Banking Royal Commission Impact Report

How the Banking Royal Commission affects CAs

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Although accountants hardly rate a mention in the Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, many of the recommendations will impact CAs in public practice, particularly those who provide financial planning services and those who work in APRA regulated entities.

Large and mid-tier firms providing specialist service offerings to clients in the financial services industry are likely to be heavily engaged in implementing Commissioner Hayne's recommendations.

Most importantly, Hayne envisages a shift to greater *professionalism* underpinned by ethical standards which are actually enforced. CAs in all fields should be heartened by this.

Chartered Accountants Australia and New Zealand has put together a brief overview of the Commissioner's major recommendations here.

Set out below are some initial observations by Chartered Accountants Australia and New Zealand on what the Final Report could mean for our members.

- Impact on financial planners
- Impact on superannuation advisers and funds
- Impact on tax advisers
- Impact on advisory and risk management services
- Impact on small business and farming clients
- Impact on valuers

Impact on financial planners

As expected, CAs working in financial planning are the group within our membership most affected by Commissioner Hayne's recommendations.

Annual renewal and payment (Recommendation 2.1)

Advisers will need to:

- seek annual renewal, in writing, of ongoing fee arrangements
- record, in writing, the services that will be provided and the associated fees; and
- mandate the client's express written authority for the payment of fees from any account held for or on behalf of a client given at, or immediately after, the latest renewal of the ongoing fee arrangement.

These requirements will apply for *all* clients. Currently, financial advisers are only required to seek clients' agreement for ongoing fee arrangements for new clients after 1 July 2013, and are only required to do this every two years

These changes will help ensure clients understand if their adviser is in receipt of any third party payments, as a wider range of advice activities will be caught under these provisions, including some which were carved out of the Future of Financial Advice (FoFA) reforms introduced in 2013.

For those advisers who have always disclosed their fees in full, this change will represent unnecessary further administrative work. It will, however, bring all advisers onto a level playing field which will be positive for client sentiment.

A 'best interests duty' (a statutory duty requiring persons who provide personal financial advice to act in the best interests of their clients) was brought in under the FoFA reforms in 2013. The reforms were meant for everyone who provided personal financial advice to retail clients and were initially aimed at ensuring retail clients understood exactly how their advisers were being remunerated by third parties. Mortgage brokers were not initially included.

It is proposed that the best interests duty provisions will be extended to mortgage brokers, which will be a positive for consumer protection. It is also proposed that the safe harbour provisions as they stand will be reviewed in three years' time, a reform that will be welcomed by many advisers.

Disclosure of lack of independence (Recommendation 2.2)

The Government will require advisers to provide a written statement to a retail client explaining why the adviser is not independent, impartial and unbiased before providing personal advice, unless the adviser is allowed to use those terms under section 923A of the *Corporations Act 2001*.

This is a good initiative for clients whose adviser is authorised by a product provider and therefore could be influenced by product sales. However, as the definition of 'independence' incorporates the receipt of any commission, even if the AFSL has no institutional ownership, this appears to be overkill.

Review of measures to improve the quality of advice (Recommendation 2.3)

There will be a review in 2022-23 on the effectiveness of FoFA reforms and the more recently introduced FASEA measures to improve the quality of advice.

CA ANZ has advocated that any inconsistencies between the previous FoFA reforms and the upcoming FASEA reforms will be addressed at the Government's earliest convenience.

The review will also encompass legislation currently before the Parliament to ensure that financial products are appropriately targeted and to give ASIC the power to intervene before a consumer suffers harm.

Grandfathered commissions (Recommendation 2.4)

In a widely expected move, the Government will end grandfathering of conflicted remuneration effective from 1 January 2021. Why?

The Government says:

- grandfathered conflicted remuneration "can entrench clients in older products even when newer, better and more affordable products are available on the market"; and
- grandfathering has been in place for over five years, and industry has had sufficient time to transition to new arrangements.

Also, the Government wants the benefits of removing grandfathering to flow to clients.

From 1 January 2021, payments of any previously grandfathered conflicted remuneration still in contracts will instead be required to be rebated to applicable clients who can reasonably be identified.

Where it is not practicable to rebate the benefit to an individual client (e.g. because the grandfathered conflicted remuneration is volume based so it is not able to be attributed to any individual client), "the Government expects industry to pass these benefits through to clients indirectly (for example, by lowering product fees)".

Whilst this is a good initiative in theory, it will be difficult to quantify whether or not insurance companies are passing on volume-based fees to clients indirectly.

