy that matter; and
- a relationship manager giving verbal approval to a loan (which lay outside the manager's lending authority), which led to the customer buying a property. When the subsequent loan application was declined, the customer did not complete the sale and forfeited the deposit paid.

[37] Transcript, Senior Counsel Assisting, 25 June 2018, 3079.

After the customer threatened legal action, the bank paid the customer the amount of the deposit.

2.3 CBA

In the tables that CBA supplied to the Commission on 22 March 2018, in response to the request to provide particulars of events of misconduct identified in the preceding five years, CBA disclosed five instances of conduct relating to agricultural financing. Three related to two products – Agri Advantage Plus and Agri Advantage – and were instances of processing errors. One related to the failure to apply fee waivers and provide promised benefits such as bonus credit interest. The matter had been reported to ASIC and had required a remediation program (completed in 2015) that led to a total of about $7.6 million being paid to about 8,400 customers. This matter was the subject of a statement made by Johanna White, Managing Director of Business Lending, and was dealt with in the case studies for this round of hearings.[38] There were two other instances of customers being either overcharged with respect to Agri Advantage products or not being provided with promised benefits. Of those, one had been discovered in September 2012, had resulted in refunds of about $72,000, and was not reported to ASIC.

The other two cases mentioned in CBA's 22 March table were, first, another case of overcharging of fees (with respect to an 'Agri Options' product) identified in 2012 and, second, an instance of potentially inappropriate advice to customers that may have involved agribusiness products. Both these cases were reported to ASIC. To remedy the overcharging of fees CBA refunded about $330,000 to 726 customers.

Before the commencement of the fourth round of hearings the Commission asked a number of entities, including CBA, whether other instances of misconduct had been identified. In CBA's submission of 18 May it noted:

- First, that there were 16 incidents recorded in records CBA had provided to the Commission from its RiskInSite records of compliance breaches. CBA said that these had not been specifically dealt with in the 22 March tables because the incident record had been rated as 'insignificant' or 'low'.

[38] Exhibit 4.135, Witness statement Johanna Charlene White, 21 June 2018.

- Second, that it had identified two further 'operational incidents' that had both occurred in 2013:
  - one concerning interest rate management mis-selling where interest rate hedges did not match customer loan terms, or customers were not clear about the terms of the arrangement, which had affected 19 customers, of whom 10 were agribusiness customers. (18 of the 19 cases had been closed with refunds to customers of $1.37 million, of which $680,000 was to agribusiness customers; one case remained unresolved.); and
  - the other concerning an incorrect mapping of a reference rate for an agricultural line of credit onto a banking platform and required payment of about $78,000.
- Third, that FOS had resolved some disputes with customers in favour of the customers.

That these matters were disclosed only at the third time of asking is further demonstration of the point made elsewhere in this report that CBA's systems appear not to allow it to obtain readily any single, let alone comprehensive, report of conduct occurring within the entity that might amount to misconduct as defined in the Terms of Reference for this Commission. And, as also pointed out elsewhere, this means that neither the senior management nor the board of the entity can be given any single coherent picture of the nature or extent of failures of compliance with those norms of conduct and behaviour that must inform the daily conduct of the entity's business.

2.4 NAB

In its submission in answer to the questions I asked at the outset of the Commission, NAB said that it had 'identified responsible lending issues and lending related breaches of the Code of Banking Practice'. It gave one example of a matter from 2013 where the Code Compliance Monitoring Committee had found that, among other things, NAB had not acted in a fair and reasonable, consistent and ethical manner.[39] But the

[39] NAB, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry NAB Group's Response to the Commission's Letter dated 15 December 2017*, 29 January 2018, 7 [3].

29 January submission made no express mention of dealings with agricultural customers.

In its second submission, NAB provided printouts of entries made in and after 2013 in its RiskInSite risk management program. At least 85 of those events concerned agricultural clients. Examination of those entries revealed failures by NAB to tell agribusiness customers who was responsible for stamping and registration fees, and misunderstandings or disagreements between NAB and its customers about important aspects or functions of customer products and accounts (such as whether a deposit account operates as an offset account, or what the interest rate or term of a particular product was). But beyond these matters, NAB identified no conduct of a relevant kind when, in May 2018, it was asked to consider agricultural lending activities particularly.

As noted elsewhere, NAB told the Commission that it could not respond promptly and completely to the request made immediately after it had provided its initial response of 29 January, to provide more particular and comprehensive material about misconduct that it had identified during the preceding five years. Instead, NAB provided printouts from its risk management program.

In light of the nature and number of incidents relating to agricultural lending that other entities recorded in their responses to the Commission it would be remarkable indeed if NAB had had only the incidents noted above. I cannot and do not say that it did. I do no more than note NAB's repeated expressions of difficulty in making full response to the inquiries I have made.

2.5 Rabobank

Rabobank acknowledged seven instances of conduct directly relating to agricultural business lending that might amount to misconduct or was conduct falling below community standards and expectations. Three concerned the application of incorrect interest rates to a number of different accounts over different periods. One was overcharging fees, in 2011, to 126 clients, which required refunding about $370,000 to the affected clients. The remaining three focused upon the conduct of three different employees:

- one of whom had more than once amended documents after the client had executed them;

- one of whom had not disclosed a conflict of interest arising from a connection with a customer but had executed a bank document on behalf of the customer; and
- the last of whom had made personal commercial arrangements with customers that were not disclosed to the bank.

2.6 Other inquiries

In addition to considering the information that the entities supplied in their several submissions to the Commission and as statements of evidence that could be given, the Commission issued 50 notices to produce to 11 agricultural lenders. About 12,000 documents were produced in response. The documents dealt with each entity's practices, procedures and conduct, both generally and in relation to particular cases.

Solicitors and counsel assisting the Commission spoke with more than 20 rural financial counsellors from New South Wales (in its northern, central and southern regions), Victoria (in the western and north-western regions), Queensland (in the northern and southern regions) and Western Australia. Some counsellors put the Commission in touch with farmers who had not made a submission to the Commission but who had a grievance with a **financial services entity**.

3 Issues identified

Consideration of all this information together with the information that farmers themselves provided, identified three important issues:

- First, there were cases where **banks revalued land or other assets held as security**, with the result that the loan-to-value ratio (LVR) changed, and the bank then relied on the deterioration in land-to-value ratio as a non-monetary default permitting the bank to call up the loan. Those who made submissions to the Commission about these matters often complained that the time given to repay the amount called was unreasonably short.
- Second, frequent reference was made to the **difficulty that farmers have in obtaining access to banking services and to appropriate support**. This issue embraced several distinct elements. There was the

difficulty presented by distance from the nearest branch and consequent difficulties in contacting and dealing with the manager responsible for management of the farmers' accounts (especially if the loans were being managed in an asset management unit of the bank). There was what farmers saw as the failure to recognise ordinary seasonal variations in cash flow as well as the effect of drought or other natural disasters when deciding whether and when to act on loan defaults.

- Third, there were complaints about **changes to conditions of lending** in ways that were to the detriment of the borrower: whether by increasing interest rates or altering the terms of overdrafts or other facilities. And particular reference was made in this connection to the changes that followed a change in the ownership of the lender.

One other issue that clearly emerged should be dealt with separately: the appointment of receivers or other external administrators to agricultural enterprises.

3.1 Receivers and other external administrators

Submissions made to the Commission complained about the conduct of receivers. The central complaint made was that receivers appointed by banks did not realise fair value for the assets under management. And associated with those complaints were complaints about the ways in which receivers acted when taking possession of assets or when in possession of those assets.

As Senior Counsel Assisting explained in the course of opening the fourth round of the Commission's hearings, the conduct of those who are receivers (or liquidators or other insolvency professionals) is not within the terms of reference of the Commission.[40] Those persons are not financial services entities. Their conduct in execution of the position to which they are appointed is not conduct *on behalf of* financial services entities; it is conduct by the receiver personally and conduct for which the receiver is personally liable. Invariably, receivers, and receivers and managers, are appointed to act as agents of the borrower not the lender. The conduct of receivers is regulated by Chapter 5 of the *Corporations Act 2011* (Cth).

[40] Transcript, Senior Counsel Assisting, 25 June 2018, 3077–8.

By contrast, the conduct of a financial services entity *appointing* a receiver, a receiver and manager, an agent for mortgagee in possession or other external administrator is directly within the Commission's terms of reference. And it is conduct that is to be considered against some well recognised basic facts of commercial life.

Sale of assets by a receiver or other external administrator is a forced sale. The price obtained on forced sale is almost always less than the best price that might have been achieved. Valuers recognise this to be so. Their valuations make clear whether the value stated is market value or forced sale value.

A receiver is bound to take 'all reasonable care to sell' property for not less than market value.[41] But that obligation is primarily focused on the process undertaken to effect the sale, especially the means of sale (by auction, tender or private treaty) and the sufficiency of advertising to bring the property to the attention of the market. If proper process is followed, the price obtained is powerful evidence of what the market would pay for the property.

It is to be recalled, however, that *market value* is defined as the price that the willing *but not anxious* seller could reasonably expect to obtain and a willing, prudent, but not anxious buyer could reasonably expect to pay after proper negotiations between them (not overlooking any ordinary business consideration).[42] On a forced sale (whether by receiver, agent for mortgagee in possession or other external administrator) the seller is seen by the market as obliged to sell. That is, the seller is seen as 'willing *and* anxious', not 'willing *but not* anxious'.

NAB rightly submitted that **'it will rarely be in the best interests of the customer or the bank to appoint an external administrator'** and that, accordingly, **'wherever possible, appointment of external administrators should be an option of last resort, *where all other options have been exhausted*.'**[43] Why that should be so was identified by Mr Steinberg (ANZ's

41 Corporations Act s 420A(1)(a).

42 *Spencer v The Commonwealth* (1907) 5 CLR 418, 441.

43 NAB, Fourth Round of Public Hearings: Experiences with Financial Services Entities in Regional and Remote Communities Submission of National Australia Bank Limited – Questions Arising from the Fourth Round of Public Hearings, 16 July 2018, 5 [19]–[20]. Cf

Head of Lending Services – Corporate and Commercial) when he agreed that it is very rare for an external administrator to recover sufficient to repay the bank in full.[44] Hence, when considering whether to appoint an external administrator, the question is not whether appointment will avoid loss; rarely will appointment avoid all loss. Rather, the relevant question is whether appointment will avoid *greater* loss than would otherwise occur. That is, appointment of a receiver will almost always lead to an outcome where both lender and borrower lose; but the central question for the appointing party is whether the loss that will probably be suffered will be less than would be sustained if there were no appointment. And of course, losses are exaggerated if the assets are sold at a time of external distress like drought or collapse in the market for the commodity produced by the business.

The view from outside an appointing bank was accurately captured by the evidence of Mr Wheatcroft, a rural financial counsellor, when he said that 'the act of putting in a receiver never benefits a client [and] … in most cases it doesn't benefit the bank'.[45] As Mr Wheatcroft said, farmers see what happens in such a case as 'a massive destruction of value'.[46] And, judging from the great depth of feeling so obviously evident in farming circles, this view is widely held.

For this inquiry, the central question must be whether a decision to appoint an external administrator was conduct that either might amount to misconduct or was conduct falling below community standards and expectations. That question arose squarely in one of the case studies arising out of ANZ's acquisition of the Landmark Financial Services loan and deposit books: where ANZ appointed an agent for the bank as mortgagee in possession of land owned by the Harleys in Western Australia.

CBA, Round 4 Hearing – Issues Affecting Australians Who Live in Remote and Regional Communities Closing Submissions Part B – Questions Arising from the Case Studies, undated, 5 [25], external administrators 'are usually only appointed as a last resort'.

44 Transcript, Benjamin William Steinberg, 26 June 2018, 3261–2. Cf CBA, *Round 4 Hearing – Issues Affecting Australians Who Live in Remote and Regional Communities Closing Submissions Part B – Questions Arising from the Case Studies*, undated, 5 [26], 'in many instances of administrator or receivership appointments, both the customer and the bank may incur a loss'.

45 Transcript, Chris Wheatcroft, 25 June 2018, 3105.

46 Transcript, Chris Wheatcroft, 25 June 2018, 3105.

More generally, however, the tenor of the evidence led in the Commission was that banks have appointed external administrators in connection with agricultural loans less frequently in recent years, than once was the case. It may be inferred that there are several reasons for this. One is what appears to be an overall decline in the number of cases where banks have taken enforcement action with respect to loans to agricultural enterprises. But another important consideration has been that banks recognise that the appointment of external administrators is apt to provoke adverse publicity with consequent damage to reputation.

ANZ reviewed and made substantial changes to its 'Farming Segment Support Strategy' in 2015.[47] As the paper submitted to its board showed, ANZ recognised that 'the special challenges facing the rural sector and loan foreclosures [had recently] attracted a heightened level of focus *including political and media attention*'.[48] And, internal emails of NAB in 2014, relating to one case study (NAB and the Smiths) spoke of the appointment of a receiver and manager as being '[n]ot acceptable due to the drought *and political environment*' and of appointment after the rains come as being 'as *politically unacceptable*'.[49] Banks have come to see the appointment of external administrators as presenting serious reputational risks. It will be necessary to return to consider further what follows from risks of this kind. Before doing that, however, it is necessary to deal more generally with the issues that arose in connection with the Commission's consideration of dealings between banks and agricultural enterprises.

4 Analysing the issues

The issues that arose can be considered under the following headings:

- An overarching problem?

[47] Exhibit 4.23, Farming Segment Support Strategy ANZ Board, 6 August 2015; Transcript, Benjamin William Steinberg, 27 June 2018, 3296–8.

[48] Exhibit 4.23, Farming Segment Support Strategy ANZ Board, 6 August 2015, 1 (emphasis added).

[49] Transcript, Ross Hugh McNaughton, 29 June 2018, 3599; Exhibit 4.115, Emails between Avent, Starky and Others, 10 November 2014, 2 (emphasis added).

- Lending against 'market value'
- Who values the land?
- Dealing with distressed loans
  - Farm debt mediation
  - Hardship
  - Default interest and the enforcement of securities

4.1 An overarching problem?

It is tempting to see the issues presented in connection with agricultural lending as stemming from a single, overarching cause. How are borrowers and lenders in the agricultural sector to deal with the consequences of uncontrollable and unforeseen external events? Those events may be the onset and persistence of drought or other natural disaster, the collapse of a market as a result of governmental action here or abroad, or any of the many other perils of farming. Especially if the farmer has borrowed to acquire an asset at a price fixed in good times, or the external events destroy any immediate prospect of continuing profit, the loans that permitted acquisition or provide working capital may quickly become stressed.

For the reasons that follow, however, I doubt that it is useful to approach the issues that arise in connection with agricultural lending as allowing any single and all-embracing answer.

Behind the single question of how to deal with the consequences of external forces lie many distinct and different issues:

- What is the borrower to do? Is the borrower to sell up whatever can be sold to meet the debt?
- What is the lender to do? Is the lender not to seek repayment? Is the lender to extend not only time but more money?
- Who is to bear the consequences of what has happened, when neither borrower nor lender could have prevented it happening?
- Are there to be special rules for farmers? If there are, who bears the added cost?

- How, if at all, are the answers to these questions to be moulded in light of existing governmental assistance programs for farmers?

It is greatly to be doubted that any of these more particular questions could be given a *single* universal answer equally applicable to all cases. Not only that, I doubt that there is any *simple* answer to any of these questions. None has been offered in the submissions that have so far been made to the Commission. And the search for some more refined criteria for application of narrower general rules would seem likely to be soon lost in the thickets of individual cases.

Hence, **although there may appear to be a single and overarching problem – how agricultural borrowers and lenders are to deal with the consequences of uncontrollable external forces – the answer to be given to each of the more particular questions that have been posed must be case specific. And the answer that should be given in a particular case will seldom if ever be clear cut and obvious**. Nice questions of judgment will be required. As the case studies considered by the Commission show, the criticisms that can rightly be levelled at banks in their dealings with agricultural lending much more often than not find their roots in the bank's failure to take all of the relevant considerations into account when deciding, in a particular case, whether to lend or what to do when the loan becomes distressed.

All substantial loans to agricultural businesses are secured – usually over the land on which the business is conducted. If the business is a family business (and many are) the security will usually encompass the principal place of residence of the family. And if the enterprise is inter-generational (as many are) there may be more than one residence on the property that is given as security for the borrowing. Often, the security taken will encompass not only the land but also the means by which the enterprise generates its income: the stock, crops, plant and equipment. Realising the security may leave the borrower, and the borrower's immediate family (in some cases the borrower's extended family as well) with no home and no means of starting a new farming business.

How and by whom is the security to be valued?

4.2 Lending against 'market value'

Determining the 'market value' of agricultural land must take account of the relevant characteristics of the land, including its productive capacity. But as pointed out at the start of this chapter, productive capacity of farming land in Australia often varies as the seasons vary and is difficult to predict accurately beyond the current season.[50] The valuations produced in evidence in the course of hearings did not deal expressly with variations of this kind. Instead, where possible, the valuer looked to comparable sales as the surest guidance to market value. And, of course, that was entirely understandable because, in accordance with commonly accepted practice, the valuer was required to express an opinion about market value *at the date of valuation*.

But **is a valuation of that kind a reliable tool for a bank to use when determining how much to lend to a venture that must endure through good times and bad where the income from the venture will inevitably vary markedly from year to year?** Are these recognised causes of volatility matters that a bank should be permitted, even required, to take to account in determining the value of its security?

Ascribing a market value to land assumes that there is a market for the land. If there has been a prolonged drought, there may be no market for the drought-affected land. How, if at all, is a bank to take account of that possibility when deciding whether to lend and, if so, how much? Again, is this a matter that can or should be taken into account?

Even if there is a market for the land, realisation may take months so that the land may not only be adequately advertised for sale but also be presented at its best. Is this a matter that can or should be taken into account in deciding how much may be lent against the land as security?

Some account of these considerations may be seen in banks fixing their LVRs. It may readily be accepted that the more conservative that ratio, the wider the buffer both borrower and lender have to absorb the effects of external events on capital values and the time it may take to realise the security. But LVRs say little or nothing about serviceability of the loan. And if external events diminish income to the point where servicing is impaired,

[50] FSRC, *FSRC Background Paper No. 16: Some Features of Finance in the Agriculture, Forestry and Fishing Industry*, 15 June 2018, 16–17 [6.1].

capitalising interest, especially default interest, may soon impair even a conservatively set LVR. And if default interest is charged, the total debt may soon be larger than the best obtainable price for the land.

None of the bank witnesses who gave evidence about these matters suggested that the possibility of external shocks to the business conducted on land affected the way in which the land was valued for security purposes. And as the Australian Prudential Regulation Authority (APRA) pointed out in its written submissions, *Prudential Standard APS 220 Credit Quality* (APS 220), which relates, among other things, to security valuation, does not distinguish between valuations of farms or other rural property and other types of security. All are to be valued, for prudential purposes, according to the valuation standards and practices of the Australian Property Institute or some equivalent local or overseas body.[51]

Market value at a date provides no more than a snapshot of value. Market value of agricultural land at a particular date takes no account of possibilities that are plainly on the cards whenever a loan is made to an agricultural business. If those possible events occur, the value of the land will be affected. Are there cases where not taking these matters into account when deciding how much to lend or on what terms to lend is to take no account of possibilities that call for consideration?

4.3 Who values the land?

As emerged from some of the case studies, banks do not always use external valuers to determine the security value of property offered as security for agricultural loans. Sometimes banks rely on an internal appraisal of value. Evidence led in the case studies showed that internal appraisals made in those cases were not always accurate.

Particular difficulty may arise if the employee who makes the appraisal is the employee who sells the loan. Especially is that so if the employee is rewarded for selling the loan. The conflict of interest and duty is evident. Contrary to the position taken by some banks, that conflict is not avoided by having a second employee 'sign off' on the appraisal made by the loan

[51] APRA, *Written Submissions of the Australian Prudential Regulation Authority (APRA) Round 4: Experiences with Financial Services Entities in Regional and Remote Communities,* undated, 5 [18]; APRA, *Prudential Standard APS 220 Credit Quality,* January 2015, Attachment B 28 [21].

originator. As illustrated by the facts and circumstances concerning Bankwest and the Ruddys, an internal appraisal may contain significant errors (in that case an error about the area of the block being valued). Not only that, an appraisal may depend upon an unduly optimistic view of the quality of the property and its productive capacity. A co-signatory who does not inspect the property has no means of checking and correcting errors of the latter kind. And even an obvious error of the kind made in the case of the Ruddys was not detected by Bankwest until long after the loan had been made.[52]

As APRA pointed out in its written submissions, APS 220 permits an ADI to use valuations of suitably qualified internal appraisers or external valuers when determining the fair value of security.[53] As it stands, APS 220 requires an ADI to have policies and procedures directed at ensuring the reliability of the valuation processes and the valuations obtained in respect of security held. And APS 220 provides that these policies and procedures may include internal reviews of valuations by appropriate management or audit staff and formal reviews by an independent valuer.

APRA said, in its submissions, that its 'longstanding position' was that it is better practice for valuations to be made independently of staff engaged in loan origination.[54] But it also said that it intended to formalise this in its prudential standards 'by adopting the Basel Committee on Banking Commission's requirement that real property valuations are appraised independently from an ADI's mortgage acquisition, loan processing and loan decision process'.[55]

I support the proposal and urge its prompt implementation.

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52 Transcript, Sinead Taylor, 28 June 2018, 3476.

53 APRA, *Written Submissions of the Australian Prudential Regulation Authority (APRA) Round 4: Experiences with Financial Services Entities in Regional and Remote Communities,* undated, 4 [15].

54 APRA, *Written Submissions of the Australian Prudential Regulation Authority (APRA) Round 4: Experiences with Financial Services Entities in Regional and Remote Communities,* undated, 5 [19].

55 APRA, *Written Submissions of the Australian Prudential Regulation Authority (APRA) Round 4: Experiences with Financial Services Entities in Regional and Remote Communities,* undated, 5 [20].