Finally, "to ensure that the benefits of industry renegotiating current arrangements to remove grandfathered conflicted remuneration ahead of 1 January 2021 flow through to clients, the Government will commission ASIC to monitor and report on the extent to which product issuers are acting to end the grandfathering of conflicted remuneration for the period 1 July 2019 to 1 January 2021 and are passing the benefits to clients, whether through direct rebates or otherwise."

The Government also sees this as a response to the Productivity Commission's report Superannuation: Assessing Efficiency and Competitiveness which also recommended ending grandfathered trailing commissions.

Life risk insurance commissions (Recommendation 2.5)

ASIC will conduct a review to determine whether reforms made in 2017 to life insurance remuneration – capping the commissions a financial adviser receives for advising on the purchase of a life insurance product – have in fact "better aligned the interests of advisers and consumers".

Commissioner Hayne thinks ASIC should consider further reducing the cap on commissions in respect of life risk insurance products and, unless there is a clear justification for retaining those commissions, the cap should ultimately be reduced to zero.

CA ANZ thinks it likely that ASIC will conclude the reforms have not resulted in significant improvement. If we are right, the Government has already stated it will move to mandate level commissions, as recommended by the Financial System Inquiry.

This ASIC review will take account of the factors identified by the Hayne Royal Commission.

Ultimately, CA ANZ thinks all commissions – upfront and ongoing – for new life insurance products are likely to be banned, a position we support. However, for existing policies which are in the clients best interest to retain, we support the Government's view that product providers be required to rebate ongoing commissions to applicable clients.

General insurance and consumer credit insurance commissions (Recommendation 2.6)

Commissioner Hayne recommended that the review referred to in Recommendation 2.3 should also consider whether each remaining exemption to the ban on conflicted remuneration remains justified, including the exemptions for:

- general insurance products and consumer credit insurance products; and
- non-monetary benefits set out in section 963C of the Corporations Act 2001.
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The Government has agreed to review these remaining exemptions in the course of its review in three years' time on the effectiveness of measures to improve the quality of advice (see Recommendation 2.3).

Reference checking and information sharing (Recommendation 2.7)

The Government will *mandate* a reference checking and information-sharing protocol for financial advisers for all Australian Financial Services Licence (AFSL) holders.

References are already sought by ASIC in many cases.

This recommendation builds on recent work to remove advisers who have engaged in misconduct from the industry, particularly, through the establishment of the Financial Advisers Register and the FASEA reforms.

Facilitating licensees to undertake reference checks will make it even more difficult for advisers who engage in misconduct to find alternative employment in the industry.

Reporting compliance concerns (Recommendation 2.8)

The Government will mandate reporting of '*serious* compliance concerns' about individual financial advisers to ASIC on a quarterly basis.

An example given of a serious compliance concern is "where the licensee believes and has some credible information in support of the concerns identified that a financial adviser may have engaged in dishonest, illegal, deceptive and \ or fraudulent misconduct or any misconduct that, if proven, would be likely to result in an instant dismissal or immediate termination".

The Government has also agreed, in its response to Recommendation 7.2, to strengthen the obligations to report breaches to ASIC. The Government will implement this recommendation as part of strengthening the breach reporting requirements.

Misconduct by financial advisers (Recommendation 2.9)

All AFSL holders will be *required* to make whatever inquiries are reasonably necessary to determine the nature and full extent of an adviser's misconduct (when detected by the licensee) and inform and remediate affected clients promptly.

There are obvious important financial issues relevant here, such as the impact on professional indemnity arrangements.

This recommendation will be reinforced by the Government announcement to provide ASIC with a new directions power as part of its response to the ASIC Enforcement Review.

A new disciplinary system (Recommendation 2.10)

The Government will introduce a new disciplinary system for financial advisers in a bid to build professionalism in the financial advice industry. Again, this is seen as building on the FASEA reforms. "The new disciplinary system will bring financial advisers into line with other professions — such as lawyers, doctors and accountants — where individual registration is standard practice."

This disciplinary system for financial advisers will operate concurrently with the existing AFSL regime and ASIC will retain the powers it has under the current regulatory framework, including the power to commence investigations and undertake enforcement action.

CA ANZ will be interested to see if this new disciplinary body will be combined with any Government endorsed FASEA Code Monitoring Body.

No hawking of insurance (Recommendation 4.1)

The hawking of insurance products will be prohibited (consistent with Recommendation 3.4 about the hawking of superannuation products). However, the ability of insurers to contact policy holders in relation to existing policies will not be restricted.

The definition of hawking will be clarified to include selling of a financial product during a meeting, call or other contact initiated to discuss an unrelated financial product.

Impact on superannuation advisers and funds

No other role or office (Recommendation 3.1)

Trustees of Registrable Superannuation Entities will be prohibited from "assuming obligations other than those arising from, or in the course of, its performance of the duties of a trustee of a superannuation fund".

This is designed to address risks associated with dual regulated entities. The Royal Commission indicated that the conflicts of interests that arise between the interests of superannuation members and members of managed investment schemes are difficult to manage where an entity acts as a trustee for *both* the superannuation fund and the managed investment scheme.

CA ANZ supports this recommendation and the government's announcement that it will legislate it. To be effectively regulated this change will necessitate greater director disclosure to APRA and ASIC.

It is interesting that other areas were not also targeted such as the issue of the ownership of shares.

No deducting advice fees from MySuper accounts (Recommendation 3.2)

The deduction of any advice fees (other than for intra-fund advice) from MySuper accounts will be prohibited.

CA ANZ would like to see no advice fees – whether intra-fund or not – being deducted from MySuper accounts.

Limitations on deducting advice fees from choice accounts (Recommendation 3.3)

The Government will limit deductions of advice fees levied on non-MySuper superannuation accounts. This is seen as consistent with the Government's response to Recommendation 2.1 (which requires ongoing fee arrangements to be renewed annually in writing by the client, and prevents fees being deducted from the client's account without the client's express written authority).

CA ANZ would like to see a complete ban – not limitation – on any advice fees being taken from a non-MySuper account without the express written permission by the client.

No hawking (Recommendation 3.4)

The hawking of superannuation products will be prohibited, and the definition of hawking clarified to include selling of a financial product during a meeting, call or other contact initiated to discuss an unrelated financial product.

This announcement will not please the "one stop property spruikers" who have been pushing potential clients hard to set up a SMSF and invest in real estate using a Limited Recourse Borrowing Arrangement.

Care will be needed in drafting the enabling legislation to avoid any unintended consequences.

One default account (Recommendation 3.5)

The Government agrees with Commissioner Hayne that a person should have only one default account.

This is also seen as a response to the recent Productivity Commission's report *Superannuation: Assessing Efficiency and Competitiveness* which recommended members without an account only be defaulted once. It also builds on the action the Government has taken to address the stock of unintended multiple accounts through the Protecting Your Super Package, which includes the automatic consolidation of low-balance inactive accounts, capping fees for low-balance accounts and preventing inappropriate account erosion by ensuring members receive insurance policies that are suitable for them and represent value for money.

CA ANZ sees merit in this policy. However, the key to its success will be how the default is selected. It has been well telegraphed post the release of the Productivity Commission report into the super sector that some industry players do not like the single default fund model.
Australians will have ring-side seats watching how a potential new Labor government implements a Royal Commission recommendation that it, and some of its key supporters, do not appear to like.

At some point all employers may need to adjust their nominated default fund.

No treating of employers (Recommendation 3.6)

The SIS Act will be amended to prohibit trustees of a regulated superannuation fund (and their associates) doing acts – such as an invitation to the corporate box at the MCG or preferential fees or charges on other products such as loans or bank deposit products – which may reasonably be understood by the recipient to have a substantial purpose of having the recipient nominate the fund as a default fund, or having one or more employees of the recipient apply or agree to become members of the fund. ASIC will enforce a civil penalty provision for any breaches.

CA ANZ notes that efforts have been made to strengthen these provisions in the past and the Royal Commission's recommendation is the next welcome evolution of this process.

Civil penalties for breach of covenants and like obligations (Recommendation 3.7)

Trustees and directors will be subject to civil penalties for breaches of their best interests obligations. *The Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2017* currently before Parliament will establish civil penalties for directors for breaches of the best interests duty. This Bill will be amended to extend civil penalties to trustees.

Although this initiative has not been talked about much this is a highly significant change. The trustee covenants are a key plank of the SIS Act but to date there has been almost no mechanism for APRA to regulate compliance. And thus far there have been very few court cases against trustees for breaching these covenants.

For APRA and – depending on how regulatory functions are to be altered (see below) – potentially ASIC, the regulatory landscape is about to change.

At this point in time it does not appear that similar changes will be made to the trustee covenants applying to SMSF trustees.

Adjustment of APRA and ASIC's roles (Recommendation 3.8)

The roles of APRA and ASIC in superannuation will be adjusted to align with the general principles of the "twin peaks model", whereby APRA is the prudential regulator and responsible for system and fund performance, including for licencing and supervision, and ASIC is the conduct and disclosure regulator.