4.4 Dealing with distressed loans

Once a business loan (including a loan made to an agricultural business) shows signs of distress, management of the loan is often transferred into a special asset management unit of the bank. Those units have various names, such as 'Lending Services' (ANZ), 'Group Credit Services' (CBA), or 'Strategic Business Services' (NAB). But the purposes of these special asset management units are substantially the same. All of the units are intended to manage the loan to the point where either it can be returned to the ordinary business management unit or it is brought to an end, if needs be by enforcement.

One of the chief lessons that ANZ took from its experiences after acquiring Landmark's lending book was the need to establish a special 'Agri team' in Lending Services (as it did in August 2014). Without specialist knowledge and experience, the manager of a distressed agricultural loan may not recognise and take proper account of what the presentation to ANZ's board described as 'the special challenges facing the rural sector'.[56] As that paper said, '[t]he agricultural sector faces special challenges such as adverse weather cycles and market fluctuations which [at that time, 6 August 2015, had] resulted in difficult farm operating conditions for a sustained period of time.'[57]

More fundamentally, however, **without specialist knowledge and experience, managers in an asset management unit cannot make informed decisions about whether or how it may be possible for the agricultural business borrower to work its way out of the difficulties that have led to financial distress**. No less importantly, those managers cannot make *timely* decisions that will accord with the needs of the business. As Mr Wheatcroft pointed out, 'if finance starts to be restricted because decisions take too long to be made, the opportunities to lower your costs, to be timely in putting in the crop are lost. And those things cost businesses significantly.'[58]

In order to make informed decisions about whether or how a business borrower (no matter what the nature of the business) might be able to work

[56] Exhibit 4.23, Farming Segment Support Strategy ANZ Board, 6 August 2015, 1.

[57] Exhibit 4.23, Farming Segment Support Strategy ANZ Board, 6 August 2015, 1.

[58] Transcript, Chris Wheatcroft, 25 June 2018, 3097.

out of financial difficulties, the manager concerned must be able to speak frankly and fully with the borrower. Many farmers are used to dealing face to face about important financial issues. A bank's asset management unit will often operate a long way away from the agricultural borrower's property. But in many, probably most, cases, direct and frequent contact between manager and borrower will assist both bank and borrower to decide what is possible and what is not. Especially is that so when the management of the facilities has passed to an asset management unit.

Mr Steinberg gave evidence of changes that had been made to the operation of ANZ's Lending Services unit in and after March 2014.[59] One of those changes was to adopt a statement described as 'Lending Services Purpose'.[60] The document spoke of Lending Services managing 'high risk customers to achieve the best outcome for both ANZ and our customers'. It said there were four pillars for its work: 'Customer experience' (amplified as being 'We care; we act with fairness and honesty; we do what is right'), 'Staff experience', 'Well-managed' and 'Trusted Advisor'.[61] And Mr McNaughton of NAB referred, in the course of his evidence in the third round of hearings, to an equivalent statement of the purposes of NAB's Strategic Business Services unit.[62]

Without seeking to take away from the importance of these statements as means of conveying to staff in the relevant unit the values and purposes that should inform their work, it is important to recognise that there may appear to be a tension between seeking to rehabilitate a distressed loan (to the point where it returns to management by the relevant business unit of the bank) or to bring the loan to an end (if needs be by enforcement) and the specification by banks of times within which one of those outcomes is to be achieved. And in at least some cases, banks state 'churn rates'[63] as

59 Transcript, Benjamin William Steinberg, 27 June 2018, 3293–9.

60 Exhibit 4.20, Witness statement of Benjamin William Steinberg, 18 June 2018, Exhibit 4.8.22 [ANZ.800.552.2654].

61 Exhibit 4.20, Witness statement of Benjamin William Steinberg, 18 June 2018, Exhibit 4.8.22 [ANZ.800.552.2654].

62 Transcript, Ross Hugh McNaughton, 31 May 2018, 2906; Exhibit 3.140, Witness statement of Ross Hugh McNaughton, 22 May 2018, Exhibit 19 [NAB.005.223.0960].

63 Transcript, Benjamin William Steinberg, 27 June 2018, 3270; Transcript, Ross Hugh McNaughton, 29 June 2018, 3573.

indicating the rate at which files are to pass through the relevant asset management unit.

But whether or not it is right to identify a tension of that kind, or to identify it only where a churn rate is stated, management of distressed loans (agricultural and other) may be better informed by noting the analogy that may be drawn between the objects of managing a distressed loan with the objects of that part of the Corporations Act that deals with the administration of a company's affairs with a view to executing a deed of company arrangement. The latter set of objects is to administer the business, property and the affairs of an insolvent company in a way that 'maximises the chances of the company, or as much as possible of its business, continuing in existence' or 'if it is not possible for the company or its business to continue in existence – results in a better return for the company's creditors and members than would result from an immediate winding up of the company'.[64]

Like all analogies, the analogy is imperfect. **But the central ideas of treating working out as the best outcome and immediate winding up as worst, has evident application to the decisions that must be made when an asset management manager is considering how best to deal with a distressed loan to a farming business.**

It is important to emphasise immediately that invoking the analogy is not intended to permit, let alone require, the asset management unit to prefer the interests of the borrower over the interests of the bank that has lent. It is to observe no more than that maximising the chances of the business, or as much as possible of the business, surviving, or where that cannot be done, achieving the best available return on sale of the business and its assets, will almost always work in favour of both bank and customer.

In that regard it is to be noted that continuing to carry an impaired loan comes at a cost to the bank. Not only are there increased costs of administering the impaired loan, carrying the loan comes at a capital cost.

Tellingly, however, Mr McNaughton of NAB could not identify the amount of the capital cost or whether there is any relationship between cost of capital

64 Corporations Act s 435A.

as a result of impairment and a bank's decision to charge default interest.[65] And in its written submissions, Westpac said that it is 'difficult to accurately identify the precise costs that are incurred by a bank when a loan falls into arrears', but that 'significant additional costs are incurred'.[66]

It appears to follow that **at least those banks are not readily able to compare the costs of waiting to enforce for a time with an estimate of how much more might be realised at the end of that waiting period**. And it is no answer to that conclusion to say, as NAB did in its written submissions, 'that there is insufficient evidence presently before the Commission to enable a meaningful answer to be given' to whether default interest reflects the cost of carrying impaired loans.[67] Nor is it an answer to say as NAB did, that this was not a topic on which NAB was asked to provide evidence.[68] Mr McNaughton is NAB's employee in charge of its Strategic Business Services unit. He could not say what the costs were. Without knowing what those costs were he could not make a comparison of the kind identified. Without being able to make a comparison of that kind, it is not possible to make an informed commercial decision about what will be in best interests of the bank or the customer. **Those responsible for those decisions should be armed with information that enables them to make informed commercial choices.**

When loans are distressed, there will be cases where both bank and borrower may be assisted by third party mediation. It is necessary to say something further about that, with particular reference to existing farm debt mediation arrangements.

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65 Transcript, Ross Hugh McNaughton, 29 June 2018, 3591.

66 Westpac, *Westpac Banking Corporation General Submissions on Experiences with Financial Services Entities in Regional and Remote Communities*, 16 July 2018, 12 [49].

67 NAB, *Fourth Round of Public Hearings: Experiences with Financial Services Entities in Regional and Remote Communities Submission of National Australia Bank Limited – Questions Arising from the Fourth Round of Public Hearings*, 16 July 2018, 11 [50].

68 NAB, *Fourth Round of Public Hearings: Experiences with Financial Services Entities in Regional and Remote Communities Submission of National Australia Bank Limited – Questions Arising from the Fourth Round of Public Hearings*, 16 July 2018, 11 [51].

4.4.1 Farm debt mediation

As explained earlier, three states provide by statute for compulsory farm debt mediation before a lender seeks to enforce a loan. In other states there are voluntary schemes that provide for mediation.

First, there appears to be obvious advantage, and no evident disadvantage, in making national provision for farm debt mediation according to a common legislative scheme.

Second, it is necessary to challenge what seems to be the presently accepted position that farm debt mediation is undertaken only when the lender has decided to enforce recovery of the loan. Mediation undertaken in those circumstances will focus only on when and how securities will be realised and when and how repayments will be made. The borrower will very likely see the negotiations as conducted with the lender holding a gun at the borrower's head.

Consistent with what has been said above about the need for asset management units to approach their task recognising the importance of considering whether it is possible for the borrower to work out of the distress that brings it into the asset management unit, there will be cases where early mediation between borrower and lender, before the bank has determined to enforce the loan, may assist in deciding whether work out may be possible and, if it is, how best it is to be attempted.

Unless both borrower and lender were to agree to the contrary, **there would seem to be advantage, therefore, in requiring an offer of mediation in every case where an agricultural loan, secured by farm property, first becomes impaired (in the sense of there being a payment under the loan contract more than 90 days past due)**. A mediation then would ordinarily be in addition to, not in substitution for, the requirement for the lender to offer mediation before taking any step to enforce the loan. Its focus would almost always be on whether work out is possible. Rarely would it be evident immediately after the loan first becomes impaired that recovery is impossible.

I say that a mediation of this kind would 'ordinarily' be in addition to, rather than in substitution for a mediation before enforcement because it may be thought that an offer of further mediation should not be necessary if a mediation had been conducted within the period of (say) six months before the giving of notice of intention to take enforcement proceedings. Even in

that latter case, however, it may be thought that it would be as well to permit the borrower to require further mediation. But these are matters for further submission and consideration.

The third point to make about farm debt mediation is that, no matter whether changes of the kind described are made, **arrangements that are proffered by lenders at mediation must be capable of practical implementation**. As the case studies examined in the fourth round of hearings revealed, nothing is to be gained by lenders insisting upon unrealistic times within which security properties are to be offered for sale or within which vacant possession of security properties should be given if sale is not effected. To say that the property must be sold by 30 June and, if it is not, vacant possession is to be given on the next day, is impractical. It is especially impractical if the borrower's principal place of residence is on the property.

Terms of this kind rarely if ever give lenders some discernible and valuable benefit not otherwise obtainable. Unless they do give some advantage of that kind, why seek them? On their face they appear to be terms that, if insisted upon, would rightly be seen by both borrower and onlookers as unfair assertions of power.

4.4.2 Hardship

All banks have hardship policies under which borrowers facing unexpected crises may be given some accommodation in meeting loan obligations. The 2013 Code of Banking Practice obliged, and the 2019 Code will oblige banks bound by the Code to try to help individual and small business customers to overcome financial difficulties. But most lenders, including banks, invite all borrowers facing financial difficulty to contact the bank and discuss what may be done to deal with the difficulty.

In many cases, financial hardship follows sudden and unexpected events: injury, death, fire or flood. The consequences may be seen as temporary. But prolonged drought is different. It is persistent and increasingly destructive. Stock is lost. Crops are lost and cannot be planted. Income is lost. Expenses persist. The effects multiply and are measured in years.

That the drought-affected borrower experiences hardship cannot be denied. But what is the bank to do?

After the fourth round of hearings, NAB announced that it would no longer charge default interest to rural customers in drought declared areas. (In the

written submissions NAB provided after the fourth round of hearings, NAB had denied that charging default interest to drought-affected customers was contrary to community standards and expectations.) If this change in policy is to be understood as NAB's recognition of what the community expects of it, it is a change rooted in community standards of fairness. That is, it is a change that recognises that insistence upon the letter of the loan contract may be unfair, and will be unfair when the borrower's business is radically affected by external forces beyond the control of lender and borrower. And if that is right, three further questions arise:

- Should others follow the same policy?
- If they should, how, and where, is the policy to be expressed?
- Should the policy apply to other natural disasters?

More generally, however, **are there other ways in which lenders can or should respond when an agricultural borrower's loan becomes distressed as a result of natural disasters like drought, flood and fire?**

Apart from cases of natural disaster, it is inevitable that there will be loans where the borrower defaults. It is inevitable that there will be cases where the lender concludes that the loan must be enforced. **Are there limits to how and when the lender pursues enforcement?**

4.4.3 Default interest and the enforcement of securities

Two particular issues emerged from the case studies: the charging of default interest and enforcement of security. One aspect of charging of default interest has been dealt with above. There are some other, more general, questions about the charging of default interest that call for examination.

Provision for a rate of default interest is commonplace in loan agreements. The agreement may provide for one rate of interest and then provide that a lower, or 'acceptable', rate will be charged if payments are made on time. The form of the provisions is not relevant to present issues. Default interest rates fixed by bank lenders may be markedly higher than the rate that is to be applied when payments are made when due. And on top of the default interest, the bank may charge fees when the account is not in order.

Default interest grows quickly. If an agricultural loan is distressed, and the borrower can make no substantial repayment in reduction of principal or interest, the balance owing can quickly become very large indeed. It seems not uncommon for a bank to use default interest as a bargaining chip to persuade the borrower to agree to prompt, sometimes immediate, realisation of the securities. That is, it seems that farm debt mediation may result in the parties making a deed of forbearance by which the borrower agrees to a program for sale of securities, the bank agrees to forgo default interest, but the parties agree that, if the property is not sold within the time fixed, the bank can enter judgment for much, if not all, of the balance then due on the loan.

Two points emerge. **What commercial purpose does the lender seek to achieve by continuing to charge default interest if the balance of the loan outstrips the likely worth of the security property?** Is there a realistic likelihood of the lender recovering the amount that is charged? If there is not, what is the purpose of charging it? And that is a question to be asked and answered in light of the fact that a bank will reach a point at which it decides not to take the interest that is charged in respect of a loan to account as profit.[69] Why continue to charge default interest then?

Second, **how, if at all, is the charging of default interest compatible with trying to rehabilitate the loan?** On the face of it, charging default interest for any extended time will amplify the borrower's difficulties. Does there not come a time where the charging of default interest shows that the loan must be enforced? And if the loan has reached that point, the immediate issues are about the best exit strategy. What steps will achieve the best outcome for lender and borrower?

5 Issues that have emerged

All agricultural enterprises are subject to the effects of events beyond the control of the individual farmer. Occurrence of any of these events, let alone a combination of them, will affect cash flow and profitability and, hence, the

[69] Transcript, Ross Hugh McNaughton, 29 June 2018, 3595–6.

ability to service debts. Their occurrence will often have profound personal effects on those who conduct the business.

Four issues emerged: about revaluation of securities; difficulties in obtaining access to banking services and appropriate support; changes to conditions of lending; and, enforcement by appointment of external administrators.

The particular questions can be identified as including:

- How are borrowers and lenders in the agricultural sector to deal with the consequences of uncontrollable and unforeseen external events?
- Does the 2019 Banking Code of Practice provide adequate protection for agricultural businesses? If not, what changes should be made?
- How, and by whom should property offered as security by agricultural businesses be valued?
  - Is market value the appropriate basis?
  - Should the possibility, or probability of external shocks be taken to account in fixing lending value? How?
  - Should the time for realisation of security be taken to account in fixing value? How?
  - Is the possibility, or probability of external shock sufficiently met by fixing the loan-to-value ratio?
  - If prudential standard APS 220 is amended to require internal appraisals to be independent of loan origination, loan processing and loan decision processes, when should that amendment take effect?
- Should distressed agricultural loans be managed only by experienced agricultural bankers?
- Do asset management managers need more information (such as the cost to the lender of holding the loan) to make informed commercial decisions about management of distressed agricultural loans?

- Are there circumstances in which default interest should not be charged?
  - In particular, should default interest be charged to borrowers in drought-declared areas?
  - If it should not, how, and where, is that policy to be expressed?
  - Should the policy apply to other natural disasters?
- In what circumstances may a lender appoint an external administrator (such as a receiver, receiver and manager or agent of the mortgagee in possession)? Is appointment of an external administrator to be the enforcement measure of last resort?
- Having regard to the answers given to the preceding questions:
  - Is any regulatory change necessary or desirable?
  - Is any change to the 2019 Code necessary or desirable?
- Should there be a national system for farm debt mediation?
  - If so, what model should be adopted?
- Should lenders be required to offer farm debt mediation as soon as an agricultural loan is impaired (in the sense of being more than 90 days past due)?

7. Remote communities

Introduction

The notions of ‘remote’ and ‘very remote’ areas, ‘financial inclusion’ and ‘financial exclusion’, and ‘financial literacy’ can all be used to help identify particular kinds of difficulty associated with the provision of financial services. My focus must be upon how financial services entities respond to those difficulties: in particular whether they have engaged in conduct that might amount to misconduct or conduct that falls short of community standards and expectations.

At 30 June 2017, about 28% of the Australian population lived in regional or remote areas. This is nearly 7 million people. At the same time, only 4% of all branches of **authorised deposit-taking institutions** (ADIs) and 2% of ATMs were located in areas classified as remote or very remote. The banks’ branch networks have been shrinking for some years. The banks have fewer face-to-face points of presence.

Some Aboriginal and Torres Strait Islander people who live in remote or very remote areas encounter particular difficulties in their dealings with banks. Some, for whom English is a second or third language, encounter language difficulties. Some encounter difficulties in satisfying some forms of identification requirements. Some may have a low level of literacy, particularly financial literacy, and may have only a limited understanding of how credit, insurance and superannuation products work. And all who live in remote or very remote areas face the difficulties of geography.

In the cities, more and more banking is done electronically. A customer with a difficulty will telephone a call centre. If the operator cannot solve the problem, the customer will be invited to ‘step into the nearest branch’. But the customer who lives in a remote or very remote area cannot just ‘step into the nearest branch’ if it is hundreds of kilometres away. They may have only limited access to phone or internet banking. They may have access to only one ATM.

In 2010, the Australian Financial Counselling and Credit Reform Association noted that the cost of ATM fees was having a significant and detrimental

effect on Aboriginal and Torres Strait Islander people living in remote communities. Withdrawal limits meant that a customer wanting to undertake a large transaction had to make more than one withdrawal, paying a fee for each separate transaction. And every time a customer wanted to check their account balance, the transaction would attract a $2 fee.

In 2012, the Australian Bankers' Association (ABA) applied to the Australian Competition and Consumer Commission (ACCC) for authorisation of an agreement to provide fee-free ATM withdrawals and balance inquiries at some ATMs operated by participating entities in remote and very remote areas. Authorisation was granted for five years to 1 December 2017; it has since been renewed for a further 10 years.

The Commission asked several financial services entities whether they had identified particular conduct relating to Aboriginal and Torres Strait Islander people that might amount to misconduct or conduct falling short of community standards and expectations. Few entities disclosed conduct of that kind. That is unsurprising when it is recognised that, ordinarily, financial services entities do not ask customers whether they identify as Aboriginal or Torres Strait Islander people.

ANZ, Bendigo, CBA and Westpac all participate in the fee-free ATM arrangements. All have a presence in regional and remote areas.

CBA maintains an Indigenous Customer Assistance Line (or 'ICAL') to provide support for geographically isolated Aboriginal and Torres Strait Islander customers, in 90 remote communities, by providing free balance inquiries, replacement cards, access to funds, and other, more general, support. ICAL uses a special identification process tailored to the customers who use the service. CBA started the service in 2009 when it recognised that customers were paying fees to check account balances.

CBA told the Commission that it has recently identified cases where customers have been charged fees for using ATMs owned and operated by third parties under the ATM fee-free agreement. CBA said that it was working to identify the customers concerned, ensure the fees are refunded, and work with the ABA and the providers of ATMs to ensure that it does not happen again.

Westpac told the Commission that in 2015 the Australian Securities and Investments Commission (ASIC) had raised concerns about car loans that

had been provided in two remote communities by Capital Finance Australia Ltd (a company later acquired by Westpac). Westpac waived repayment of the loans and ensured that the customers had no default listed against them. Westpac continues to make car loans in remote areas. It told the Commission that it had reviewed a sample of accounts in substantial arrears to identify whether there were responsible lending issues but the results of those inquiries had not been made available to the Commission by the end of August 2018.

One other **financial services entity** should be mentioned. The Traditional Credit Union, or TCU, has branches in 14 remote communities in the Northern Territory, as well as branches in Darwin, Katherine and Alice Springs. TCU operates a business model different from other ADIs in that it relies on fee income rather than interest income. Because it has a low interest income, TCU cannot cross subsidise the costs of its branch and ATM networks. Its transaction and account fees are markedly higher than other ADIs.

1 Remote area issues

The issues that arose in connection with banking services in remote communities related to access to services; account fees; and the application of standard identification requirements. None of the banking relationships examined was complicated. The prevailing theme in the evidence was of basic transactions made bewildering by inadequate recognition on the part of the bank of an Indigenous customer's circumstances.

Four more particular kinds of issue relating to banking in remote and very remote areas emerged. All are issues affecting some Aboriginal and Torres Strait Islander people who live in remote or very remote areas. They concerned:

- basic accounts
- informal overdrafts;
- dishonour fees; and
- identification issues.

1.1 Basic accounts

'Basic' bank accounts provide the account holder with essential banking services at a lower cost than other forms of account. Those whose only income is from Centrelink benefits may therefore find that a basic bank account suits their needs better than other forms of account.

One of the case studies looked at in evidence showed a customer who lived in a remote community encountering needless difficulty in switching to a basic account, despite having the support and assistance of a very able community worker. The customer and her supporter had to travel long distances to go into the Katherine branch of ANZ more than once to achieve what should have been the simplest objective.

The banker with whom they dealt seemed either ignorant of, or unwilling to implement, the necessary steps. The banker embarked on a wide-ranging survey of the customer's 'needs' evidently seeking to sell the customer other bank products. And this she did. Only after several inquiries to ANZ's call centre to check information, only after several three-hour round trips to and from Katherine, and only on the third time of asking was the request to open a basic account met. Surely it need not be so hard.

One of the chief reasons for Centrelink recipients to prefer a basic bank account is to avoid incurring fees. Two particular kinds of fee require special mention: overdraft and dishonour fees.

1.2 Informal overdrafts

A bank may allow a customer to withdraw more than the amount standing to the credit of the customer's account. In former times, the bank would honour the customer's cheque even though the transaction would result in the account being overdrawn. The bank may allow overdrawing without any prior agreement with the customer. If the bank does meet the customer's request to withdraw an amount larger than the balance standing to the credit of the account, the bank will charge the customer a fee for lending the customer the amount of the informal overdraft.

Each fee may be small. But overdraw repeatedly, and the fees soon mount up.

In many cases, lending a Centrelink recipient even a small amount may be to make a loan that is unsuitable for the borrower. It may be unsuitable

because repayment of the amount lent, with the fee charged for the loan, will cause hardship. But whether or not the loan is contrary to the *National Consumer Credit Protection Act 2009* (Cth), there are circumstances in which the customer will know no more than that the request to withdraw has been met and will not consider whether the amount withdrawn is larger than the credit balance in the account.

If a Centrelink recipient seeks an overdraft facility, the application will be determined according to ordinary processes. Informal overdrafts are not allowed on basic accounts but the bank may allow other accounts to be overdrawn. Banks permit customers to 'turn off' informal overdraft arrangements. But are there circumstances in which banks should not allow informal overdrafts? In particular, should informal overdrafts not be allowed if credits to the account are only, or are substantially, by payment of Centrelink benefits?

If the overdrawn balance of an account builds up, arrangements called '90% arrangements' can be made by which only 10% of Centrelink payments are applied in reduction of debt and the remaining 90% is available to the recipient. (Those arrangements are recorded in a Code of Operation endorsed by the Commonwealth Departments of Human Services and Veterans Affairs and the ABA and others.[1]) **Should the application of these arrangements be at the discretion of the bank, the customer or both? Or should banks apply these arrangements automatically?**

1.3 Dishonour fees

Some bank customers in remote and very remote areas make arrangements with retailers and others that require periodic payments. The person to whom the payment is to be made will often have the customer give a direct debit authority to the bank. If the account on which the customer has given the authority has insufficient funds, the debit will be dishonoured and the bank will charge the customer a dishonour fee.

[1] Exhibit 4.202, Witness statement of Tony Colin Tapsall, 21 June 2018, Exhibit TCT-17 [ANZ.800.643.0441].

Should direct debit arrangements be available in respect of all kinds of account? In particular, are there cases in which dishonour fees should not be charged for direct debits?

1.4 Identification issues

Aboriginal and Torres Strait Islander people may not always be readily able to assemble documentary proof of identity. Some Aboriginal and Torres Strait Islander people dealing with phone banking call centres may find it difficult to satisfy the operator of their identity.

The Australian Transaction Reports and Analysis Centre (AUSTRAC) has published guidelines intended to overcome the first kind of difficulty.[2] Bank staff must be trained to apply those guidelines.

The second kind of issue also requires thought and suitable training. CBA's solution of having a special assistance line for persons in remote and very remote communities appears to be the best practice so far devised and applied.

2 Funeral insurance

The Australian Securities and Investments Commission (ASIC) told the Commission that it had identified issues arising from the sale of funeral insurance products to Aboriginal and Torres Strait Islander people. ASIC pointed to inappropriate sales practices, particularly misrepresentations and pressure selling tactics, and to sales where what was sold was of little or no benefit to the purchaser. The issues extend, but are not confined, to persons in remote or very remote areas.

About half of all who take a form of funeral insurance are aged between 50 and 74 years. By contrast, about half of those who take a form of funeral insurance and identify as Aboriginal or Torres Strait Islander people, are aged under 20 years.

Funeral insurance is sold directly to consumers. It can be seen as a type of life insurance. There are two kinds of funeral insurance: funeral life

[2] See AUSTRAC, Aboriginal and/or Torres Strait Islander People <www.austrac.gov.au/aboriginal-andor-torres-strait-islander-people>.

insurance and funeral expenses insurance. A consumer buying funeral life insurance nominates a benefit amount (typically between $5,000 and $20,000) payable, on the death of the nominated life, to a person nominated by the policy holder. The recipient may apply the benefit as the recipient thinks fit. By contrast, funeral expenses insurance will pay funeral costs up to a nominated limit. Often the funeral expenses will be less (sometimes much less) than the nominated limit of cover.

The most recent statistics about funeral insurance were gathered by ASIC as at 30 June 2014. There were then about 430,000 policies covering about 740,000 insured lives. In the year ended 30 June 2014, more than 12,500 claims were accepted and more than $103 million paid in claims – an average payout of about $8,100. The amount paid in claims was about one-third of the value of premiums collected. (In the preceding year the proportion was one-fifth.) Nearly 73,000 policies were cancelled during the 2014 year but the rate of cancellation of new policies was about 80%.

Nearly two-thirds of policies had been held for less than three years. About 17.5% had been held for five or more years. Fewer than 5% had been held for more than eight years.

These figures suggest that the policies give little value to consumers. If they give little value, how are they sold?

The view that funeral insurance policies give little value is reinforced when it is observed that most consumers hold policies with stepped premiums increasing with age and it is further observed that the total premiums paid for a policy will often far exceed the costs of a funeral. And the particular cases examined in evidence emphasise not only the view that the policies are of little value but also the corollary that the policies are too often sold by the unscrupulous to the unsophisticated and vulnerable.

Three points emerge. They can be stated shortly.

2.1 Funeral insurance issues

First, are policies of this kind **financial products** warranting consideration by ASIC in the exercise of the product intervention powers soon to be given? Are there features of any of these policies that warrant attention of that kind?

Second, both funeral life policies and funeral expenses policies are life policies under the *Life Insurance Act 1995* (Cth) and contracts of life insurance under the *Insurance Contracts Act 1984* (Cth). But the consumer protection provisions of Chapter 7 of the *Corporations Act 2001* (Cth) apply only to funeral life policies, not funeral expenses policies. That is, issuers of funeral life policies must do all things necessary to ensure that the financial services they provide are provided efficiently, honestly and fairly; issuers of funeral expenses insurance fall outside those requirements. Is there any reason to draw this distinction? Is there any reason not to provide that all forms of funeral insurance are financial products for the purposes of Chapter 7?

Third, it is suggested that there may be some doubt about whether the consumer protection provisions of Part 2 Division 2 of the *Australian Securities and Investments Commission Act 2001* (Cth) apply to funeral expenses insurance. (It is accepted that the provisions do apply to funeral life policies.) Is there any reason not to put the point beyond doubt by providing that all forms of funeral insurance are covered by these provisions?

3 Issues that have emerged

This chapter examined how financial services entities are responding to the financial needs and vulnerabilities that can be experienced by Indigenous Australians, in particular those living in remote communities.

In relation to banking services in remote communities, the issues that arose related to access to services; account fees; and the application of standard identification requirements. None of the banking relationships examined was complicated. The prevailing theme in this part of the chapter was of basic transactions made bewildering by inadequate recognition on the part of the bank of an Indigenous customer's circumstances.

In relation to funeral insurance, what emerged was evidence pointing to predatory behaviour by insurers and salespeople. What followed were questions about the way in which funeral insurance should be regulated, and therefore how it should be categorised by the law.

Common to both parts of the chapter was the issue of culturally appropriate communication, a lack of which aggravated the existing difficulties in the interaction between entity and customer.

More specifically, the questions that arose can be set out as follows:

- Do financial services entities have in place appropriate policies and procedures to assist Aboriginal and Torres Strait Islander people:
  - to overcome obstacles associated with the geographical remoteness?
  - to address the cultural barriers to engagement that some face?
  - to address the linguistic barriers to engagement that some face?
  - to address the obstacles posed for some by their level of financial literacy?
- Are banks' identification requirements appropriate for Aboriginal and Torres Strait Islander customers?
  - If they are, are those policies sufficiently understood and applied by staff?
- Should more banks have a telephone service staffed by employees with specific training in assisting Indigenous consumers?
- Do banks take sufficient steps to promote the availability of fee-free accounts to eligible customers?
- If a customer seeking to open a basic bank account has no substantial income other than Centrelink benefits, should a bank ever try to sell the customer another form of account?
- Should informal overdrafts be allowed on a bank account if credits to the account are only, or are substantially, by payment of Centrelink benefits?

- Should the application of the 90% arrangements provided by the Code of Operation be at the discretion of the bank, the customer or both? Or should banks apply these arrangements automatically?
- If direct debits are dishonoured for want of sufficient funds, are there cases in which dishonour fees should not be charged?
- Are funeral policies, or particular kinds of funeral policy, **financial products** warranting intervention by ASIC in the exercise of its product intervention powers?
- Should all forms of funeral insurance be financial products for the purposes of Chapter 7 of the *Corporations Act 2001* (Cth)?
- Should all forms of funeral insurance be covered by Part 2 Division 2 of the *Australian Securities and Investments Commission Act 2001* (Cth)?
- Should it be unlawful to sell funeral insurance for persons under 18 years?

8. Regulation and the regulators

Introduction

In its submission on key policy issues dated 13 July 2018, Treasury said, and I agree, that there are three matters that go to the heart of the conduct that has been identified in the Commission's hearings:

- the **culture and governance** of financial (and other firms) and the related regulatory framework;
- the **capability and effectiveness of the financial system regulators** to identify and address misconduct; and
- **conflicts of interest** arising from **conflicted remuneration** and integrated business models.

The first of these issues, about entity culture and governance, is dealt with in the next chapter of this report. Conflicts of interest have been considered elsewhere, especially in Chapters 2 and 3. This chapter looks particularly at regulation and the regulators.

Almost all of the conduct identified and criticised in this report contravened existing norms of conduct. The most serious conduct broke existing laws. Other conduct either broke the law or broke the promises entities had made, generally (in documents like the Code of Banking Practice) or more specifically. Little if any of the identified conduct was *not* contrary to some existing norm of conduct.

The conduct that has been identified and criticised can be described simply. It included:

- **taking a customer's money when not entitled to take it** (for example by charging a fee for service when no service was given);
- **preferring personal financial interest over the customer's interest** when obliged to act in the customer's best interests;

- **misleading or deceiving** the customer; and
- **breaking some specific requirement of the law** including, but not limited to, provisions intended to protect the customer (such as the consumer lending provisions of the *National Consumer Credit Protection Act 2009* (Cth) – the NCCP Act).

Because the conduct was contrary to existing laws, two questions arise. First, **why were these breaches as widespread as they were?** Second, **why would changing the law make any difference?**

One important premise for those questions must not be ignored. Each **financial services entity** is responsible for its own conduct. It, and it alone, is responsible for every act that is identified in this report as conduct that might constitute misconduct or is conduct that falls short of community standards and expectations. The criticisms that are made of the ways that regulators have responded to this conduct must not be understood as diminishing in any way the culpability of the entities that engaged in the relevant conduct.

1 Why were breaches so many and so widespread?

To understand why the banks could, and did, act as they did, it is necessary to look at some fundamental considerations.

Banks have a special position in the economy. They are licensed under Commonwealth statute, by the Australian Prudential Regulation Authority (APRA), a statutory authority. To carry on any banking business in Australia without authority is an indictable offence.[1] Others can therefore enter the market only with permission. **Banks are regulated by APRA to ensure the proper functioning of the banking system and avoid failure of individual entities. Competition within the banking industry is weak.** Barriers to entering the industry are high. To participate in the economy, to participate in everyday life, **Australians need a bank account**. But **they**

1 *Banking Act 1959* (Cth) ss 8, 9.

are reluctant to change banks. Each of the four largest banks is a powerful player in the market.

Then there are some considerations that arise from the very nature of banking. Banks' dealings with customers seek to minimise risk to the bank. The bank fixes *its* risk appetite. It decides to whom it will lend and on what terms. It decides whether security should be provided and what form and value it should take. Hence, banks have only as much 'skin in the game' in their dealings with customers as *the bank* chooses. And there is always a striking asymmetry of power and information between bank and customer that favours the bank.

Important deterrents to misconduct are, therefore, missing from the banking industry. Competitive pressures are slight. Fears of the enterprise failing are eliminated as far as possible. Fears of failure of particular transactions are mitigated by banks writing the terms on which the deal is done and then taking security against the customer's default.

Like any commercial enterprise, banks seek to maximise profit. Having survived the Global Financial Crisis, and being prudentially regulated against failure, annual profit has become the defining measure of success of Australian banks. That measure has been justified as being in the interests of shareholders and, because superannuation funds hold bank shares, as being in the interests of all Australians. But there being little threat of failure of the enterprise, and there being little competitive pressure, pursuit of profit has trumped consideration of *how* the profit is made. The banks have gone to the edge of what is permitted, and too often beyond that limit, in pursuit of profit. And they have gone beyond the limit:

- because they can; and
- because they profit from the misconduct that is described in this report.

Risk to reputation was ignored. Discovery of misconduct was 'managed' by words of apology and promises to do better. But little more was done than utter the apology and make the promise. More often than not, remediation programs were eventually set up but usually after protracted negotiation. Profit remained the informing value.

The law sets the bounds of permissible behaviour. If competitive pressures are absent, if there is little or no threat of enterprise failure, and if banks can and do mitigate the consequences of customers

failing to meet obligations, only the regulator can mark and enforce those bounds. But neither the Australian Securities and Investments Commission (ASIC) nor APRA has done that in a way that has prevented the conduct described in this report.

Why not?

APRA's chief focus is on governance and risk culture. In performing and exercising its functions and powers it is obliged 'to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, *is to promote financial system stability in Australia*.'[2] APRA's central task is to prevent failure of the financial system and to prevent failure of entities within the system. ASIC's focus is conduct regulation. Given the extent of known misconduct, attention must first be directed to whether, and how, ASIC might have better regulated conduct within the industry. Then, the more general issues of governance and risk culture with which APRA deals will be considered.

2 ASIC

2.1 ASIC's remit

In its 13 July submission, Treasury said that:

> Over the past twenty years the remit of ASIC has expanded considerably, as has ASIC's regulated population. ASIC now has a wider regulatory remit than comparable market conduct regulators in overseas jurisdictions, such as the United Kingdom, the United States and Germany. The breadth of this regulatory remit increases the complexity of ASIC's operations and places demands on its leadership, internal communications and governance, and resourcing.[3]

So much may be accepted. But for present purposes, it is essential to consider *how* ASIC has dealt with reported misconduct by banks.

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2 *Australian Prudential Regulation Authority Act 1998* (Cth) s 8(2) (emphasis added).

3 Treasury, *FSRC Background Paper No. 24: Financial Services Royal Commission Submission on Key Policy Issues*, 13 July 2018, 23 [86].

2.2 ASIC's response to misconduct

When banks have disclosed, or ASIC has otherwise learned of, misconduct, ASIC has almost always sought to negotiate what will be done in response. Very often, remediation of customers has taken centre stage. Sometimes ASIC has used its banning powers to have one or more individual excluded from further participation in the industry. Rarely has ASIC gone to court to have the defaulting party penalised. The criminal prosecutions that have been brought have all been directed at individuals. Civil penalty proceedings have seldom been brought. **Enforceable undertakings** have been negotiated and agreed on terms that the entity admits no more than that ASIC has reasonably based 'concerns' about the entity's conduct. ASIC has issued infringement notices. But by paying the infringement notice the entity makes no admission. It is not taken to have engaged in the relevant contravention. Yet, ASIC and the Commonwealth are prevented from starting a civil or criminal proceeding in relation to the contravention that caused ASIC to issue to the infringement notice.[4]

ASIC has a range of regulatory tools available. These tools include enforcement; engagement with industry and stakeholders; surveillance; guidance; education and policy advice.[5]

ASIC assigns 70% of its regulatory resources to surveillance and enforcement.[6] Its 2016–2017 Annual Report states: 'Where we identify breaches of the law, we use our resources and power to ensure that there are meaningful consequences for the perpetrators.'[7] Elsewhere, ASIC has emphasised that 'Our credibility as an effective regulator, across all our areas of responsibility, depends in part on how well we use our enforcement powers.'[8]

In deciding whether to undertake enforcement action, ASIC has said that it considers: the seriousness of the alleged misconduct; its consequences for the market, investors and consumers; whether the misconduct is

4 *Australian Securities and Investments Commission Act 2001* (Cth) s 12GXD.

5 Exhibit 3.171, Witness statement of Timothy Mullaly, 30 May 2018, 2–3 [8].

6 ASIC, *Annual Report 2016–2017*, 5 October 2017, 4.

7 ASIC, *Annual Report 2016–2017*, 5 October 2017, 4.

8 ASIC, *Information Sheet 151: ASIC's Approach to Enforcement*, September 2013, 3.

widespread and whether pursuing enforcement will send a message to others; the time elapsed since the misconduct, and the evidence available.[9] ASIC's Enforcement Outcomes reports classify as enforcement outcomes criminal and civil court determinations, administrative remedies, guilty pleas, enforceable undertakings, any regulatory action taken to secure compliance about which a public announcement has been made, and Small Business Compliance and Deterrence Team outcomes that are not generally made public.[10]

Seventy per cent of all of ASIC's enforcement outcomes come from the Small Business Compliance and Deterrence Team, which focuses very heavily on the prosecution by in-house ASIC legal teams of strict liability offences, primarily in relation to the failure of directors to assist liquidators.[11]

When the Small Business Team outcomes are excluded, ASIC's enforcement results are very different. Between 1 July 2011 and 30 June 2016, 48% of all enforcement outcomes were administrative outcomes; 20% were enforceable undertakings and other negotiated outcomes; 18% were criminal outcomes; 12% were civil outcomes and 1% were public warning notices.[12] This trend is consistent with more recent statistics: between January and June 2018 ASIC's enforcement results, excluding small business, were 57% administrative; 21% enforceable undertakings and other negotiated outcomes; 4% criminal and 18% civil.[13]

Between 1 January 2008 and 30 May 2018, ASIC commenced 1,102 proceedings, an average of about 110 per year.[14] Of those, more than half (587) were administrative proceedings, which include disqualification or bans on individuals from the industry; revocation, suspension or variation of

9 Exhibit 3.171, Witness statement of Timothy Mullaly, 30 May 2018, 5–6 [15].

10 ASIC, *Report 536: ASIC Enforcement Outcomes: January to June 2017*, 22 August 2017, 21 [76]–[77].

11 Ian Ramsay and Miranda Webster (2017) 'ASIC Enforcement Outcomes: Trends and Analysis', (2017) 35(5) *Company and Securities Law Journal*, 289, 297–8.

12 Ian Ramsay and Miranda Webster (2017) 'ASIC Enforcement Outcomes: Trends and Analysis', (2017) 35(5) *Company and Securities Law Journal*, 289, 301.

13 ASIC, *Report 585: ASIC Enforcement Outcomes: January to June 2018*, August 2018, 24, Tables 5–7.

14 Exhibit 3.171, Witness statement of Timothy Mullaly, 30 May 2018, 9–10 [28].

a licence; and public warning notices.[15] That is, they were outcomes carried out in-house by ASIC and not through the courts, though they may be appealed to the Administrative Appeals Tribunal. In that time, ASIC commenced 238 criminal proceedings and 277 civil proceedings, and accepted 194 enforceable undertakings.[16] Of those proceedings, just 10 were against major banks.[17] Three of those proceedings arose out of the Storm Financial scandal and four of them related to Bank Bill Swap Rate manipulation.[18] In the last 10 years ASIC has issued 45 infringement notices to the major banks, and accepted 13 enforceable undertakings.[19] Enforceable undertakings are heavily negotiated.[20] As at April 2018, ASIC had never brought, or sought to have the Commonwealth Director of Public Prosecutions (CDPP) bring, proceedings against a licensee for failing to comply with the 10 day time limit for breach reporting under Section 912D of the *Corporations Act 2001* (Cth) (the Corporations Act),[21] despite affirming that it believed that entities frequently fail to comply with the Section.[22] At 30 May 2018, ASIC had never commenced, or sought to have CDPP commence, proceedings under Section 12DI of the *Australian Securities and Investments Commission Act 2001* (Cth) (the ASIC Act). This prohibits accepting payment for financial services when the payee does not intend to, or there are reasonable grounds to believe it cannot, supply the service.[23]

15 Exhibit 3.171, Witness statement of Timothy Mullaly, 30 May 2018, 9–10 [28], 7 [21].

16 Exhibit 3.171, Witness statement of Timothy Mullaly, 30 May 2018, 9–10 [28].

17 Defined as Commonwealth Bank of Australia, Westpac Banking Corporation, Australia and New Zealand Banking Group Limited, National Australia Bank Limited, Bank of Queensland Limited and Suncorp-Metway Limited or entities related to them. Exhibit 3.171, Witness statement of Timothy Mullaly, 30 May 2018, 10–11 [31].

18 Transcript, Timothy Mullaly, 1 June 2018, 3017–8.

19 Exhibit 3.171, Witness statement of Timothy Mullaly, 30 May 2018, 12–13 [33], 14 [36].

20 Transcript, Louise Macaulay, 27 April 2018, 1923.

21 Transcript, Louise Macaulay, 27 April 2018, 1907.

22 Exhibit 2.1, Witness statement of Peter Kell, 12 April 2018, 32 [125].

23 Exhibit 3.171, Witness statement of Timothy Mullaly, 30 May 2018, 10 [29]; ASIC Act s 12DI.

2.3 Infringement notices

Over the 10 years to 1 June 2018, ASIC's infringement notices to the major banks have amounted to less than $1.3 million.[24] By contrast, in one year (the year ending 30 June 2017) one bank, CBA, declared a profit about 7,000 times greater – $9.93 billion (net profit after tax on a statutory basis).[25] And the total amount that CBA had paid out in remediation of customers was many hundreds of millions of dollars.

ASIC issued infringement notices to the major banks as the outcome agreed with the bank.

In one case, ASIC issued infringement notices totalling $180,000 to CBA in relation to what ASIC believed were breaches of responsible lending obligations in the *National Consumer Credit Protection Act 2009* (Cth) (the NCCP Act) that prohibit a lender from entering into credit contracts that are unsuitable for the consumer. The breaches were the result of a programming error in the automated serviceability calculator that CBA used to assess applications for personal overdrafts. The breach continued for four years while the error went unnoticed, with the result that from 2011 to 2015 CBA failed to take into consideration customers' declared housing and living expenses when calculating their ability to service the loan. Approximately 11,000 customers required remediation. Yet CBA gave no Section 912D report to ASIC, only notifying it informally about two months after discovering the error.