The Royal Commission suggested "ASIC should be given the power to enforce all provisions in the SIS Act that are, or will become, civil penalty provisions or otherwise give rise to a cause of action against an RSE licensee or director for conduct that may harm a consumer. There should be co-regulation by APRA and ASIC of these provisions … APRA should retain its current functions, including responsibility for the licensing and supervision of RSE licensees and the powers and functions that come with it, including any power to issue directions that APRA presently has or is to be given."

In response the Government merely says, "Regulators' responsibilities under the [SIS Act] will be shared in a way that aligns with ASIC and APRA's mandates." So, we will wait to see how these changes might be implemented.

The Government's response is also seen as a partial answer to the Productivity Commission's report *Superannuation: Assessing Efficiency and Competitiveness* which recommended clarifying the regulators' roles and powers.

Accountability regime (Recommendation 3.9)

Over time, provisions modelled on the Banking Executive Accountability Regime should be extended to all RSEs, another fundamental reform.

Impact on tax advisers

It may seem odd to raise tax issues given that Commissioner Hayne devotes almost no attention to this topic, however CAs specialising in tax have several reasons to be interested in the Final Report.

The tax treatment of compensation (recipient perspective)

The CA ANZ Tax Team has been liaising with the ATO on the income tax ramifications of receiving compensation from financial institutions.

The tax issues are complex and in total terms, we're talking about a lot of money here. According to Commissioner Hayne, "Between them, AMP, ANZ, CBA, NAB and Westpac will pay customers of their advice licensees or their superannuation funds compensation totalling $850 million, or more, for taking money as payment for services that were not provided". More compensation will no-doubt flow for other types of wrong-doing. This may be paid voluntarily, as because of successful litigation against financial entities.

The ATO has published some initial guidance and we understand more is under development on more complex issues, including the important area of advice for individuals where there are superannuation implications.

The tax treatment of compensation (payer perspective)

We suspect that the tax treatment of the massive amounts paid (or to be paid) by some large financial institutions will attract some ATO attention.

Payers naturally seek to treat such outlays on revenue account (deductible), but any financial penalties attracted for breach of the law or court convictions attract non-deductible treatment under section 26-5 of the Income Tax Assessment Act 1997.

The nexus between compensation or brand re-building outlays and goodwill (a CGT asset) is an interesting topic in tax circles.

Regulation of tax and financial advisers (Recommendation 2.10)

To say there is confusion about where tax advice ends, and financial planning advice begins, is a massive understatement. Throw SMSFs into a client conversation and the boundaries become even more blurred.

The Final Report cites the Tax Practitioners Board as a reason for recommending the mandatory individual registration of financial planners but the Commissioner fails to mentions the TPB's own struggle with demarcation lines between different types of service providers.

Hayne favours "a single, central disciplinary body for financial advisers" but does not expound on his preferred model, acknowledging the resourcing issues and suggesting this is a matter for government.

CA ANZ will watch this topic with keen interest.

Impact on advisory and risk management services

Chartered Accountants working in advisory and risk management roles will learn much from the Final Report about how systemic risks can develop within large financial institutions despite the good intentions of employees, senior managers and Board members.

CA ANZ suspects that those with Board and C-suite advisory skills will be in demand.

The role of the Board

Commissioner Hayne highlights the important role of the Board in effectively challenging management and following through to see if its decisions have been implemented. His summary of two case studies – that involving the Commonwealth Bank of Australia and its CML\CTF compliance issues (para 3.1.1), and the National Australia Bank's charging adviser fees to members of superannuation funds (para 3.1.2) – are sobering.

The *quality* of communications between the Board and management, as well as the interrogative ability of audit committees are squarely raised. The Commissioner also says Boards must do more to first ascertain who is actually accountable, and then create a culture of accountability.

Hayne's poses the question simply: Is the Board getting the *right, quality* information?

Engagement with regulators

The quality of the engagement between financial institutions and regulators was also found wanting in a number of case studies.

Negotiations with regulators tended to be prolonged. It took too long to report breaches and in deciding what was to be done.

Communication is a two-way street, and both regulators and the regulated clearly need to improve.

Re-setting Board priorities in the wake of the Final Report

Commissioner Hayne's comments on the priorities a Board should have in carrying out its task may prompt a re-assessment of priorities.

Hayne argues that the Board's focus should not just be on shareholders, but rather on the corporation itself. This he says, "demands consideration of more than the financial returns that will be available to shareholders in any particular period".