In another case, ASIC issued infringement notices totalling $212,500 to ANZ, for what ASIC believed were breaches of the NCCP Act obligation to make reasonable inquiries about the credit limit a customer requires, after ANZ distributed letters to its customers offering pre-approved overdraft amounts. ANZ did not, and does not, accept that it breached the NCCP Act. ASIC asked ANZ to provide remediation to affected customers. ANZ did not take any steps to do so.

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[24] Transcript, Timothy Mullaly, 1 June 2018, 3024.

[25] CBA, 'Profit Announcement for the Full Year Ended 30 June 2017' (Announcement, 9 August 2017) 2.

In both cases, the ASIC media release about the infringement notices featured the disclaimer that 'The payment of an infringement notice is not an admission of guilt in respect of the alleged contravention'.[26]

It is difficult to identify any correspondence between the scale or severity of the conduct and the penalty imposed in either of these cases. With regard to a different penalty, of $40,800 paid by NAB, Mr Timothy Mullaly, the Senior Executive Leader of ASIC's financial services enforcement team, agreed that if ASIC had gone to court against NAB it would have sought a penalty markedly higher than the amount of the infringement notice.[27]

If penalties are intended to have a deterrent effect, as suggested by the words of the ASIC media release about ANZ – 'This case demonstrates that ASIC will impose penalties for breaching these important protections'[28] – then it must be plainly said that the amounts imposed in these cases do not.

2.4 Other regulatory responses

In the second round of hearings, the Commission heard evidence about ASIC's approach to misconduct among financial advisers.

At the time of those hearings, ASIC had not commenced civil penalty proceedings against an adviser in the previous five years.[29] ASIC had never instigated a civil penalty proceeding against a financial adviser for a breach of the best interests duty.[30] Since 2008 ASIC had banned 229 advisers, just under half of whom were banned permanently, in an industry that now has approximately 25,000 financial advisers.[31]

In the previous 10 years, ASIC had commenced six civil penalty proceedings against **Australian financial services licensees**, of which four

[26] ASIC Act s 12GXD.

[27] Transcript, Timothy Mullaly, 1 June 2018, 3019–20.

[28] ASIC, 'ANZ Pays $212,500 Penalty for Breaching Responsible Lending Laws When Offering Overdrafts' (Media Release, 16-063MR, 7 March 2016).

[29] Transcript, Louise Anne Macaulay, 27 April 2018, 1915.

[30] Transcript, Louise Anne Macaulay, 27 April 2018, 1915.

[31] Transcript, Louise Anne Macaulay, 27 April 2018, 1914; Exhibit 2.247, Witness statement, Louise Anne Macaulay, 25 April 2018, 5 [20].

were commenced in 2018.[32] It had undertaken one criminal action against a licensee, preferring to take criminal proceedings against individuals within an entity.[33] In that period, ASIC took action three times against a licensee for breach of the general obligations in Section 912A of the Corporations Act. In one case, it removed the licensee's licence. The two others resulted in suspensions of six and eight weeks respectively[34] and these were the only two cases in which ASIC suspended licences in connection with the provision of financial advice.[35] The other cases in which ASIC cancelled licences were what Ms Louise Macaulay, Senior Executive Leader of ASIC's financial advisers team described as 'binary' circumstances – easily proved failures on the part of the licensee to fulfil some statutory obligation, like lodging accounts.[36] By contrast, in the last 10 years ASIC has accepted 24 enforceable undertakings.[37]

Ms Macaulay noted that ASIC 'rarely if ever' uses its statutory power to disclose information about an adviser to a licensee and releases little information about the circumstances of individual banning orders due to what it sees as procedural fairness concerns.[38]

Yet ASIC has substantial concerns about the quality of financial advice provided in Australia. ASIC performed a review of sample customer files as part of the project that led to its *Report 562: Financial Advice: Vertically Integrated Institutions and Conflicts of Interests*. It observed that in 75% of the customer files reviewed, 'the adviser had not demonstrated compliance with the best interests duty in Section 961B of the Corporation[s] Act.'[39] For 10% of the files reviewed, ASIC had 'significant concerns about the potential

32 Exhibit 2.247, Witness statement of Louise Anne Macaulay, 25 April 2018, 14–15 [43].

33 Transcript, Louise Anne Macaulay, 27 April 2018, 1923–4.

34 Transcript, Louise Anne Macaulay, 27 April 2018, 1919–20, 1922.

35 Transcript, Louise Anne Macaulay, 27 April 2018, 1922.

36 Transcript, Louise Anne Macaulay, 27 April 2018, 1920–1.

37 Exhibit 2.247, Witness statement of Louise Anne Macaulay, 25 April 2018, 14–5 [43].

38 Exhibit 2.247, Witness statement of Louise Anne Macaulay, 25 April 2018, 13 [34]; Transcript, Louise Anne Macaulay, 27 April 2018, 1910.

39 ASIC, *Report 562: Financial Advice: Vertically Integrated Institutions and Conflicts of Interests*, January 2018, 36 [137].

impact of the advice on the customer's financial situation'.[40] ASIC noted that a common theme that it observed in non-compliant advice 'was the unnecessary replacement of **financial products**'.[41] The outcomes across the surveyed vertically-integrated institutions reflected that theme. For customers of the surveyed institutions 91% of customer funds invested in platforms were invested in an in-house product, 69% of funds invested in superannuation were invested in an in-house product and 65% of funds invested in insurance were invested in an in-house product.[42]

ASIC's detailed research produced a report that revealed matters of serious concern. It may be said that its enforcement activities did not reflect the gravity of what its work revealed.

2.5 Responding to misconduct: The proper starting point

When deciding what to do in response to misconduct, ASIC's starting point appears to have been: How can this be resolved by agreement?

This cannot be the starting point for a conduct regulator. **When contravening conduct comes to its attention, 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 to penalise the breach.** Laws are to be obeyed. Penalties are prescribed for failure to obey the law because society expects and requires obedience to the law.

These ideas are hardly novel. They inform the prosecuting policies of the CDPP and every state and territory prosecuting authority. Can a case be made? Is it in the public interest that proceedings *not* be commenced? If a case can be made, and there is no public interest reason for not prosecuting, charges are laid.

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40 ASIC, *Report 562: Financial Advice: Vertically Integrated Institutions and Conflicts of Interests*, January 2018, 37 [145].

41 ASIC, *Report 562: Financial Advice: Vertically Integrated Institutions and Conflicts of Interests*, January 2018, 36 [139].

42 ASIC, *Report 562: Financial Advice: Vertically Integrated Institutions and Conflicts of Interests*, January 2018, 30 [120], Figure 4.

Breaches of the offence and civil penalty provisions of the financial services laws are not to be dismissed as '*just* a breach of *those* laws' as if the laws governing the conduct of financial services entities are some less important form of law. The financial services laws regulate the conduct of central actors in the Australian economy. Their enforcement should be governed by the same principles that inform enforcement of the general law.

Contraventions of law are not to be treated as no more than bargaining chips to procure agreement to remediate customers. If a contravener wants to face a penalty hearing without offering effective compensation to those harmed by its conduct, the absence of compensation will be reflected in the penalty. It will go directly to whether the entity remains a fit and proper person to retain the licence that it has to operate in the industry. Of course ASIC can, and should, offer its views about remediation and the adequacy of any proposal for remediation. But if ASIC has a reasonable prospect of proving contravention, the starting point must be that the consequences of contravention should be determined by a court.

This is not to ignore the Commonwealth's obligation to act as a model litigant that is set out in Appendix B to the *Legal Services Directions 2017* (Legal Services Directions) and which applies to ASIC in the conduct of civil litigation, including the bringing of civil penalty proceedings. One aspect of the Model Litigant Policy is that agencies should endeavour to avoid, prevent and limit the scope of legal proceedings, including, where possible, by giving consideration to alternative dispute resolution before initiating proceedings. However, that is not to be understood as precluding the commencement of proceedings without first attempting to resolve the matter. For example, Note 4 to Appendix B recognises that the model litigant obligation does not prevent the Commonwealth, and Commonwealth agencies, from pursuing litigation in order to clarify a significant point (or, I would interpose, to obtain a civil penalty for a serious contravention) even if the other party wishes to settle the dispute.

Bringing proceedings does not preclude negotiation about how the proceedings may be resolved. Nor does bringing proceedings preclude discussion about how affected persons may be remediated. Often enough, the prospect of trial is a sharp spur to prompt and realistic discussion of whether and how issues about liability, final relief and compensation for those who have been affected by the conduct could be resolved.

There are statutory provisions on which ASIC can rely in civil penalty proceedings to seek compensation for persons affected.

First, for contraventions of the unconscionable conduct or consumer protection provisions in the ASIC Act that cause or are likely to cause loss to a class of consumers, ASIC can seek orders pursuant to Section 12GNB of the ASIC Act to redress loss or damage suffered by the consumers, or prevent or reduce loss likely to be suffered. Section 12GM of the ASIC Act gives a more general power to the Court to make orders for compensation for loss or damage arising from contraventions of the provisions of the ASIC Act about unconscionable conduct and consumer protection. The Court may make orders under Section 12GM on ASIC's application if ASIC has obtained the consumer's prior written consent.

Second, pursuant to Section 1324 of the Corporations Act or Section 177 of the NCCP Act, ASIC can apply for an injunction requiring an entity to take steps to identify consumers who have suffered loss or damage as a consequence of the entity's contravening conduct. And it may be that those powers could be invoked in support of the compensation arrangements that licensees are required to have in place. Section 912B of the Corporations Act requires financial services licensees to have arrangements, approved by ASIC, for compensating retail clients that suffer loss because of contraventions of Chapter 7 of the Corporations Act. Section 48 of the NCCP Act requires credit licensees to have adequate arrangements, approved by ASIC, for compensating persons who suffer loss because of contraventions of the NCCP Act.

Third, ASIC could apply for compensation orders on behalf of consumers pursuant to Section 1317HA and Section 1317J of the Corporations Act or pursuant to Section 178 or Section 179 of the NCCP Act (though not for breaches of the National Credit Code). Such orders require identification of the relevant consumers and the amount of the loss. But courts have ample powers to assist identification of the relevant consumers and the relevant amount of the loss and it is not to be supposed that a court would allow its processes to be frustrated by delay or intransigence on the part of an entity.

Because holders of financial services licences must report breaches of the requirement that the licensee do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly

and fairly,[43] there will often be cases where the licensee admits the facts that ASIC alleges constitute a breach of law. If misconduct is admitted, the only question should be whether there is some public interest in not taking enforcement proceedings.

In some cases, there may be real and lively debate between ASIC and an entity about the breadth and operation of the applicable provisions. But if there is, it may be all the more important to commence litigation than attempt to settle it. Only the courts can give binding interpretations of applicable law and, if there is doubt about the reach of particular provisions, it will often be better that the doubt is resolved once for all than allowed to linger. Resolution of the doubt will guide future conduct by all regulated entities.

The importance of seeking clarity about disputable provisions is amply demonstrated by ASIC's not seeking to litigate the operation of Section 912D of the Corporations Act. Continued uncertainty about the application of that provision, combined with ASIC's evident reluctance to seek to prosecute for breach of the section, has not encouraged entities to make timely breach reports. Too often this has meant that ASIC has been made aware of events long after they have occurred, at a time and in circumstances of the contravening entity's choosing. Entities appear to have treated the law as applying only when and if they chose to obey it.

When ASIC has sought to negotiate outcomes with entities, the negotiations have taken far too long. Too often, I suspect, ASIC has sought to accommodate the expressed wishes of the entity rather than determine what ASIC wants from the negotiation, tell the entity what it wants and insist upon it being provided promptly. Too often ASIC appears to have accepted an entity's request for time to take steps to remedy past misconduct or prevent future breach without examining, let alone examining closely, whether that time is needed. There have been too many cases where remediation programs have taken months, even years, to formulate and implement.

[43] Corporations Act ss 912A, 912D.

Too often, entities have been treated in ways that would allow them to think that they, not ASIC, not the Parliament, not the courts, will decide when and how the law will be obeyed or the consequences of breach remedied.

Attitudes of this kind have not been discouraged by ASIC's approach to the implementation of new provisions of financial services laws. Too often, ASIC has permitted entities confronted with new provisions, of which ample notice has been given (such as the unfair contract terms provisions), to take even longer to implement the provisions than the legislation provided.

2.6 Implementing new provisions

In the third round of hearings, the Commission heard from ASIC and Australian Competition and Consumer Commission (ACCC) about their approaches to the coming into effect of unfair contract terms (UCT) provisions for small business. The legislation to bring in the UCT legislation received royal assent in November 2015 and was due to come into effect on 12 November 2016. ASIC and ACCC were asked by Treasury to assist businesses to comply with the new legislation. Businesses would have to change the terms of the standard form contracts they used with small business.

The banks told ASIC that they intended to use the full 12 month transition period to update their small business contracts. On that basis, ASIC decided to wait until the new contracts were available to check their terms for compliance.[44] In February 2016, ASIC published an information sheet for small business providing guidance on the new provisions. In March 2016, ASIC participated in a joint webinar with ACCC directed to helping small business understand the new protections in the law.[45] Between March and August 2016, ASIC's work in relation to the UCT provisions consisted of what Mr Michael Saadat, Senior Executive Leader of ASIC's deposit takers, credit and insurers team described as presentations to and discussions with industry.[46]

In the meantime, ACCC had identified five high risk industries (later extended to seven) with common UCT terms and examined the contracts of

[44] Transcript, Michael Saadat, 1 June 2018, 2975.

[45] Transcript, Michael Saadat, 1 June 2018, 2978.

[46] Transcript, Michael Saadat, 1 June 2018, 2979–80.

a number of key companies within those industries. Where a term was identified that potentially breached the provisions, ACCC asked the company to amend the term and, if it would not, to explain why. Where that did not satisfy ACCC's concerns, the company was warned of potential court action after 12 November 2016. ACCC was also planning to produce an industry report on the state of contracts in the five industries before 12 November 2016.[47]

Mr Saadat agreed that, by August 2016, ACCC had 'done more' than ASIC in securing compliance with UCT provisions.[48] He suggested that a reason why ASIC took the approach that it did was that the institutions ASIC regulates 'were all very much aware about these new protections' because they were 'actively involved in the development and passage of this legislation, including lobbying against the legislation applying to them'.[49] That is, it would appear ASIC was sufficiently reassured of the banks' coming compliance with the legislation that it chose not to ask any of the banks about their particular small business contracts until 7 September 2016, a little more than two months before the law was to commence operation.[50]

In those letters of early September 2016, ASIC asked for copies of the banks' amended small business contracts. On reviewing those contracts, 'ASIC became concerned that some banks had taken a minimalist approach … by making only a few changes that were deemed absolutely necessary or by adding the word "reasonable" to qualify the exercise by the [bank] of its many broad powers and discretions in the terms.'[51] Mr Saadat said that the banks' approach did not surprise ASIC.[52]

But the result was that, when the UCT provisions came into effect on 12 November 2016, ASIC was of the view that a number of the banks' standard form contracts did not comply with the law in that they contained unfair

47 Exhibit 3.162, Witness statement of Michael Saadat, 24 May 2018, Exhibit MS-9 [ASIC.0900.0005.0002 at .0003].

48 Transcript, Michael Saadat, 1 June 2018, 2981.

49 Transcript, Michael Saadat, 1 June 2018, 2983.

50 Transcript, Michael Saadat, 1 June 2018, 2984–6.

51 Exhibit 3.162, Witness statement of Michael Saadat, 24 May 2018, 21 [41].

52 Transcript, Michael Saadat, 1 June 2018, 2987.

terms.[53] Even so, Mr Saadat said that ASIC would not express its belief that a term was unfair or in breach of the law unless a court had made such a finding. Instead, ASIC preferred to frame its comment in terms of 'potential' unfairness.[54] Moreover, ASIC would only express to a bank its belief that a term was 'potentially' unfair where ASIC had decided it was prepared to take the matter to court if the bank did not accept ASIC's position. And because ASIC was not yet prepared to commence proceedings against the banks who had 'taken a minimalist approach', in ASIC's internal view making those banks non-compliant with the law, ASIC was not prepared even to state directly that it believed terms in those contracts were unfair.[55]

Instead, ASIC's approach would be 'consultative', that is, ASIC would 'assist non-compliant businesses to comply with their obligations in the first few months of the new regime'. If a business was uncooperative, enforcement action would be 'considered'. [56]

ACCC also defined its approach at this time as 'consultative'. But in the case of ACCC, 'consultative' meant 'working with businesses to ensure they are ready to comply from 12 November.' ACCC made plain that, after the law came into operation, it would take enforcement action where it saw breaches of the UCT provisions.[57] In October 2017, ACCC commenced action against a company for breaches of the provisions.[58]

In March 2017, (several months after the law had come into operation), a further ASIC review of small business loan contracts from eight lenders concluded that there had been a failure to comply with the new legal regime. On 16 May 2017, ASIC published a joint media release with the Small Business Ombudsman, stating that 'lenders, including the big four banks, needed to lift their game in meeting the unfair terms legislation.'[59] Mr Saadat agreed that at this point ASIC was in a position in which the Ombudsman

53 Transcript, Michael Saadat, 1 June 2018, 2987.

54 Transcript, Michael Saadat, 1 June 2018, 2988.

55 Transcript, Michael Saadat, 1 June 2018, 2988.

56 Transcript, Michael Saadat, 1 June 2018, 2989.

57 Transcript, Michael Saadat, 1 June 2018, 2989.

58 *Australian Competition and Consumer Commission v JJ Richards & Sons Pty Ltd* [2017] FCA 1224

59 Exhibit 3.169, 16 May 2017, Media Release of ASIC and ASBFEO, 2.

was pushing it regarding the UCT provisions.[60] But over the next 10 months ASIC negotiated with the banks, and in March 2018 published a report detailing the changes the big banks had agreed to make to their small business contracts.[61]

Asked to reflect on the regulator's approach to the UCT reforms, the major banks between them could not find a word of criticism for ASIC. Both Westpac and ANZ called ASIC's approach 'appropriate'[62] and 'effective'[63] and emphasised that negotiation with industry could achieve a result faster than compulsory enforcement action,[64] presumably on the basis they would have fought such action. CBA submitted that ASIC's approach was 'constructive', and enabled 'understanding from ASIC's perspective' of the 'genuine interests of the bank.'[65] It continued that:

> ASIC's approach has prioritised persuasion and engagement with its regulated community rather than reliance on other methods of enforcement. This has been effective, albeit potentially involves longer consultation than a mandated, regulated outcome.[66]

60 Transcript, Michael Saadat, 1 June 2018, 3001.

61 ASIC, *Report 565: Unfair Contract Terms and Small Business Loans*, 15 March 2018.

62 Westpac, *Westpac Banking Corporation General Submissions on Business Lending,* 12 June 2018, 21 [78]; ANZ, *Submissions by ANZ in Respect of General Questions – Round 3 Hearing,* 12 June 2018, 13 [69].

63 Westpac, *Westpac Banking Corporation General Submissions on Business Lending,* 12 June 2018, 21 [79]; ANZ, *Submissions by ANZ in Respect of General Questions – Round 3 Hearing,* 12 June 2018, 13 [69].

64 Westpac, *Westpac Banking Corporation General Submissions on Business Lending*, 12 June 2018, 21 [79]; ANZ, *Submissions by ANZ in Respect of General Questions – Round 3 Hearing*, 12 June 2018, 13 [69].

65 CBA, *Commonwealth Bank of Australia and Its Associated Australian Entities (Group) Round 3 Hearing – Loans to Small and Medium Enterprises, Closing Submissions PART B – Questions Arising from the Case Studies,* undated, 15 [70].

66 CBA, *Commonwealth Bank of Australia and Its Associated Australian Entities (Group) Round 3 Hearing – Loans to Small and Medium Enterprises, Closing Submissions PART B – Questions Arising from the Case Studies,* undated 15 [65].

ANZ emphasised the testimony of Mr Saadat in explaining the advantages of ASIC's approach over the commencement of proceedings against it.[67]

A regulator should look carefully at such positive reviews. They point to the regulated community having its way about when and how the law will be enforced. In this particular case it is necessary to bear at the very forefront of consideration the inescapable fact that the regulator did not cause the regulated community to begin to obey the law by the date set by Parliament. Obedience came later than the law required. That is unsatisfactory. That the regulated community found the result convenient and free from discomfort is simply beside the point.

2.7 Limited powers

ASIC's powers are limited. All regulatory and enforcement powers are limited. But ASIC has had greater enforcement powers than it has used.

ASIC pointed to gaps in its powers. The ASIC Enforcement Review Taskforce has recommended that ASIC's powers be expanded and some penalties increased. Final adoption of those recommendations has been said to depend upon the recommendations made by this Commission. At this point, it is enough to say that there appears to be good reason to make the several changes recommended but that the effect of making those changes depends entirely upon the way in which the provisions are implemented. In particular, increased penalties for misconduct will have only limited deterrent (or punitive) effect unless there is greater willingness to seek their application.

2.8 Litigation and regulation

More than once, ASIC witnesses referred to the cost of litigation, the time it takes and the inevitable uncertainties associated with it.

When it does go to court, ASIC's success rate for litigation has averaged above 90% since 2011–2012. In 2015–2016 it reached 96%.[68] That seeming accomplishment has concerning implications, for it suggests that

[67] ANZ, *Submissions by ANZ in Respect of General Questions – Round 3 Hearing*, 12 June 2018, 13 [69]; see also, eg, Transcript, Michael Saadat, 1 June 2018, 3003.

[68] Treasury, *FSRC Background Paper No. 24: Financial Services Royal Commission Submission on Key Policy Issues*, 28 [102] n 71.

ASIC has a preference for easily won cases – the 'binary' cases mentioned by Ms Macaulay – and does not do enough to resolve grey areas in the application of the law.

Financial services entities include some very large entities. Complex litigation against large entities is necessary. Regulation of banks must reflect their size, influence and market restraints. ASIC itself recognises that the behaviour of major banks shapes market conduct more widely. Mr Saadat, for example, explained ASIC's approach to the UCT provisions as directing its negotiations to the big four banks so as to leverage across the other financial institutions in the market.[69] If persuading major banks to change their ways by way of protracted negotiation will inspire smaller entities to follow suit, there is every reason to think that imposing civil penalties or other litigated consequences upon them would have the same effect on smaller entities.

Yet the ASIC Capability Review found, in 2015, that ASIC's litigation strategy is risk averse and that ASIC does not pursue strategically important litigation.[70] Only 41% of external stakeholders agreed that 'ASIC deters individuals or organisations from engaging in misconduct'. Only 23% of external stakeholders, and 37% of ASIC senior executive leaders and Commissioners, thought that 'ASIC acts quickly to investigate potential breaches of the law'.[71]

ASIC explained its approach to enforcement by reference to its limited resources. Of course ASIC, like any regulator, must make choices and assign priorities on the basis of resources. I need no persuasion that litigation is expensive. The expense is not just of financial outgoings but of the time and effort expended by staff. Their number is limited. As was the tenor of ASIC's evidence, resources spent on litigation represent an opportunity cost to it in respect of other forms of enforcement.[72] But I do not accept that the appropriate response to the problem of allocating scarce

69 Transcript, Michael Saadat, 1 June 2018, 2993, 3004.

70 ASIC, *Fit for the Future: A Capability Review of the Australian Securities and Investments Commission*, 4 December 2015, 120.

71 ASIC, *Fit for the Future: A Capability Review of the Australian Securities and Investments Commission*, 4 December 2015, 8; quoted in Treasury, *FSRC Background Paper No. 24: Financial Services Royal Commission Submission on Key Policy Issues*, 28 [103].

72 eg. Transcript, Louise Anne Macaulay, 27 April 2018, 1915.

resources is for a regulator to avoid compulsory enforcement action and instead attempt to settle all delinquencies by agreement.

Negotiation and persuasion are important and universal regulatory tools. The Commonwealth Government has issued a guide to regulators' administration of the Australian Consumer Law that features an escalating enforcement pyramid[73] based on the Braithwaite enforcement pyramid. The Braithwaite pyramid is often referred to in regulatory literature and founds the model of 'responsive regulation'. Regulatory response escalates from the tools at the base of the pyramid to the tools at the apex. The strength of response increases at each step. Central to the model is the regulator's willingness to escalate its response in order to secure compliance.[74] In the **Australian Credit Licence** enforcement pyramid, the base options are education, advice and persuasion; industry self-regulation; and formal written warnings. The next step is infringement notices; then enforceable undertakings, public warning notices and adverse publicity orders; then civil action; and finally criminal action.[75]

The United States Consumer Financial Protection Bureau expresses the same ideas, in simpler terms, by describing its work as being to: 'Empower', 'Enforce' and 'Educate'.[76]

Enforcement generates the moral suasion that underpins regulatory authority. A regulator 'speaking softly' will rarely be effective unless the regulator also carries a big stick. The academic literature has warned of the:

> dangers in adopting a pure 'advise and persuade' or compliance oriented strategy of enforcement, which can easily degenerate into intolerable laxity and fail to deter those who have no interest in complying voluntarily. More broadly, there is considerable evidence that cooperative approaches

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73 Commonwealth of Australia, *Compliance and Enforcement: How Regulators Enforce the Australian Consumer Law*, 2010, 11.

74 Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press, 1992) 38.

75 Commonwealth of Australia, *Compliance and Enforcement: How Regulators Enforce the Australian Consumer Law*, 2010, 11.

76 Consumer Financial Protection Bureau, *The Bureau* (undated) <www.consumerfinance.gov/about-us/the-bureau/>.

> may actually discourage improved regulatory performance amongst better actors if agencies permit lawbreakers to go unpunished.[77]

Persuasion of the major players has not had the effect of changing behaviour across the industry. Though that was ASIC's stated strategy with regard to the UCT provisions and ASIC submitted that a litigated outcome may have been confined to its facts and not had 'broader applicability'.[78] Once the negotiations with the big four were over, ASIC was left with 'a concern more broadly that other institutions may not have made the changes that are necessary', among them the fact that Suncorp had not even ascertained whether its contracts were compliant with the provisions.[79]

The effect of negotiated outcomes that do not require approval by a court is that, at least to some degree, sanctions for breaches (or what ASIC considers to be breaches) are always within the control of the regulated entity. The consequence is that conduct that breaches the law, or is likely to breach the law, may be treated as involving calculated risks, taken in pursuit of some desired end (usually profit), with consequences that are seen as being manageable. Breach and the consequences of breach come to be treated as just a cost of doing business.

By contrast, litigated outcomes are compulsory. They produce outcomes that can only be produced by the judgments of the courts. Prime among them are general and specific deterrence. Specific deterrence involves imposing on offenders a penalty that will persuade them that it is not in their interests to reoffend. And, at the same time, penalties must be set at a level that deters other members of the regulated community from engaging in conduct of the same kind. A court judgment provides public denunciation of the conduct as wrong and meriting punishment. Both the determination of contravention and the proper setting of penalty provide a measure of general deterrence of the regulated community.

Of course, if a regulator commences a court proceeding against an entity, it is possible for the regulator and the entity to 'settle' the proceeding in the sense that they can agree that the entity will admit certain contraventions

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77 Neil Gunningham, 'Compliance, Deterrence and Beyond' in *Compliance and Enforcement of Environmental Law* (Edward Elgar Publishers, LeRoy Paddock ed, 2017) 63, 66.

78 Transcript, Michael Saadat, 1 June 2018, 3003.

79 Transcript, Michael Saadat, 1 June 2018, 3004.

(and the regulator may not press other alleged contraventions). They may also agree on what they consider to be the appropriate pecuniary penalty (taking into account co-operation and early admissions) and other relief for those admitted contraventions. That is a conventional course adopted by other regulators. But such a course still requires the approval of the court. It still requires a court to be satisfied that the agreed penalty is appropriate.[80] The court still delivers a judgment and by that judgment the court denounces the contravening conduct.

Public denunciation of unlawful conduct enforces and affirms the applicable norms of behaviour. It both expresses and forms community standards and expectations. ASIC's witness Ms Macaulay agreed, however, that public denunciation plays no part in ASIC's current enforcement approach.[81]

Judicially determined consequences have other obvious advantages. They set a binding precedent. They depend upon a judicial determination of the proper construction and application of relevant legislation. It should bring the understanding of the applicable law better into line with the principles of the general law than can readily be achieved by one agency interpreting and applying what it sees as 'its own' legislation.

There is also value in the public and conclusive demonstration that legislation is not achieving its stipulated aims. ASIC has taken the view, at least until very recently, that Section 912D of the Corporations Act is too difficult to enforce through litigation. While ASIC has informed government of its view, there is no more powerful way of making the point that the law is not working as it was intended to work than litigating its application. This would of course be a drain on ASIC's resources in the first instance. But if ASIC's legal advice is correct the resulting, binding, judicial determination would be a powerful persuasive tool when seeking to obtain a workable legislative alternative. (In that regard, reference may usefully be made to the ACCC's losses in a series of proceedings in 2015 under the misuse of market power provisions of the *Competition and Consumer Act 2010* (Cth). Those losses added to pressure for reform of the relevant legislative test, eventually yielding legislative amendment in 2017.)

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[80] *Commonwealth of Australia v Director, Fair Work Building Industry Inspectorate* (2015) 258 CLR 482 at 504 per French CJ, Kiefel, Bell, Nettle and Gordon JJ.

[81] Transcript, Louise Anne Macaulay, 27 April 2018, 1910.

3 The future: Regulation

3.1 Change the law?

As noted elsewhere in this report, I begin from the premise that breaches of existing law are not prevented by passing some new law that says 'Do not do that'. And given the existing breadth and complexity of the regulation of the financial services industry, adding any new layer of law or regulation will add a new layer of compliance cost and complexity. That should not be done unless there is a clearly identified advantage. It should be considered recognising that there is every chance that adding a new layer of law and regulation would serve only to distract attention from the very simple ideas that must inform the conduct of financial services entities:

- **Obey the law.**
- **Do not mislead or deceive.**
- **Be fair.**
- **Provide services that are fit for purpose.**
- **Deliver services with reasonable care and skill.**
- **When acting for another, act in the best interests of that other.**

These ideas are very simple. Their simplicity points firmly towards a need to simplify the existing law rather than add some new layer of regulation. But the more complicated the law, the easier it is to lose sight of them. The more complicated the law, the easier it is for compliance to be seen as asking 'Can I do this?' and answering that question by ticking boxes instead of asking 'Should I do this? What is the *right* thing to do?' And there is every reason to think that the conduct examined in this report has occurred when the only question asked is: 'Can I?'.

The existing law has rightly been described, in at least some respects, as labyrinthine and overly detailed. In the blizzard of provisions, it is too easy to lose sight of those simple ideas that must inform the conduct of financial services entities.

It follows that **the regulatory framework does not always assist the regulator to impose discipline on entities. Regulatory complexity increases pressure on the regulator's resources and may allow entities to develop cultures and practices that are unfavourable to compliance**.

Regulatory complexity affects the conduct of banks and other financial services entities. In particular, it affects how legal requirements are interpreted by and for front line staff. Mr David Cohen, Chief Risk Officer of CBA, observed that the accretion of new legal requirements:

> has been an additive process and layer upon layer upon layer is introduced, is absorbed. Rules and policies are set around that new layer. And it is sometimes difficult to distil the very essence of the fundamental obligations out of all of that set of policies, procedures, processes, etc.[82]

In particular, as noted above, regulatory complexity may foster the development of a 'box-ticking' approach to compliance, in which entities develop and focus on internal procedures intended to fulfil various complicated legal obligations, not only at the expense of considering the circumstances in each matter on their merits but also at the expense of measuring what is proposed against those simple ideas that must inform the conduct of all entities in the financial services industry.

3.2 The place of the Banking Code of Practice

Significant instances of conduct identified and criticised in this report are criticised because the relevant bank did not comply with the banking industry code of practice as it stood at the relevant time. The most notable of these instances concerned lending to small and medium enterprises (SMEs) and lending to agricultural enterprises. Their occurrence requires consideration of what place the Banking Code of Practice (the Code) should have in moulding general practice in the industry and particular dealings with individual customers.

Until the most recent code, the content of all codes of banking practice has been determined only by the industry. And in years past, the codes did not bind all banks. Although approved by ASIC, it is necessary to recognise that the content of the 2019 Code was also determined by those who are to be

[82] Transcript, David Antony Keith Cohen, 30 May 2018, 2822.

bound by its provisions: the banks themselves. It is they who decided how the definition of small business should be framed. It is the banks, therefore, who determined what reach the Code will have.

Contravention of a provision of the current Code or of a provision of the 2019 Code may be a breach of contract but otherwise it is not, and will not be, a contravention of law. The Code stands as a set of promises made by the banks enforceable only at the behest of an aggrieved customer. Yet, the Code has particular significance for SMEs and some agricultural enterprises.

The Code is not subject to Part IVB of the *Competition and Consumer Act 2010* (Cth) (Sections 51ACA–51AEA). The Code therefore stands in sharp contrast with generally similar industry codes of practice that are dealt with under that Part. Codes dealt with by Part IVB of the Competition and Consumer Act are called 'applicable industry codes'. Section 51ACB of the Competition and Consumer Act provides that '[a] corporation must not, in trade or commerce, contravene an applicable industry code'.[83] And a contravention of an applicable industry code engages all the remedial provisions of Part VI of the Competition and Consumer Act. Further, if the relevant provision of an applicable industry code is a civil penalty provision, the regulator, ACCC, may bring civil penalty proceedings under Section 76. None of this applies to the current banking code and none of this will apply to the 2019 Code.

As has been noted in connection with both lending to SMEs and lending to agricultural enterprises, the banking codes state norms of conduct that are very important to borrowers, especially SMEs and agricultural enterprises. The norms that are stated in the Code provide important protections to those borrowers.

The enforcement of these norms should not be left to borrowers. To leave enforcement to borrowers means, too often, that failure to comply with relevant norms of behaviour by a bank is unrecognised or, if recognised, is not remedied. The default will seldom emerge before the borrower is in

[83] An 'applicable industry code' is defined by s 51ACA as 'the prescribed provisions of any mandatory industry code and the prescribed provisions of any voluntary industry code that binds the corporation'.

difficulty. Too often, then, the borrower will not have the means, or the will, to take on the battle.

But if provisions of the kind provided by the Competition and Consumer Act are applied to the Code, the regulator may enforce its provisions. And if there were evidence of systemic failure, the regulator should.

Making the promises made in the Code enforceable, as contraventions of the law, may provide better protection for SMEs and agricultural enterprises.

The immediate response to proposals of this kind may be to warn of effects on the availability or cost of credit. (As explained in Chapter 4, much was made of these matters in connection with the definition of small business in the 2019 Code.) If warnings of that kind are sounded, they should be examined with care. The banks have agreed to apply the norms that are stated in the Code. It is to be presumed that they now seek to apply them. That being so, it is far from obvious why making their contravention a breach of law (as well as a breach of contract) should impose any additional cost or burden on the banks. In particular, it is anything but obvious why applying provisions of the kind now found in Part IVB of the Competition and Consumer Act to the 2019 Code should affect the availability or price of credit.

No matter whether the banking or other financial services industry codes should be given legislative recognition and application similar to the provisions of Part IVB of the Competition and Consumer Act, application for approval of a code by ASIC must be taken to entail that ASIC will determine for itself whether the terms proposed are complete and satisfactory. The fact that the industry has settled upon a draft of the Code cannot be treated as determinative.

If contravention of codes becomes a contravention of law, it will be even more important that the regulator makes its own decisions about how the relevant provisions of the Code should be framed. Those decisions extend beyond debates about the framing of particular provisions. They call for careful consideration of whether the Code should deal with additional issues. The course of evidence in this Commission may well be thought to suggest that there are matters not now dealt with in the 2019 Code that should be considered. Without seeking to limit the field of debate, reference may be made to some of the issues that arose in connection with the

enforcement of loans to agricultural enterprises and in connection with access to banking services by Aboriginal and Torres Strait Islander peoples.

4 The future: The regulators

4.1 ASIC

As the Commission's work has continued, there are signs that ASIC may be seeking to alter its approach to enforcement. Even so, I remain to be persuaded that it can and will make the necessary changes.

There are several reasons for caution. First, there is the size of ASIC's remit. Second, there seems to be a deeply entrenched culture of negotiating outcomes rather than insisting upon public denunciation of and punishment for wrongdoing. Third, remediation of consumers is vitally important but it is not the *only* relevant consideration. Fourth, there seems no recognition of the fact that the amount outlaid to remedy a default may be much less than the advantage an entity has gained from the default. Fifth, there appears to be no effective mechanism for keeping ASIC's enforcement policies and practices congruent with the needs of the economy more generally.

Something more should be said about each of these points.

4.1.1 Size of remit

Is ASIC's remit *too* big? If it were to be reduced, who would take over those parts of the remit that are detached from ASIC? Why would detachment be better?

The ASIC Capability Review observed that ASIC's mandate has increased over time. ASIC now administers 11 pieces of legislation and their associated regulations.[84] The legislation itself has grown longer and more complex. The length of the Corporations Act, for example, has increased by 178% since 1981.[85] The Commission's preparation of Background Papers for the hearings found that an introductory overview of the law governing

[84] ASIC, *Fit for the Future: A Capability Review of the Australian Securities and Investments Commission*, 4 December 2015, 133.

[85] ASIC, *Fit for the Future: A Capability Review of the Australian Securities and Investments Commission*, 4 December 2015, 134.

consumer credit in Australia required 86 pages of explanation; financial advice and sale of financial products required 114; and small business lending, which did not repeat matters overlapping with consumer lending, required 41 pages.

ASIC is called upon to provide the additional guidance required by these expanding regulatory regimes. It has done this by more than 450 regulatory guides and information sheets published on its website.[86] That work, and the undoubted corollary of informal discussion and liaison with industry, deflects resources from ASIC's enforcement work. The regulatory guidance issued by ASIC is generally first class. But it is important that emphasis is not placed on guidance at the expense of enforcement. Hence, if guidance is given, it is important to discover whether the guidance is being applied and, if it is not, to do what is necessary to have it applied. When guidance is given about the operation of the law (as it is in the many regulatory guides ASIC has published) the law, as interpreted by ASIC, should be monitored and enforced. When guidance is given about desirable business practices (as it was, for example, in connection with funeral insurance) consideration must be given to whether those practices are then adopted and, if they are not, whether some enforcement action can and should be taken or some regulatory change promoted.

That is particularly so with respect to the largest entities. Although regulatory complexity imposes burdens on business, the largest entities are very sophisticated and well-resourced. They are well able to find out what the law requires of them. It may be that there are respects in which compliance imposes unjustified costs for business. That is a question periodically examined by government and one that the banks are quite able to agitate for themselves.

4.1.2 Negotiated outcomes

Of course there will be cases where a negotiated outcome to some contravention of law, outside any proceedings in court, will serve the public interests best. But whether or not proceedings are on foot or anticipated, there can be no satisfactory negotiated outcome if ASIC has not *first*

[86] ASIC, *Fit for the Future: A Capability Review of the Australian Securities and Investments Commission*, 4 December 2015, 134.

decided what it *wants* from the negotiation (as distinct from what it thinks the entity is prepared to give).

4.1.3 Remediation

Remediation programs can be long and difficult. But paying attention to how the entity will remedy those hurt by its conduct must never be allowed to detract from the fact of contravention. What is to be done about the contravention? The regulator is not called on to choose between remediation and enforcement. Often, enforcement will induce an entity to set about remedying the consequences of its default, or committing to doing so, before the penalty is fixed.

4.1.4 Remedy less than profit

Financial services entities will often have profited from their contraventions of the law. Often the profit earned will be larger than the damage to consumers. Nothing in the evidence before the Commission shows that ASIC takes this into account when negotiating outcomes with entities. So-called community benefit payments associated with enforceable undertakings appear, at least on their face, to be less than the penalty that ASIC might properly have sought in civil penalty proceedings and unrelated to the profit derived by the entity from the contravening conduct. The regulator *must* do whatever can be done to ensure that breach of the law is not profitable.

4.1.5 Congruence between policies and the needs of the economy

Legislation allowing punishment (criminal or civil) of conduct proceeds from the premise that engaging in the conduct is harmful to society. In financial services legislation, the premise is more likely to be that the conduct will be harmful to the economy generally. Hence, the ways in which ASIC (or APRA) enforce these laws will affect the overall health of the economy. Is the manner of enforcement of these laws a matter that is to be supervised by or on behalf of the political branches of government – either by the Parliament generally or by a particular minister?

In its Final Report, the Murray Inquiry did not recommend major changes to the overall regulatory system but did recommend action in five areas 'to improve the current arrangements and ensure regulatory settings remain fit

for purpose in the years ahead'.[87] One of those areas was to improve 'the regulator accountability framework' by, among other things, establishing a new Financial Regulator Assessment Board 'to undertake annual ex post reviews of overall regulator performance against their mandates'.[88] Is it time to revisit these ideas? Is there a case for a supervisory body of this kind? That is, is there a case for external review by an inspectorate or a statutory officer reporting directly to the Parliament about how regulatory powers have been exercised in some preceding period?

These may not be small changes. They are changes that would have to be examined in the light of what, if any, other changes in law were to be made.

4.2 APRA

APRA's chief focus is governance and risk culture. Proper governance and risk culture are critical to the prudent conduct of banking business; they are subjects falling within the 'prudential matters' about which APRA can issue, and has issued, Prudential Standards under the *Banking Act 1959* (Cth).[89]

The *Australian Prudential Regulation Authority Act 1998* (Cth) provides that 'In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia'. That is, 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 widespread occurrence of the conduct described in this report may, perhaps, be more readily understood. Even so, by August 2017, there had been so many 'incidents in CBA's recent history that [had] damaged its reputation and public standing' that APRA decided to establish a Prudential

[87] Exhibit 2.1, Witness statement of Peter Kell, 12 April 2018, Exhibit PK-22 [ASIC.0902.0001.0581 at .0845].

[88] Exhibit 2.1, Witness statement of Peter Kell, 12 April 2018, Exhibit PK-22 [ASIC.0902.0001.0581 at .0845].

[89] See, eg, APRA, *Prudential Standard CPS 510 Governance*, July 2017; APRA, *Prudential Standard CPS 220 Risk Management*, July 2017.

Inquiry into governance, culture and accountability within the CBA group.[90] Until that time, 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.

As a consequence of the CBA review, CBA offered, and APRA accepted, an enforceable undertaking to 'submit a remedial action plan' that would include 'a clear and measurable set of responses in respect of each recommendation made in the Final Report' of the review.

For the purposes of this report, the central question posed by the chain of events that has been described is whether other financial services entities have the same or similar deficiencies of governance and risk culture the panel identified in relation to CBA. As this report records, other entities have engaged in conduct of the kinds that led APRA to conduct its inquiry into CBA. The conduct suggests that there has been insufficient attention given within those entities to regulatory and compliance risk. It suggests want of attention by those entities to reputational risk. Some of the conduct suggests want of proper governance in the entity.

What steps can APRA take with respect to other entities? What steps (if any) should it take?

These questions and the several questions raised in connection with ASIC's responses to the conduct that has been identified and criticised in this report must be considered in light of the issues raised in the next chapter of this report. But it is convenient to draw together the questions that have been identified in this chapter.

[90] APRA, *Prudential Inquiry into the Commonwealth Bank of Australia*, April 2018, 6 [1.1].