Any re-setting of Board priorities clearly requires a well though through communication strategy for the many stakeholders who keenly observe Board decision-making.

Management of non-financial risk

The Final Report highlights the difficulties encountered by management in addressing the types of risk associated with misconduct – compliance risk, conduct risk, regulatory risk and operational risk.

Hayne acknowledges these are more difficult to measure than most types of financial risk but says "financial services entities must give sufficient attention, and devote sufficient resources, to the effective management of non-financial risks". He urges APRA to consider how that requirement can be made more prominent in its prudential standards.

Ethics and cultural issues

Commissioner Hayne clearly thinks some entities are unwilling to recognise and accept responsibility for misconduct.

He warns against tokenism by any entity that "contents itself with statements of purpose, vision or values, too often expressed in terms that say little or nothing about those basic standards that underpin both the concept of misconduct and the community's standards and expectations".

Impact on small business and farming clients

Avoiding a credit drought

Treasurer Josh Frydenberg was careful to preface the Government's response by saying that, in undertaking the reforms, the Government would ensure that the financial system continues to provide consumers and small businesses with access to credit and other affordable financial services.

Exactly how it would do this was not spelt out.

At a practical level, lending institutions may well look to CAs to do even more to support their SME and rural clients loan applications with expert analysis and forecasts.

Helping small business access to redress

Some CAs may be in a position to help their small business clients seek redress for wrongdoing identified by the Royal Commission, working hand in hand with legal advisers to help quantify losses.

The Treasurer's response said he would go beyond the Royal Commission's recommendations by:

- paying around $30 million in compensation owed to almost 300 consumers and small businesses for the unpaid determinations of the Financial Ombudsman Service and the Credit and Investments Ombudsman;
- establishing for the first time an industry-funded and forward looking compensation scheme of last resort to be administered by AFCA as recommended by the Royal Commission;
- expanding the remit of the Australian Financial Complaints Authority (AFCA) for a period of 12 months to accept applications for disputes dating back to 1 January 2008 (the period covered by the Royal Commission) for disputes that fall within AFCA's thresholds. The aim is to ensure that consumers and small businesses that have suffered from misconduct but have not yet been heard will be able to take their cases to AFCA and have them considered; and
- strengthening oversight and transparency of financial entities' remediation activities by enhancing AFCA's role in the establishment and public reporting of firm remediation activities.

Compensation scheme of last resort (Recommendation 7.1)

Small business clients can look forward to the establishment of an industry-funded, forward-looking compensation scheme of last resort (CSLR). The CSLR will operate as a last resort mechanism to pay out compensation owed to consumers and small businesses that receive a court or tribunal decision in their favour or a determination from the Australia Financial Complaints Authority but are unable to get the compensation owed by the financial firm (e.g. because the firm has become insolvent).

The timing for the establishment of the CSLR as part of AFCA is unclear.

Insurance commission-based businesses and mortgage brokers

The business models of insurance commission-based businesses and mortgage brokers will suffer as a result of the Royal Commission's conflicted remuneration recommendations. Note however that the Government's response to the mortgage broker recommendations are not on all fours with Hayne's Recommendation 1.3.

In all the brouhaha surrounding these recommendations, it is easy to overlook that those impacted are often small businesses. Clients in these sectors will need advice on redesigning their business strategy and some may consider diversifying to attract new income streams.

Farming clients (Recommendation 1.14)

Some CAs will play a future role in assisting their farming clients work through new national farm debt mediation processes recommended for loans classified as distressed.

There will also be some accounting challenges in identifying when the charging of default interest should cease "when there is no realistic prospect of recovering the amount charged".

Rural CAs will be delighted in Commissioner Hayne's recommendation that, when dealing with distressed agricultural loans, banks should ensure that those loans are managed by experienced agricultural bankers whose goal will be to seek the best outcome for both the bank and borrower, with enforcement (foreclosure) "the worst".

CAs specialising in solvency may however question whether the Commissioner has it right when he says banks providing farm finance should “recognise that appointment of receivers or any other form of external administrator is a remedy of last resort”.

This may not be popular, but CA ANZ believes there will always be some situations where early intervention for any business which is clearly uneconomic is desirable for all concerned.

Impact on valuers

Valuing land (Recommendation 1.12)

CAs will also need to boost their network of trusted, competent valuers. In valuing agricultural and other land, APRA has been tasked to amend Prudential Standard APS 220 to:

- require that internal appraisals of the value of land taken or to be taken as security should be independent of loan origination, loan processing and loan decision processes; and

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

CAs specialising in valuation take note.