5 Issues that have emerged

5.1 The present regulatory regime

- Is the law governing financial services entities and their conduct too complicated?
  - Does it impede effective conduct risk management?
  - Does it impede effective regulatory enforcement?

5.2 Accountability of the regulators

- Should there be annual reviews of the regulators' performance against their mandates?

5.2.1 ASIC

- Is ASIC's remit too large?
  - If it were to be reduced, who would take over those parts of the remit that are detached?
  - Why would detachment be better?
- Is the regulatory regime too complex? Should there be radical simplification of the regulatory regime?
- Should industry codes relating to the provision of financial services, such as the 2019 Banking Code of Practice, be recognised and applied by legislation like Part IVB of the *Competition and Consumer Act 2010* (Cth)?
- Are ASIC's enforcement practices satisfactory? If not, how should they be changed?
- If the recommendations of the 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 it is in the public interest not to do so?

5.2.2 APRA

- Are APRA's regulatory practices satisfactory? If not, how should they be changed?
- Are APRA's enforcement practices satisfactory? If not, how should they be changed?
- Does the conduct identified and criticised in this 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?

9. Entities: Causes of misconduct

1 Culture, governance and remuneration

The Terms of Reference require me to inquire into whether my findings about misconduct and conduct falling short of community standards and expectations:

> (a) are attributable to the particular culture and governance practices of a financial services entity or broader cultural or governance practices in the relevant industry or relevant subsector; or
>
> (b) result from other practices, including risk management, recruitment and remuneration practices, of a financial services entity, or in the relevant industry or relevant subsector.

One simple, but telling, observation informs those inquiries. **All the conduct identified and criticised in this report was conduct that provided a financial benefit to the individuals and entities concerned.** If there are exceptions, they are immaterial. For individuals, the conduct resulted in being paid more. For entities, the conduct resulted in greater profit.

The governance and risk management practices of the entities did not prevent the conduct occurring.

The culture and conduct of the banks was driven by, and was reflected in, their remuneration practices and policies.

The conduct that is at the heart of the Commission's work is inextricably connected with remuneration practices, with deficiencies in governance and risk management and with the culture of the entities concerned.

Remuneration policies were tailored to different parts of the staff or work of each of the major banks but substantially they were the same for almost every employee at almost every level of the organisation. At least until very recently, the central tenet of the remuneration policies of not only the four

largest banks but other banks as well (apart from the mutuals) has been to reward what the organisation treats as important: sales and profit. If there were exceptions to this approach, they were immaterial.

The conduct identified and criticised in this report was driven by the pursuit of profit – the entity's revenue and profit and the individual actor's profit. Employees of banks learned to treat sales, or revenue and profit, as the measure of their success.

The banks say that they have changed or are changing their remuneration policies and it will be necessary to look carefully at those claims. But almost every piece of conduct identified and criticised in this report can be connected directly to the relevant actor gaining some monetary benefit from engaging in the conduct. And 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.

2 Management by measurement

Banks have sought to manage their staff by measurement. From the most senior executives to the most junior employee, remuneration has been measured in two parts: a base salary and a short term incentive payment or bonus. Often enough a large part of the short term incentive payment has been payable if the employee has performed satisfactorily. That is, a bonus has been paid for an employee doing what the employee is employed to do. The premise must be that the immediate supervisor either cannot, or will not, adequately manage and supervise those employees.

An employee will treat as important what the employee believes that the employer generally, or the employee's supervisors and peers, treat as important. When the employee and others in the organisation, including the employee's supervisors and peers, are remunerated according to how much product they sell, or how much revenue or profit they contribute to the entity, sales or revenue and profit are treated as the goal to pursue. *How* the goal is pursued is treated as a matter of lesser importance. If the short term incentive scheme reduces the amount allowed if an employee does not meet some standard (of accuracy or behaviour) the employee may focus as much upon avoiding error being discovered as upon avoidance of error.

Management by measurement assumes, wrongly, that measurement can capture all that matters in dealings between bank and customer. It cannot and does not. So much was illustrated most clearly in the financial advice cases considered by the Commission. There are often circumstances where it is in the best interests of an adviser's client or a bank's customer to make no change to existing arrangements and take no new or different product. It is not easy to measure how often an employee is right to give advice to do nothing.

There can now 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 emphasis given to sales and profit, and the rewards that were given for selling the employer's product, are central reasons for the conduct of banks and intermediaries that has been identified and is criticised in this report.

The connections between remuneration, governance, risk management and misconduct have been recognised for many years. It is, therefore, useful and important to trace some of that history.

3 Some matters of history

3.1 The GFC and remuneration

As the Australian Prudential Regulation Authority's (APRA's) Prudential Inquiry into governance, culture and accountability within the CBA group noted, remuneration practices at financial institutions globally 'came under a harsh spotlight during the global financial crisis'.[1] The report said that remuneration practices 'were exposed as promoting behaviours and outcomes that were inconsistent with sound risk management and the best interests of customers'.[2]

[1] APRA, *Prudential Inquiry into the Commonwealth Bank of Australia*, April 2018, 65 [8.1].

[2] APRA, *Prudential Inquiry into the Commonwealth Bank of Australia*, April 2018, 65 [8.1].

The immediate responses to this exposure were directed to improving risk management. In 2009, the Financial Stability Board[3] released its Principles for Sound Compensation Practices[4] and accompanying Implementation Standards.[5] As the panel inquiring into CBA recorded, these principles 'sought to realign executive remuneration systems with prudent risk management and long-term financial sustainability'.[6] The published principles and standards were not explicitly directed to issues about the best interests of customers.

Soon after the Financial Stability Board had published these principles and standards, APRA issued a Prudential Practice Guide about remuneration.[7] The guide was directed to all institutions regulated by APRA including **authorised deposit-taking institutions** (ADIs), general insurers and life companies. It was described as supporting compliance with APRA's prudential standards about governance.[8] The guide said that 'APRA's remuneration requirements and guidance relate to managing or limiting risk incentives associated with remuneration'.[9] The guide did not identify the kinds of risk, or risk incentives, to which it was directed. It said nothing about conduct risk, compliance or regulatory risk and nothing about reputational risk. Coming, as it did, in the immediate wake of the Global Financial Crisis, it seems probable that those to whom the guidance was addressed would

3 Established in 2009 as the successor to the Financial Stability Forum that had been founded in 1999 by the G7 Finance Ministers and Central Bank Governors as a mechanism (among other things) for developing and implementing strong regulatory, supervisory and other policies in the interest of financial stability. See Financial Stability Board, *Our History* (2018) Financial Stability Board <www.fsb.org/about/history/>.

4 Financial Stability Forum, *FSF Principles for Sound Compensation Practices* (2 April 2009) Financial Stability Board <www.fsb.org/wp-content/uploads/r_0904b.pdf>.

5 Financial Stability Board, *FSB Principles for Sound Compensation Practices Implementation Standards* (25 September 2009) Financial Stability Board <www.fsb.org/wp-content/uploads/r_090925c.pdf>.

6 APRA, *Prudential Inquiry into the Commonwealth Bank of Australia*, April 2018, 65 [8.1].

7 APRA, *Prudential Practice Guide PPG 511 – Remuneration*, 30 November 2009 <www.apra.gov.au/sites/default/files/PPG511_REM_revised-Dec-09_1.pdf>.

8 See APRA, *Prudential Standard APS 510 – Governance*; APRA, *Prudential Standard GPS 510 – Governance*; and APRA, *Prudential Standard LPS 510 – Governance;* as made from time to time.

9 APRA, *Prudential Practice Guide PPG 511 – Remuneration*, 30 November 2009, 5 [2].

have seen it as directed primarily, even exclusively, to the management of financial risk taking.

3.2 Future of Financial Advice reforms

The **Future of Financial Advice** (FoFA) reforms of 2012 drew the connection between remuneration and poor customer outcomes. The legislation did that by including provisions expressly directed to the subject of **conflicted remuneration**, defined as: benefits (monetary and non-monetary) given to a **financial services licensee**, or a representative of a licensee, who gives **financial product** advice to persons as retail clients that 'because of the nature of the benefit or the circumstances in which it is given' could reasonably be expected to influence the choice of product recommended or product advice given to the client.[10]

To the extent to which the banks or their subsidiaries participated in the personal financial advice market, these provisions applied directly. But no wider application of the premise for these FoFA amendments (that remuneration affects conduct) to general remuneration arrangements within the banks seems to have been identified or considered by the Australian Securities and Investments Commission (ASIC), APRA or the banks themselves until several years after the FoFA reforms came into effect.

3.3 International developments

By 2015, there had been significant incidents of misconduct at financial institutions around the world. In that year, the Financial Stability Board launched a work plan to reduce misconduct.[11] The work resulted in the publication, in March 2018, of *Supplementary Guidance to the FSB*

[10] *Corporations Act 2001* (Cth) s 963A.

[11] See Financial Stability Board, *Supplementary Guidance to the FSB Principles and Standards on Sounds Compensation Practices* (9 March 2018) Financial Stability Board <www.fsb.org/2018/03/supplementary-guidance-to-the-fsb-principles-and-standards-on-sound-compensation-practices-2/>.

Principles and Standards on Sound Compensation Practices.[12] As the foreword to that guide said:[13]

> Inappropriately structured compensation arrangements can provide individuals with incentives to take imprudent risks that are inconsistent with the firm's long-term value creation and time horizon of firm's risk. Costs may be imposed on firms and their customers not only by inappropriate risk-taking but also by misconduct that can result in harm to institutions, and their customers and other stakeholders and impair trust in the financial system more generally.

3.4 The Sedgwick Review

In the meantime, in Australia, the Australian Bankers' Association had appointed Mr Stephen Sedgwick AO to conduct an independent review into remuneration practices in retail banking. The review began in July 2016 and Mr Sedgwick provided his final report in April 2017.[14] The report said that:[15]

> [S]ome current [remuneration] practices carry an unacceptable risk of promoting behaviour that is inconsistent with the interests of customers and should be changed. Some of these relate to management practices that may reduce the effectiveness of the bank's risk mitigation strategies. Other practices relate to the way incentives and remuneration are structured. The need for change is true of both direct (i.e. staff) and some third party channels …
>
> New approaches to retail bank remuneration are by no means a panacea. But the Issues Paper [issued by Mr Sedgwick in January 2017] has documented instances in retail banking and across the financial services sector more broadly, both in Australia and abroad, in which incentives have at least appeared to drive behaviour that was not in the best interests of customers and, on occasion, scandalously so.

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12 See Financial Stability Board, *Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices: The Use of Compensation Tools to Address Misconduct Risk* (9 March 2018) Financial Stability Board <www.fsb.org/wp-content/uploads/P090318-1.pdf>.

13 See Financial Stability Board, *Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices: The Use of Compensation Tools to Address Misconduct Risk* (9 March 2018) Financial Stability Board 1 <www.fsb.org/wp-content/uploads/P090318-1.pdf>.

14 Exhibit 4.57, 19 April 2017, Retail Banking Remuneration Review.

15 Exhibit 4.57, 19 April 2017, Retail Banking Remuneration Review, i.

Mr Sedgwick made 21 recommendations. He summarised the effect of the recommendations he made about retail bank staff (as distinct from introducers, referrers, franchisees and **mortgage brokers**) as being:

- Incentives are no longer paid to any retail staff based directly or solely on sales performance (see Recommendations 2 and 7);
- Instead, eligibility to receive any personal incentive payments will be based on an assessment of that individual's contribution across a range of measures, of which sales (if included at all) will not be the dominant component (Recommendations 3, 4, 5, and 6); and the maximum available payments will be scaled back significantly for some roles (Recommendation 8);
- Retail bank culture will be demonstrably ethically and customer oriented (Recommendation 9);
- A significant investment will have been undertaken, as necessary, to ensure that performance is managed consistently with such a philosophy, supported by proactive steps to develop leadership and management skills at all levels so that management practices match the intent of the recommendations (Recommendations 10,11, and 12); and
- With clear and consistent leadership shown by the Board and the most senior managers of the bank (Recommendations 13 and 14).[16]

The important features of those recommendations were to propose eliminating incentives directly or solely related to sales and reducing the influence of sales in performance scorecards. But those proposals were coupled with the need for changes in culture, philosophy and leadership. And as the report made clear, the sales oriented culture is deeply ingrained.[17] Care must therefore be taken in considering discretionary remuneration arrangements lest that ingrained culture cause the exercise of discretion favouring sales over other goals or targets. No less importantly, the report observed that not all indicators of desirable behaviour can be measured.[18] It follows, therefore, that to implement the recommendations,

[16] Exhibit 4.57, 19 April 2017, Retail Banking Remuneration Review, ii.

[17] Exhibit 4.57, 19 April 2017, Retail Banking Remuneration Review, 21 [5.1].

[18] Exhibit 4.57, 19 April 2017, Retail Banking Remuneration Review, 23 [5.2].

especially with their focus on changing culture and developing leadership and management skills at all levels of the entities, marked changes would be needed in remuneration arrangements.

4 Responses to the Sedgwick Review: Changing remuneration and changing culture

Much attention is given in the Sedgwick Review, and in other reports looking at the connection between culture and remuneration, to the remuneration of front line staff. But, as already noted, the general scheme of remuneration by base salary plus incentive payments has been applied at every level of employment within most banks.

It is important, therefore, to recognise that providing senior management with incentives based on sales or revenue and profit will inevitably affect how senior management acts with respect to more junior members of staff. It will always be in the interests of any manager (no matter how senior) to have subordinates carry out their work in a way that will allow the manager to achieve whatever incentive targets have been set for that manager.

It follows, then, that **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**. The behaviour that the manager will applaud and encourage is behaviour that yields sales or revenue and profit. The behaviour that is applauded and encouraged sets the standards to be met and forms the culture that will permeate at least that part of the entity's business.

When it is the most senior levels of the organisation that applaud and encourage behaviour that yields sales or revenue and profit, but do not adequately applaud and encourage consideration of compliance and conduct risks, the lesson from APRA's Prudential Inquiry into CBA is that the entity's culture is compromised. As the panel said in its report, CBA was 'vulnerable to missteps' because the 'voice of risk' particularly for 'non-financial risks' and the 'customer voice' were muted and were not

heard.[19] And this, the panel found, was brought about by deficiencies in governance and risk management, especially management of conduct risk.

In response to the Sedgwick Review, all the major banks have made changes in remuneration practices. All would say that they now assess staff performance according to a 'balanced scorecard'. But what does this mean? It will be sufficient to explore that question by reference to ANZ and Westpac. That exploration shows that both continued (at least until very recently) to remunerate employees in ways that emphasised profit. That is, both entities sought to fix the amount of each employee's incentive payment by drawing, for the employee, an explicit connection between the ultimate success of the bank (as measured by revenue and profit) and the particular ways in which the individual employee had performed her or his job.

4.1 ANZ

ANZ has used a balanced scorecard since at least April 2017. The scorecard seeks to move away from focusing only on sales.

Before April 2017, ANZ branch staff had been required to achieve a 100% score on their financial Key Results Area (KRA) target in order to receive an incentive payment.[20] If 100% was achieved, the bonus would be paid unless a manager exercised his or her discretion to deprive the staff member of the payment.[21]

Since April 2017, ANZ says, the approach has placed greater emphasis on non-financial KRAs by requiring an overall performance of 'good' across both the financial KRA and the other three, non-financial KRAs: Customer; People and Reputation; and Risk and Process. So, Mr Tony Tapsall, ANZ's General Manager, retail branch network for Northern Queensland and Northern Territory said that 'a staff member who did not meet their financial KRA might still receive an incentive payment if they performed at above expectations in one or more of the other three KRAs.'[22]

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19 APRA, *Prudential Inquiry into the Commonwealth Bank of Australia*, April 2018, 4.

20 Exhibit 4.202, Witness statement of Tony Colin Tapsall, 21 June 2018, 12 [48(a)].

21 Exhibit 4.201, Witness statement of Tony Colin Tapsall, 21 June 2018, 12 [48(a)].

22 Exhibit 4.201, Witness statement of Tony Colin Tapsall, 21 June 2018, 12 [48(b)].

The description of the operation of the balanced scorecard is very complicated. But beneath the complexity lies a simple point, made in ANZ's 2017 Performance Management and Performance Measures for the Australian Branch Network. It is that 'Performance is reviewed half yearly and annually *to ensure employees are appropriately recognised and rewarded for their contributions towards ANZ's overall results*'.[23] The purpose of the incentive scheme is to improve 'ANZ's overall results'.

To be eligible to participate in the incentive program a staff member must meet certain minimum standards for the performance period. These assess performance, competencies and behaviours (the ratings and categories differing according to the employee's designation); completion of all accreditations and training required by their role; and meeting compliance standards for their role.[24]

For retail staff that are not home lenders, the only two compliance measures that automatically disqualify an employee from the incentive program are failure to complete mandatory training or failure to attain sales accreditation.[25] For home lenders, there is one additional compliance requirement, which is that they achieve a greater than 85% initial pass rate and a greater than 95% final pass rate in their home loan file compliance review, which is calculated monthly.[26] A failure to achieve these minimum standards will not result in full disqualification from a half-yearly incentive payment until the failure has endured for at least four months. Failure to meet the minimum standard in the first three months will result in partial reduction of any incentive.[27] But ANZ tells its employees that 'where a large

23 Exhibit 4.202, Witness statement of Tony Colin Tapsall, 21 June 2018, Exhibit TCT-10 [ANZ.800.638.0001 at .0003] (emphasis added).

24 Exhibit 4.202, Witness statement of Tony Colin Tapsall, 21 June 2018, Exhibit TCT-9 [ANZ.800.634.3072 at .3076]. References are to the program as it stood at April 2017. ANZ sought and obtained a non-publication direction preventing disclosure of some details of its current program. The changes that were made to the program after April 2017 are not immediately relevant to the points considered here.

25 Exhibit 4.202, Witness statement of Tony Colin Tapsall, 21 June 2018, Exhibit TCT-10 [ANZ.800.638.0001 at .0038].

26 Exhibit 4.202, Witness statement of Tony Colin Tapsall, 21 June 2018, Exhibit TCT-10 [ANZ.800.638.0001 at .0039].

27 Exhibit 4.202, Witness statement of Tony Colin Tapsall, 21 June 2018, Exhibit TCT-9 [ANZ.800.634.3072 at .3081].

number of the same final breaches are recorded in the same month, impact to incentives may be limited to 1 month, subject to DM & GM approval. For the rest of the 6 month rolling period, this multi-breach situation would count as a single breach for incentives impact and eligibility assessment.'[28]

Once the minimum standards have been met, the retail employee's performance is assessed according to the four KRAs mentioned above: Customer (weighted at 35%), People and Reputation (15%), Financial and Discipline (30%) and Risk and Process (20%). Within each KRA are 'sub pillars' or subcategories that detail the outcomes that contribute to the KRA. Most subcategories are assessed at an individual level, but some are assessed at branch or even district level. The following discussion takes the breakdown of KRAs as assigned to personal bankers and home investment lending managers and associates as its example.

The Customer KRA contains four subcategories:

- Voice of Customer;
- SNBC Leads and Offers;
- Digital Engagement; and
- A–Z reviews.

Voice of Customer is assessed half at the individual level and half at the branch level. Voice of Customer is measured by Net Promoter Score, which is a measure of customer satisfaction based on real-time feedback.[29] The Net Promoter Score does not measure whether a customer has been serviced according to their best interests, or indeed their needs and it does not measure whether the service they have received is legally compliant. The Net Promoter score captures only the customer's level of satisfaction at the time of their interaction with bank staff.

SNBC Leads and Offers includes a measure for action rate, lead acceptance rate, and offer acceptance rate. Leads and offers are potential

[28] Exhibit 4.202, Witness statement of Tony Colin Tapsall, 21 June 2018, Exhibit TCT-9 [ANZ.800.634.3072 at .3082].

[29] Exhibit 4.202, Witness statement of Tony Colin Tapsall, 21 June 2018, Exhibit TCT-10 [ANZ.800.638.0001 at .0047–.0048].

sales to customers.[30] Action rate is measured by the number of customers a staff member contacts to try to make a sale. Lead and offer acceptance rate is measured by the number of sales resulting.[31]

Digital Engagement, for all roles but one, is measured by the percentage of accounts opened where a customer uses online banking or the ANZ app within 28 days of opening.[32] The measure rewards staff for identifying and discussing 'digital solutions in interactions for new and existing customers' and 'educating customers about ANZ's digital offerings.'[33] Migrating customer activity online is a key aspect of many entities' strategy to reduce costs.

An A–Z review is said to be an opportunity to have a 'needs based conversation' with the customer. That is, it is an opportunity to sell products to the customer. For the purposes of the employee's scorecard, the item 'A–Z reviews' focuses entirely on what is called the 'quality' of the review.[34] The quality of an A–Z review is measured by the percentage of sales to customers who have completed an A–Z review in the last six months. This, like SNBC Leads and Offers, is a sales target.

Home lenders have a fifth Customer subcategory, called Home Loan Pipeline.[35] It is a measure of increased funds under management.[36] It too is a sales target.

30 Exhibit 4.202, Witness statement of Tony Colin Tapsall, 21 June 2018, Exhibit TCT-10 [ANZ.800.638.0001 at .0052].

31 Exhibit 4.202, Witness statement of Tony Colin Tapsall, 21 June 2018, Exhibit TCT-10 [ANZ.800.638.0001 at .0052–.0053].

32 Exhibit 4.202, Witness statement of Tony Colin Tapsall, 21 June 2018, Exhibit TCT-10 [ANZ.800.638.0001 at .0055].

33 Exhibit 4.202, Witness statement of Tony Colin Tapsall, 21 June 2018, Exhibit TCT-10 [ANZ.800.638.0001 at .0035].

34 See, eg, Exhibit 4.202, Witness statement of Tony Colin Tapsall, 21 June 2018, Exhibit TCT-10 [ANZ.800.638.0001 at .0016–.0017].

35 Exhibit 4.202, Witness statement of Tony Colin Tapsall, 21 June 2018, Exhibit TCT-10 [ANZ.800.638.0001 at .0017].

36 Exhibit 4.202, Witness statement of Tony Colin Tapsall, 21 June 2018, Exhibit TCT-10 [ANZ.800.638.0001 at .0057].

The People and Reputation KRA considers how well an employee 'brings the ANZ Purpose to life', implements change initiatives, contributes to customer and banker experience, delivers customer promises and is competent with digital products.

The Financial and Discipline KRA measures financial performance relevant to each retail role, with sales of products contributing different weightings towards the target. Cross selling is also rewarded, with referrals to other groups in the bank allocated weightings.[37]

The Risk and Process KRA contains the compliance steps discussed above. In addition to the two compulsory requirements, without which an employee is ineligible for a bonus, and the home loan file compliance review for home lenders, the Risk and Process KRA requires the employee to have taken at least 10 days' annual leave and to have participated in workplace health and safety activities, training, and the conduct of a review.[38] Home lenders must have completed a home loan interview guide.[39] Apart from the two compulsory requirements, the employee's manager has the discretion to determine whether failure of any criterion should disqualify the employee from an incentive payment.

Both the Customer KRA and the Financial Discipline KRA emphasise financial performance. Together they account for more than half of the measures that go into the score. Though variously described – as meeting 'customer needs' or as 'leads accepted' – it is well open to the employee to read the scorecard as emphasising and rewarding sales. And that is its focus. The scorecard is 'balanced' in as much as it takes account of more than sales. But, despite the scorecard's complexity, sales lie at its heart and the chief purpose of the whole incentive program remains to enhance the bank's 'overall results'.

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37 Exhibit 4.202, Witness statement of Tony Colin Tapsall, 21 June 2018, Exhibit TCT-10 [ANZ.800.638.0001 at .0008].

38 Exhibit 4.202, Witness statement of Tony Colin Tapsall, 21 June 2018, Exhibit TCT-10 [ANZ.800.638.0001 at .0038].

39 Exhibit 4.202, Witness statement of Tony Colin Tapsall, 21 June 2018, Exhibit TCT 10 [ANZ.800.638.0001 at .0039].

4.2 Westpac

Westpac has moved from variable remuneration arrangements that saw 80% to 85% of variable remuneration dependent upon achieving financial goals to the point where 'the only time that somebody is considered for variable reward is where they meet our behavioural expectations and where they also meet the risk and compliance requirements for the roles'.[40] Hence, it is said that there is to be a 'holistic performance assessment' based on:

- behaviours and compliance gates;
- behaviours and risk considerations;
- role deliverables and Development Goals; and
- Performance Goals (Individual and Scorecard).[41]

The so-called 'compliance gates', however, require no more than attendance at mandatory training and the taking of 10 days' consecutive leave.[42]

Despite referring to 'holistic assessment', Ms Carol Separovich, Westpac's Head of Reward and Performance Management for Consumer Bank, Business Bank and Support Functions, said of Westpac's variable remuneration program that 'the variable reward is really our mechanism for people to share in our business success', it is 'a very objective view of their performance and contribution'.[43]

It is, then, unsurprising that in Westpac's FY18 Banker Performance Framework, 'scorecard goals' for most roles are said to be '50% financial and 50% customer measures' and the customer measures or metrics are described as comprising four measures:

40 Transcript, Carol Separovich, 23 May 2018, 2274.

41 Exhibit 3.28, Witness statement of Carol Separovich, 21 May 2018, Exhibit CS4-9 [WBC.107.003.1047 at .1058].

42 Exhibit 3.28, Witness statement of Carol Separovich, 21 May 2018, Exhibit CS4-9 [WBC.107.003.1047 at .1058].

43 Transcript, Carol Separovich, 23 May 2018, 2273.

- ‘Customer Needs per Connection’ (measuring whether ‘we have met 12 defined needs groupings centred around cash flow, financing, investing and protection needs’);
- ‘Net Promoter Score’ making up 20% of the scorecard and measuring how customers rate their individual banker and the Westpac brand;
- ‘Growth in Payments and Transactions’ directed to ‘having deep and enduring main bank relationship with customers’; and
- ‘New to Bank’ measuring the acquisition of new customers.[44]

All but one of the Customer metrics (the Net Promoter Score) are directly related to sales.

Read as a whole, Westpac’s variable remuneration program (like ANZ’s) places much emphasis on sales. And that is unsurprising when the program seeks ‘a very objective view of their [that is the individual member of staff’s] performance and contribution’ to ‘our [that is, Westpac’s] business success’.[45]

4.3 Other banks

Some of the smaller banks accept that they have not implemented the Sedgwick recommendations. They are recommendations that do not fit easily with the franchise model adopted by Bank of Queensland (BOQ).[46] And Mr Bradley James of Rabobank accepted that its then current remuneration structure for rural managers was not consistent with the Sedgwick recommendations.[47]

[44] Exhibit 3.28, Witness statement of Carol Separovich, 21 May 2018, Exhibit CS4-9 [WBC.107.003.1047 at .1059].

[45] Transcript, Carol Separovich, 23 May 2018, 2273.

[46] Transcript, Douglas Robert Snell, 24 May 2018, 2353–4.

[47] Transcript, Bradley Mark James, 28 June 2018, 3410–1.

5 Changed remuneration and changed culture?

The point of present importance is that, despite the Sedgwick recommendations, banks continue to remunerate employees in ways that emphasise sales. True it is, the emphasis has been reduced, but sales remain an important feature of variable remuneration arrangements. They take that place because the *entity's* success is measured by reference *only* to revenue and profit and it is sought to measure the *individual's* contribution to that measure.

This need not be so. It is not necessary to attempt to draw an immediate and direct connection between *individual* conduct and entity profit.

The Sedgwick Review referred to remuneration practices in the UK and the radical changes that have been made there with respect to incentive pay since 2006 when the then Financial Services Authority launched what was called 'Treating Customers Fairly'.[48] Around one half of the UK banks surveyed allocated variable pay 'based on a discretionary performance assessment of the individual by the line manager against a balanced scorecard of measures, rather than a formulaic assessment of the individual's performance against quantitative targets'.[49] Some allocated variable pay 'based on a flat share of the variable pay pool based on organisation performance' thereby seeking 'a consistent "cross-bank" one-team approach to reward'.[50] Some have removed all variable remuneration for customer facing staff. To varying degrees and in different ways, each of these approaches either severed, or at least loosened, the connection between individual conduct and entity profit. The simplest and most comprehensive severance may be the adoption of a flat share of a variable pay pool that varies with overall entity performance.

48 Exhibit 4.57, 19 April 2017, Retail Banking Remuneration Review, 41.

49 Exhibit 4.57, 19 April 2017, Retail Banking Remuneration Review, 42.

50 Exhibit 4.57, 19 April 2017, Retail Banking Remuneration Review, 42.

6 What can or should be done about remuneration practices and policies?

Two points should be made at the outset. First, **changing culture in the Australian banks may not be easy and may take time**. It cannot be assumed that entities will embrace change willingly or immediately. It cannot be assumed that entities will make desirable changes at all levels of the organisation. The move to balanced scorecards may be one step along the path of change, but scorecards of the kind described do not complete that journey.

Second, and no less important, **the unstated premise for so much of the debate about remuneration of both bank staff and intermediaries, that staff and intermediaries will not do their job properly and to the best of their ability without incentive payments, must be challenged**. And in the case of intermediaries, **arguments based in predictions of industry damage or collapse should be examined with special care**.

6.1 Is incentive remuneration necessary?

Why do staff (whether customer facing or not) need incentives to do their job *unless* the incentive is directed towards maximising revenue and profit? How can staff (especially customer facing staff) be encouraged to do the right thing (to ask 'Should I') except by the line manager observing, encouraging counselling and supporting the staff in that task? What is the point of allowing an incentive payment for doing the assigned task in a way that meets but does not exceed what is expected of that staff member?

And, as explained earlier, if customer facing staff should not be paid incentives, why should their managers, or those who manage the managers? Why will altering the remuneration of front line staff effect a change in culture if more senior employees are rewarded for sales or revenue and profit?

6.2 Would better disclosure help?

In its 13 July submission on key policy issues, Treasury asked whether better disclosure of remuneration arrangements would make a difference.[51] In considering that question it is important to recognise that the interests of shareholders are not the same as the interests of customers. It may be that they are opposed. Shareholders will see what happens at the entity only through the lens of dividend and share price. Some shareholders will take a short term view of both dividends and share price, others may have a longer term view. But customers are concerned only with how the entity's conduct affects them in their dealings with the entity.

Shareholders might be able to bring some pressure to bear to have an entity change its remuneration policies. It is not apparent to me that consumers could do that.

6.3 Regulatory intervention?

Is regulatory intervention possible and necessary?

I have already referred to APRA's publication, in 2009, of its Prudential Practice Guide about remuneration. In 2017, 'APRA reviewed remuneration policies and practices across a sample of large APRA-regulated entities to gauge how their stated remuneration frameworks and policies were translated into outcomes for senior executives'.[52] Based on this work, APRA published, in April 2018, an information paper in which it said that it 'intends to strengthen its prudential requirements on remuneration to better support' an outcome that 'better [aligns entities'] remuneration arrangements with good risk management and the long-term soundness' of the entities.[53]

The paper noted that 'other financial regulators and industry bodies' had conducted reviews focused on remuneration 'largely from the perspective of limiting the potential for misconduct'.[54] It went on to say that the link

[51] Treasury, *FSRC Background Paper No. 24: Submission on Key Policy Issues*, 13 July 2018, 19 [68]–[70].

[52] APRA, *Prudential Inquiry into the Commonwealth Bank of Australia*, April 2018, 65 [8.1].

[53] APRA, *Information Paper: Remuneration Practices at Large Financial Institutions*, April 2018, 5.

[54] APRA, *Information Paper: Remuneration Practices at Large Financial Institutions*, April 2018, 6.

between remuneration and misconduct 'is also of interest to APRA as a prudential supervisor' but explained that this was 'because conduct issues can provide additional insights into an organisation's attitudes towards risk more generally'.[55] Evidently, APRA did not then treat the link between remuneration and misconduct as a matter calling for direct consideration in its proposals to 'strengthen its prudential requirements on remuneration'.[56]

Yet, when setting the terms of reference for the prudential inquiry into CBA, APRA specifically required the panel to assess whether CBA's remuneration frameworks conflicted with sound risk management and compliance outcomes.[57] Chapter 8 of the panel's report was devoted wholly to that subject and the panel recommended that the CBA Board 'exercise stronger governance to ensure the effective application of the remuneration framework' and, in particular, assess certain remuneration outcomes 'to reflect individual and collective accountability for material adverse risk management *and compliance* outcomes'.[58] Not only that, the **enforceable undertaking** that CBA offered and APRA accepted following the report included undertakings about remuneration. They were:

- First, to report to APRA by 30 June 2018 'how the findings contained in the Final Report have been reflected in remuneration outcomes for current and (where appropriate) past executives'.
- Second, to 'reflect and give significant weight to the accountability for completing items in the remedial action plan with the performance scorecards of the senior executive team, and other staff as relevant'.[59]

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55 APRA, *Information Paper: Remuneration Practices at Large Financial Institutions*, April 2018, 6.

56 APRA, *Information Paper: Remuneration Practices at Large Financial Institutions*, April 2018, 5.

57 APRA, *Prudential Inquiry into the Commonwealth Bank of Australia*, April 2018, 105 [2(d)].

58 APRA, *Prudential Inquiry into the Commonwealth Bank of Australia*, April 2018, 74 Recommendation 23 (emphasis added).

59 See APRA, *Enforceable Undertaking*, 30 April 2018, <www.apra.gov.au/sites/default/files/20180430-CBA-EU-Executed.pdf> 3 pt 14.

When APRA released the report of the Inquiry into CBA, it said, in a press release, that:[60]

> Given the nature of the issues identified in the Report, all regulated financial institutions will benefit from conducting a self-assessment to gauge whether similar issues might exist in their institutions. APRA supervisors will also be using the Report to aid their supervision activities, and will expect institutions to be able to demonstrate how they have considered the issues within the Report.

In June 2018, APRA wrote to regulated entities pointing to what it had said in that press release and seeking, for the largest financial institutions, board endorsed written assessments of whether issues similar to the issues identified about CBA might exist in those entities.

The Information Paper on Remuneration practices at large financial institutions, that APRA published in April 2018, suggested that APRA saw the undoubted link between remuneration and conduct risk as no more than a matter of indirect interest and concern in formulating a new prudential standard about remuneration. Given the terms of reference for, and the resulting report of, the Prudential Inquiry into CBA it would be surprising and cause for concern, if APRA's approach to prudential governance of remuneration remained as narrowly focused as its Information Paper suggested.

There can be no doubt that the banks and other financial services entities are primarily responsible for the management of conduct and compliance risks. But as APRA's inquiry into CBA showed, the culture of and governance within the entity will determine how effective that management is. As APRA's report said, conduct risk is now rightly seen by bank boards and by regulators as a clear and present danger.[61]

How is that danger to be met?

6.4 Meeting the dangers of conduct risk

Good culture and proper governance cannot be implemented by passing a law. Culture and governance are *affected* by rules, systems

[60] See APRA, 'APRA Releases CBA Prudential Inquiry Final Report and Accepts Enforceable Undertaking from CBA' (Media Release, 1 May 2018).

[61] APRA, *Prudential Inquiry into the Commonwealth Bank of Australia*, April 2018, 3.

and practices but in the end they *depend* upon people applying the right standards and doing their jobs properly.

This being so, what are banks doing to meet the danger of conduct risk? What are regulators doing to meet it? What can banks do? What can regulators do? What should either or both be doing?

Should any bank employee dealing with a customer be rewarded (whether by commission or as part of an incentive remuneration scheme) for selling the client a product of the employer? That is, 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? **If more junior employees should not be remunerated in this way, why should their managers and senior executives?**

Should other changes be made to the remuneration practices of banks? What would they be, and how could change be required?

6.5 The BEAR

The Banking Executive Accountability Regime ('the BEAR') individualises accountability for ADIs. In its 13 July submission on key policy issues, Treasury described the BEAR as providing 'an enhanced accountability framework for ADIs and persons in director and senior executive roles (accountable persons)' and said that '[a]n ADI must ensure that it has clearly defined accountability statements for each accountable person and an accountability map covering its ADI group'.[62] Under these arrangements, ADIs must defer a minimum percentage of a senior executive's variable remuneration for at least four years and have a remuneration policy that provides for reduction of the deferred variable remuneration where a senior executive has not met obligations under the BEAR.[63]

How will this 'enhanced accountability' affect the culture of banks? Is the BEAR relevant to the intersections between remuneration and culture more

[62] Treasury, *FSRC Background Paper No. 24: Submission on Key Policy Issues*, 13 July 2018, 10 [33].

[63] Treasury, *FSRC Background Paper No. 24: Submission on Key Policy Issues*, 13 July 2018, 10 [35].

generally than in its application to particular senior executives? Should the BEAR be changed? Should its application be extended?

6.6 Intermediaries

How do the questions about remuneration, culture and governance apply outside the realm of employer and employee? How do they apply to:

- introducers or referrers;
- advisers; and
- brokers and other intermediaries?

These issues are identified and considered in more detail in the chapters about consumer lending and about financial advice. It may be useful, however, to repeat some of them here and to do that in two parts: one about duties and the other about remuneration.

Is it desirable to prescribe that some or all of those who are not employees of banks, but deal with bank customers, must act in the interests, or the best interests, of the client? In particular, what duty, if any, should a mortgage broker owe to the prospective borrower? Is value based commission, paid to the broker by the lender, consonant with that duty? Should a **mortgage aggregator** owe any duty to the borrower? Again, are the remuneration arrangements for aggregators consonant with that duty?

If some or all of those who are not employees of banks, but deal with bank customers, should owe the customer a duty to act in that customer's interests, **is it enough to prescribe the duty and require 'management' of conflicts between interest and duty?** What is to be made of the fact that, when persons are paid to give advice and rewarded for selling their employer or sponsoring entity's products, all too often the client's interests are treated as coinciding with the adviser's commercial advantage, no matter how obviously that course harms the client? Perhaps the adviser believes that selling the employer's or sponsor's product is in the client's interests, perhaps the adviser does not think about the conflict. But in too many cases, what is sold is not in the interests of the client.

What, if anything, is to be done about remuneration of intermediaries? How is a value based commission consistent with acting in the interests, or

best interests, of the client? Should intermediaries be subject to rules generally similar to the conflicted remuneration prohibitions applying to the provision of financial advice?

6.7 Business structures

Finally, it is necessary to ask whether the conduct that has been identified and is criticised in this report directs attention to questions about the structure of financial services entities.

In considering these issues it is important to recognise that legislative regulation of the structure of the banking industry is not unknown. From time to time, overseas jurisdictions have limited not only the kinds of transaction, but also the affiliations with other firms, that banks may have. The *United States Banking Act of 1933* (usually called the 'Glass Steagall Act') sought to separate commercial and investment banking. In 2013, the UK enacted the *Financial Services (Banking Reform) Act 2013* requiring banks to 'ring-fence' certain 'core activities' by 2019.[64] These references are not to be misunderstood. They are not to be read as my suggesting that either of these laws could be, or should be, directly imported and applied here. But the point of immediate relevance is that structural regulation of banking activities is not novel.

The inescapable fact seems to be that interest too often trumps duty. Too often conflicts between interest and duty are 'managed' in a way that coincides with the interests of the party who owes some conflicting duty or has some conflicting interest.

Three of the four large banks are withdrawing, or have withdrawn, from some or all aspects of the financial advice business. CBA is disposing of its interests in Aussie Home Loans the **mortgage broker**. Other changes in the structure of the financial services industry are underway.

Do the events that have happened raise any issue about business structures? More particularly, do they provoke examination of how and to what extent conflicts of interest and duty arising from the structure of the business *can* be managed? The very basis of a business structure in which a financial product manufacturer (or a related entity of the manufacturer)

[64] See generally, Kate Britton et al, 'Ring-Fencing: What Is It and How Will It Affect Banks and Their Customers' in *Bank of England Quarterly Bulletin* (2016) Q4, 164.

engages others to advise clients about which product to buy appears to be the expectation that the adviser will recommend and sell the manufacturer's products. How is that expectation congruent with the adviser's duty to the client?

Do the events that have happened invite consideration of whether structural changes should now be made?

Do the events that have happened suggest that manufacturers of financial products and the related entities of manufacturers should not be permitted to provide, whether by employee or authorised representative, personal financial advice in relation to products of a kind it manufactures?

7 Issues that have emerged

The issues identified above can then be presented by reference to the following questions:

7.1 Conduct risk

- What are banks doing to meet the danger of conduct risk?
- What are regulators doing to meet it?
- What can banks do? What can regulators do?
- What should either or both be doing?

7.2 Remuneration

- What more should be done to implement the recommendations of the Sedgwick Review?
- Should any bank employee dealing with a customer be rewarded (whether by commission or as part of an incentive remuneration scheme) for selling the client a product of the employer? That is, 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? If more junior employees should not be remunerated in this way, why should their managers and senior executives?
- Should other changes be made to the remuneration practices of banks? What would they be, and how could change be required?

7.3 The BEAR

- Is the Banking Executive Accountability Regime ('the BEAR') relevant to the intersections between remuneration and culture more generally than in its application to particular senior executives?
  - Should the BEAR be altered?
  - Should the BEAR be extended in application?

7.4 Intermediaries

- Is it desirable to prescribe that some or all of those who are not employees of banks, but deal with bank customers, must act in the interests, or the best interests, of the client?
  - In particular, what duty, if any, should a mortgage broker owe to the prospective borrower?
  - Is value based commission, paid to the broker by the lender, consonant with that duty?
  - Should an aggregator owe any duty to the borrower?
  - Again, are the remuneration arrangements for aggregators consonant with that duty?
- How is a value based commission consistent with acting in the interests, or best interests, of the client?

- Should intermediaries be subject to rules generally similar to the **conflicted remuneration** prohibitions applying to the provision of financial advice?
- If some or all intermediaries should owe the customer a duty to act in that customer's interests, or best interests, is it enough to prescribe the duty and direct 'management' of conflicts between interest and duty?

7.5 Business structures

- Do the events that have happened raise any issue about business structures?
- Do the events that have happened invite consideration of whether structural changes should now be made?
- Do the events that have happened suggest that manufacturers of **financial products** should not be permitted to provide, whether by employee or authorised representative, personal financial advice in relation to products of a kind it manufactures?
- More particularly, do they provoke examination of how and to what extent conflicts of interest and duty arising from the structure of the business can be managed?

10. Issues that have emerged

Introduction

In all but the introductory chapter of this report. I have sought to identify issues that arise from the matters examined in that chapter. Although it is to repeat what appears elsewhere in this report, it is convenient to set out again those issues, substantially in the form in which they appear at the end of each of the relevant chapters. I will then seek to draw the issues together in ways that may assist identification of common threads and some more general questions.

1 Consumer lending

The issues that emerged in connection with consumer lending concerned:

- intermediaries, and confusion of roles;
- communication with customers; and
- responsible lending.

Intermediaries stand between consumers and the providers of financial services. They include **mortgage brokers**, **mortgage aggregators**, introducers, financial advisers, authorised representatives of **financial services licensees**, and representatives (at point of sale) of credit licensees. Often, intermediaries are given tasks that, done properly, will help to fulfil the entity's responsible lending obligations. There are, therefore, issues about entities' oversight of these contractually stipulated tasks, and their responsibility for their own, non-delegable statutory obligations. Intermediaries are often seen by the customer as the face of the entity. Entities, on the other hand, have given conflicting messages about whether intermediaries represent entities, themselves, or the customer. There are, therefore, questions about intermediaries' obligations toward customers and

entities, and customer expectations of the intermediaries with whom they deal.

Both entities and customers appear to be confused about the roles of intermediaries. Issues then arise about how entities can communicate with customers to create realistic expectations of products bought through intermediaries. And questions of communication arise when considering what obligations an entity owes to clients of an employee or intermediary when the entity suspects that employee or intermediary of misconduct toward at least some of their clients.

Responsible lending raises issues about the interpretation and application of obligations imposed by the *National Consumer Credit Protection Act* 2009 (Cth) (the NCCP Act). A particular issue that arose concerned entities' interpretation of the requirement to verify a customer's financial situation. Later changes to verification processes may suggest some entities have changed their interpretation of the relevant provisions. Examination of responsible lending also directed particular attention to the tension between responsible lending and some products long sold by, and some processes long used by, entities and intermediaries, including add-on insurance, pre-approved credit limit increases and the **Household Expenditure Measure** (HEM).

The particular issues can be identified as including:

- What duties does an intermediary owe to a borrower?
- What duties should an intermediary owe to a borrower?
- How can entities' systems be improved to detect and prevent breaches of responsible lending obligations by intermediaries?
- Are 'introducer' programs compatible with responsible lending obligations?
- Do broker contracts, as they stood at the time of the hearings, meet the statutory requirement imposed by Section 912A of the *Corporations Act* 2001 (Cth) to have arrangements in place to manage conflicts of interests? Do broker contracts, as now made, meet those requirements?
- What should be disclosed to borrowers about an intermediary's obligations to the lender and to the borrower?

- What should be disclosed to borrowers about an intermediary's remuneration?
- What steps, consistent with responsible lending obligations, should a lender take to verify a borrower's expenses?
- Do the processes used by lenders, at the time of the hearings, to verify borrowers' expenses meet the requirements of the NCCP Act? Do the processes now used meet those requirements?
- Should the HEM continue to be used as a benchmark for borrowers' living expenses?
- Is the offer of a credit limit increase, where the customer has consented to receive such marketing, consistent with the NCCP Act obligation not to provide credit that is not unsuitable for the customer, having regard to their requirements and objectives?
- Is the offer of a credit limit increase based only on information held by the bank about a customer a breach of the NCCP Act obligation to take reasonable steps to verify the consumer's financial situation?
- When an employee or intermediary is terminated for fraud or other misconduct, should a licensee inform their clients of the reason for termination?
- When an employee or intermediary is terminated for fraud or other misconduct, should a licensee review all the files or clients of that employee or intermediary for incidence of misconduct?
- Are certain types of add-on insurance, by their nature, poor value propositions for customers?

2 Financial advice

The issues that emerged in connection with financial advice related to:

- culture and incentives;
- conflicts of interest and duty, and confusion of roles; and
- regulator effectiveness.

The first of those themes, culture and incentives, includes issues about the culture of particular parts of the financial services industry, such as mortgage brokers, financial advisers, and point of sale agents for consumer lending. But it also includes more specific issues about the culture created and maintained by particular entities. And running through all of those issues are questions about how industry participants are paid (including how bonuses and other incentives are calculated).

The second theme, conflict of interest and duty, and confusion of roles, is closely related to the first. It includes issues about FoFA's treatment of conflicts of interest as conflicts that can, and should be, 'managed' (by advisers and licensees meeting the 'best interests duty' and giving the client's interests priority over the interests of the adviser and licensee). The second theme goes further, however, and requires consideration of structural considerations. In particular, the second theme draws attention to consequences that appear to be related to, if not stem from, some entities being vertically integrated, in the sense that the entity manufactures and sells **financial products** while, at the same time, advising clients which products to use or buy. And the second theme also embraces the issues that emerged in the first round of hearings about the confusion of roles and responsibilities of, for example, mortgage brokers and aggregators.

The third theme, regulator effectiveness, directs attention to what responses regulators can make, and what responses regulators should make, to conduct of the kinds examined in the Commission's hearings. A necessary part of the second branch of that inquiry (what responses regulators should make) is to consider whether (with all the benefit of hindsight) the responses that were made have proved to be satisfactory.

The particular issues can be further identified as including:

- How does a financial adviser's employer encourage provision of sound advice (including, where appropriate, telling the client to do nothing)?
- How do advice licensees encourage advisers aligned with the licensee to provide sound advice (including, where appropriate, telling the client to do nothing)?
- Can conflicts of interest and duty be managed?
- How far can, and how far should, there be separation between providing financial advice and manufacture or sale of financial products?

- Should financial product manufacturers be permitted to provide financial advice?
  - At all?
  - To retail clients?
- Should financial product sellers be permitted to provide financial advice?
  - At all?
  - To retail clients?
- Should an authorised representative be permitted to recommend a financial product manufactured or sold by the advice licensee (or a related entity of the licensee) with which the representative is associated?
  - At all?
  - Only on written demonstration that the product is better for the client than comparable third party products?
- Should the grandfathered exceptions to the **conflicted remuneration** provisions now be changed?
  - How far should they be changed?
  - If they should be changed, when should the change or changes take effect?
- Should the life risk exceptions to the conflicted remuneration provisions now be changed?
  - How far should they be changed?
  - If they should be changed, when should the change or changes take effect?
- Should any part of the remuneration of financial advisers be dependent on value or volume of sales?
- Should all financial advisers (including those who now act as authorised representatives of an advice licensee) be licensed by ASIC?

- Are current product and interests disclosure requirements sufficient to allow customers to make fully informed choices?
- Should the period after which a client must positively review an ongoing fee arrangement be reduced from two years to one?
- Should platform operators be permitted to deduct fees on behalf of licensees without the express authority of the client of the platform operator?
- When an employee or authorised representative is terminated for fraud or other misconduct, should a licensee inform their clients of the reason for termination?
- When an employee or authorised representative is terminated for fraud or other misconduct, should a licensee review all the files or clients of that employee or intermediary for incidents of misconduct?
- Should negotiation and settlement be the main approach for a regulator?
- Should there be greater focus on general deterrence in regulatory strategy?
- Should a component of **enforceable undertakings** be the acknowledgment of specific wrongs?
- Should self-reported breaches of the Corporations Act generally attract legal sanctions unless some special circumstances exist?
- Should banning orders continue to be preferred to civil penalty proceedings in case of licensee/adviser misconduct?
- Should ASIC make more use of its Section 916G power to give a licensee information about a person who is or will be a representative of the licensee?
- Does Section 916G need to be amended so as to be more effective?
- Should there be more focus on criminal proceedings against licensees rather than individual advisers?

3 Small and medium enterprises

The most general issues emerging from consideration of lending to small and medium enterprises can be identified as being:

- Should there be any change to the legal framework governing small and medium enterprise (SME) lending?
- In particular, should any lending to SMEs come within the reach of the *National Consumer Credit Protection Act 2009* (Cth) (the NCCP Act)?

The other issues calling for consideration can be described by reference to the following themes:

- the content of Code of Banking Practice obligations;
- third party guarantors; and
- dispute resolution approaches by the Financial Ombudsman Service (FOS) and the Australian Financial Complaints Authority (AFCA).

The first of these themes, the content of Code of Banking Practice obligations, concerns the meaning in particular of two obligations set out in the Code: first, the requirement that a bank providing a loan or limit increase will do so exercising the care and skill of a diligent and prudent banker, and second, the requirement that a bank assess whether a small business customer can repay a loan based on their financial position and account conduct. Submissions in response to this round of hearings demonstrated disagreement about the bounds and content of these obligations. That is significant given that they are the obligations that provide most practical protection to small businesses seeking funding from subscribing banks.

The second theme, **third party guarantors**, draws into sharp focus the disconnect between how the law, and lenders, may treat third party guarantors (as interested, or at least, rationally motivated actors) and the reality of the role played by many if not most guarantors of small business (family members assisting their loved ones in their plans). The questions raised here attempt to balance these inconsistent models, a task made more difficult by the central and perhaps irreplaceable role played by guarantors in securing funding for small businesses and the particular vulnerability of small businesses to failure.

The third theme, dispute resolution approaches by FOS and AFCA, relates to the outcomes available to consumers who successfully seek intervention by a dispute resolution body. This round of hearings demonstrated that customers who were wholly or partly successful in their claims nonetheless sometimes struggled to achieve what they believed was a satisfactory outcome. If those beliefs were unrealistic, it is important to explore why. This theme encompasses the approach both of FOS and, necessarily, the approach of banks to the resolution of claims.

The issues can be amplified as follows:

3.1 Code of Banking Practice

- What inquiries should a diligent and prudent banker make when deciding whether to lend to an SME?
- Does 'forming an opinion about the customer's ability to repay the loan facility' as required by Clause 51 of the 2019 Code involve bringing critical analysis to the cash flow forecasts and other business plan documents presented by customers?
- If so, what level of analysis is acceptable?
- Is it enough that the lender satisfy itself the borrower can repay the loan and that the business plan is not obviously flawed?
- Is the standard set out in Clause 51 of the 2019 Code, which requires a bank to determine whether a customer can repay a loan based on their financial position and account conduct, a sufficient standard?

3.2 Guarantees

- If established principles of judge-made law and statutory provisions about unconscionability would not relieve a guarantor of responsibility under a guarantee, and if, further, a bank's voluntary undertaking to a potential guarantor to exercise the care and skill of a diligent and prudent banker has not been breached, are there circumstances in which the law should nevertheless hold that the guarantee may not be enforced?
- What would those circumstances be?

- Would they be defined by reference to what the lender did or did not do, by reference to what the guarantor was or was not told or by reference to some combination of factors of those kinds?
- Is there a reason to shift the boundaries of established principles, existing law and the industry code of conduct?
- If the guarantor is a volunteer, and if further, the guarantor is aware of the nature and extent of the obligations undertaken by executing the guarantee, is there some additional requirement that must be shown to have been met before the guarantee was given if it is to be an enforceable undertaking?
- Should lenders give potential guarantors more information about the borrower or the proposed loan? What information could be given with respect to a new business?

3.3 External dispute resolution

- Should AFCA adopt FOS's approach of putting the borrower back in the position they would be in if the loan had not been made, but not awarding compensation for losses or harm caused?
- Are there circumstances in which AFCA should waive a customer's debt?

4 Agricultural lending

All agricultural enterprises are subject to the effects of events beyond the control of the individual farmer. Occurrence of any of these events, let alone a combination of them, will affect cash flow and profitability and, hence, the ability to service debts. Their occurrence will often have profound personal effects on those who conduct the business.

Four issues emerged: about revaluation of securities; difficulties in obtaining access to banking services and appropriate support; changes to conditions of lending; and, enforcement by appointment of external administrators.

The particular questions can be identified as including:

- How are borrowers and lenders in the agricultural sector to deal with the consequences of uncontrollable and unforeseen external events?

- Does the 2019 Banking Code of Practice provide adequate protection for agricultural businesses? If not, what changes should be made?
- How, and by whom should property offered as security by agricultural businesses be valued?
  - Is market value the appropriate basis?
  - Should the possibility, or probability of external shocks be taken to account in fixing lending value? How?
  - Should the time for realisation of security be taken to account in fixing value? How?
  - Is the possibility, or probability of external shock sufficiently met by fixing the loan-to-value ratio?
  - If prudential standard APS 220 is amended to require internal appraisals to be independent of loan origination, loan processing and loan decision processes, when should that amendment take effect?
- Should distressed agricultural loans be managed only by experienced agricultural bankers?
- Do asset management managers need more information (such as the cost to the lender of holding the loan) to make informed commercial decisions about management of distressed agricultural loans?
- Are there circumstances in which default interest should not be charged?
  - In particular, should default interest be charged to borrowers in drought-declared areas?
  - If it should not, how, and where, is that policy to be expressed?
  - Should the policy apply to other natural disasters?
- In what circumstances may a lender appoint an external administrator (such as a receiver, receiver and manager or agent of the mortgagee in possession)? Is appointment of an external administrator to be the enforcement measure of last resort?
- Having regard to the answers given to the preceding questions:

  - Is any regulatory change necessary or desirable?
  - Is any change to the 2019 Code necessary or desirable?
- Should there be a national system for farm debt mediation?
  - If so, what model should be adopted?
- Should lenders be required to offer farm debt mediation as soon as an agricultural loan is impaired (in the sense of being more than 90 days past due)?

5 Remote communities

This chapter examined how financial services entities are responding to the financial needs and vulnerabilities that can be experienced by Indigenous Australians, in particular those living in remote communities.

In relation to banking services in remote communities, the issues that arose related to access to services; account fees; and the application of standard identification requirements. None of the banking relationships examined was complicated. The prevailing theme in this part of the chapter was of basic transactions made bewildering by inadequate recognition on the part of the bank of an Indigenous customer's circumstances.

In relation to funeral insurance, what emerged was evidence pointing to predatory behaviour by insurers and salespeople. What followed were questions about the way in which funeral insurance should be regulated, and therefore how it should be categorised by the law.

Common to both parts of the chapter was the issue of culturally appropriate communication, a lack of which aggravated the existing difficulties in the interaction between entity and customer.

More specifically, the questions that arose can be set out as follows:

- Do financial services entities have in place appropriate policies and procedures to assist Aboriginal and Torres Strait Islander people:
  - to overcome obstacles associated with the geographical remoteness?

  - to address the cultural barriers to engagement that some face?
  - to address the linguistic barriers to engagement that some face?
  - to address the obstacles posed for some by their level of financial literacy?
- Are banks' identification requirements appropriate for Aboriginal and Torres Strait Islander customers?
  - If they are, are those policies sufficiently understood and applied by staff?
- Should more banks have a telephone service staffed by employees with specific training in assisting Indigenous consumers?
- Do banks take sufficient steps to promote the availability of fee-free accounts to eligible customers?
- If a customer seeking to open a basic bank account has no substantial income other than Centrelink benefits, should a bank ever try to sell the customer another form of account?
- Should informal overdrafts be allowed on a bank account if credits to the account are only, or are substantially, by payment of Centrelink benefits?
- Should the application of the 90% arrangements provided by the Code of Operation be at the discretion of the bank, the customer or both? Or should banks apply these arrangements automatically?
- If direct debits are dishonoured for want of sufficient funds, are there cases in which dishonour fees should not be charged?
- Are funeral policies, or particular kinds of funeral policy, financial products warranting intervention by ASIC in the exercise of its product intervention powers?
- Should all forms of funeral insurance be financial products for the purposes of Chapter 7 of the *Corporations Act 2001* (Cth)?
- Should all forms of funeral insurance be covered by Part 2 Division 2 of the *Australian Securities and Investments Commission Act 2001* (Cth)?

- Should it be unlawful to sell funeral insurance for persons under 18 years?

6 Regulation and the regulators

Chapter 8 of the Report, about regulation and the regulators sought to identify questions that had emerged in the course of the first four rounds of hearings about the content of the law governing financial services entities and their conduct and about the ways in which the regulators, ASIC and APRA had responded to the conduct identified and criticised in this report.

As indicated in Chapter 8, I begin from the premise that no new layer of law or regulation should be added unless there is clearly identified advantage to be gained by doing that. And I begin from the further premise that very simple ideas must inform the conduct of financial services entities.

Hence, the first question to be asked and answered is:

- Is the law governing financial services entities and their conduct too complicated?
    - Does it impede effective conduct risk management?
    - Does it impede effective regulatory enforcement?

The questions that are raised about the regulators, ASIC and APRA can be described as follows:

- Should there be annual reviews of the regulators' performance against their mandates?
- Is ASIC's remit too large?
    - If it were to be reduced, who would take over those parts of the remit that are detached?
    - Why would detachment be better?
- Is the regulatory regime too complex? Should there be radical simplification of the regulatory regime?

- Should industry codes relating to the provision of financial services, such as the 2019 Banking Code of Practice, be recognised and applied by legislation like Part IVB of the *Competition and Consumer Act 2010* (Cth)?
- Are ASIC's enforcement practices satisfactory? If not, how should they be changed?
- If the recommendations of the 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 it is in the public interest not to do so?
- Are APRA's regulatory practices satisfactory? If not, how should they be changed?
- Are APRA's enforcement practices satisfactory? If not, how should they be changed?
- Does the conduct identified and criticised in this 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?

7 Entities: Causes of misconduct

In Chapter 9, I noted that all of the conduct identified and criticised in this report was conduct that provided a financial benefit to the individuals and entities concerned. (If there were exceptions, they were immaterial.) The governance and risk management practices of the entities did not prevent the conduct. The culture and conduct of the banks was driven by, and was reflected in their remuneration practices and policies.

The issues identified in that chapter give rise to the following questions:

7.1 Conduct risk

- What are banks doing to meet the danger of conduct risk?
- What are regulators doing to meet it?
- What can banks do? What can regulators do?
- What should either or both be doing?

7.2 Remuneration

- What more should be done to implement the recommendations of the Sedgwick Review?
- Should any bank employee dealing with a customer be rewarded (whether by commission or as part of an incentive remuneration scheme) for selling the client a product of the employer? That is, 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? If more junior employees should not be remunerated in this way, why should their managers and senior executives?
- Should other changes be made to the remuneration practices of banks? What would they be, and how could change be required?

7.3 The BEAR

- Is the Banking Executive Accountability Regime ('the BEAR') relevant to the intersections between remuneration and culture more generally than in its application to particular senior executives?
  - Should the BEAR be altered?
  - Should the BEAR be extended in application?

7.4 Intermediaries

- Is it desirable to prescribe that some or all of those who are not employees of banks, but deal with bank customers, must act in the interests, or the best interests, of the client?

  - In particular, what duty, if any, should a mortgage broker owe to the prospective borrower?
  - Is value based commission, paid to the broker by the lender, consonant with that duty?
  - Should an aggregator owe any duty to the borrower?
  - Again, are the remuneration arrangements for aggregators consonant with that duty?
- How is a value based commission consistent with acting in the interests, or best interests, of the client?
- Should intermediaries be subject to rules generally similar to the conflicted remuneration prohibitions applying to the provision of financial advice?
- If some or all intermediaries should owe the customer a duty to act in that customer's interests, or best interests, is it enough to prescribe the duty and direct 'management' of conflicts between interest and duty?

7.5 Business structures

- Do the events that have happened raise any issue about business structures?
- Do the events that have happened invite consideration of whether structural changes should now be made?
- Do the events that have happened suggest that manufacturers of financial products should not be permitted to provide, whether by employee or authorised representative, personal financial advice in relation to products of a kind it manufactures?
- More particularly, do they provoke examination of how and to what extent conflicts of interest and duty arising from the structure of the business can be managed?

8 Restating the issues

The many questions that have been set out above can then be distilled and organised in three categories:

- Issues
- Causes
- Responses

8.1 Issues

The issues can be divided into four groups. First, there are issues about *access* to banking services. Second, there is a group of issues about the *roles and responsibilities of intermediaries* – those who stand between the purchaser of a financial service and the provider of that service. Third there is a group of issues about *responsible lending*. And fourth, there is a group of issues about *regulation and the regulators*.

The issues intersect and overlap in different ways. Putting the issues in groups should not be allowed to diminish the importance of identifying and responding to those intersections and overlaps.

8.1.1 Access

Do all Australians have adequate and appropriate access to banking services?

8.1.2 Intermediaries

- For whom do the different kinds of intermediary act?
  - mortgage brokers
  - mortgage aggregators
  - introducers
  - financial advisers
  - authorised representatives of Licensees

  - point of sale sellers of loans
- For whom should each kind of intermediary act?
- If intermediaries act for the consumer of a financial service
  - What duty do they now owe the consumer?
  - What duty should they owe?
- Who is responsible for each kind of intermediary's defaults?
- Who should be responsible?
- How should intermediaries be remunerated?
- Are **external dispute resolution** mechanisms satisfactory?
- Should there be a mechanism for compensation of last resort?

8.1.3 Responsible lending

- Consumers
  - Should the test to be applied by the lender remain 'not unsuitable'?
  - How should the lender assess suitability?
  - Should there be some different rule for some home loans?
- Should the NCCP Act apply to any business lending? In particular, should any of its provisions apply to:
  - SMEs?
  - agricultural businesses?
  - some guarantors of some business loans?
- To what business lending should the Banking Code of Practice apply?
  - Is the definition of 'small business' satisfactory?
- Should lenders adopt different practices or procedures with respect to agricultural lending?

- Are there classes of persons from whom lenders
  - should not take guarantees; or
  - should not take guarantees unless the person is given particular information or meets certain conditions?
- How should lenders manage exit from a loan
  - at the end of the loan's term;
  - if the borrower is in default?

8.1.4 Regulation and the regulators

- Have entities responded sufficiently to the conduct identified and criticised in this report?
- Has ASIC's response to misconduct been appropriate?
  - If not, why not?
  - How can recurrence of inappropriate responses be prevented?
- Has APRA's response to misconduct been appropriate?
  - If not, why not?
  - How can recurrence of inappropriate responses be prevented?

8.2 Causes

What were the causes of the conduct identified and criticised in this report?

- Conflict of interest and duty?
- Remuneration structures?
- Culture and governance?
- Regulatory response?

8.3 Responses

What responses should be made to the conduct identified and criticised in this report?

- Are changes in law necessary?
  - Should the financial services law be simplified?
  - Should carve outs and exceptions be reduced or eliminated? In particular, should
    - grandfathered commissions
    - point of sale exceptions to the NCCP Act
    - funeral insurance exceptions

    be reduced or eliminated?
- How should entities manage conduct and compliance risks?
- How should
  - APRA
  - ASIC

  respond to conduct and compliance risk?
- Should the regulatory architecture change?
  - Are some tasks better detached from ASIC?
  - Are some tasks better detached from APRA?
  - What authority should take up any detached task?
  - Should either or both of ASIC and APRA be subject to external review?
- What is the proper place for industry codes of conduct?
  - Should industry codes of practice like the 2019 Banking Code of Practice be given legislative recognition and application?

- Should an intermediary be permitted to
  - recommend to a consumer
  - provide personal financial advice to a consumer about
  - sell to a consumer

  any financial product manufactured by an entity (or a related party of the entity) of which the intermediary is an employee or authorised representative?
- Is structural change in the industry necessary?