Australian Banking Association

Submission to the Royal Commission Interim Report

Australian Banking Association

26 October 2018

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About ABA

With the active participation of 24 member banks in Australia, the Australian Banking Association provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services.

The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and community. It strives to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

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Introduction

There are no excuses for the behaviour that has been exposed by the Royal Commission.

We as Australia's banks accept full responsibility for these failures and right now are working to make this right for customers who have been hurt. The ABA thanks all those customers who have come forward to give evidence along with Commissioner Hayne and his team for the comprehensive examination of the issues.

It is clear throughout the report, and the hearings, that there were several themes of unacceptable behaviour. These include a focus on sales rather than service, poor culture and the way staff and third parties were paid.

The industry acknowledges that over a number of years the prevailing culture of Australian banking failed our customers.

Simply put:

- The focus was not always on the customer.
- We have been short-sighted.
- Our approach has been too technical, legalistic, complicated and not 'human enough'.
- The way staff were paid was not always in the customer's best interest.

The Royal Commission has been an important wake-up call for the industry and is showing banks the necessary path to earn back the trust that has been lost. Banks acknowledge the great responsibility of operating a business that plays such a crucial role in the lives of everyday Australians.

Australian banks must serve and treat customers fairly, as well as contributing to a strong Australian economy.

Individual banks are each making significant efforts to change their structures, processes and culture to ensure there is no repeat of the cases heard at the Commission. Further to this ABA members are making industry-wide changes, including:

- An industry wide and individual bank commitment to implement in full the Banking Code of Practice
- A renewed focus on the Statement of Guiding Principles – Trust and Confidence, Integrity, Service, Transparency and Accountability[1], and
- Implementing the recommendations of the Sedgwick Review to change remuneration structures and governance culture and performance management.

These efforts have already begun and they won't stop until we've earned back the trust from all the Australians we serve.

[1] The Australian Banking Association, The Banking Code of Practice, September 2018 available at http://www.ausbanking.org.au/images/uploads/Banking_Code_of_Practice_2019_web.pdf, Page 5 [EXHIBIT 3.144.4 - ABA.001.008.0434 - EXHIBIT AB-1-4 - ABA-#133505-v1-Banking_Code_(all_changes_reflected_-_ASIC_approval_process)]

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Summary of positions

Background

Purpose of banking

- The banking industry must serve and treat its customers fairly, and perform key functions to contribute to economic wellbeing, through efficient, resilient and fair operation.
- Australia's banks have an important and privileged role in the community. Banks are rightly held to a higher standard and must balance their obligations to customers, communities, staff and shareholders.

Competition

- Competition can discipline banks to serve their customers well, to innovate and to drive better customers outcomes. Competition within the banking industry should continue to be strengthened and reforms in the industry should promote competition.

Financial benefits and remuneration

Retail banking remuneration

- Australia's banks must be profitable but profit is a tool to achieve the interests of all stakeholders and is not an end in itself.
- ABA members accept that remuneration structures need reform to address conflicts of interest while providing appropriate incentives to attract and retain well qualified staff who to contribute to the long-term profitable performance of the bank.
- The banking industry's implementation of the recommendations of the Sedgwick Review provides an essential and effective basis for remuneration reform in the industry.
- ABA members believe the Commission should consider the repeal of the FOFA ADI exemption, provided any changes are consistent with the continued use of balanced scorecards where financial measures are allowed but are not the dominant factor and are in line with the Sedgwick recommendations.
- When aligned with recommendation 13 of the Sedgwick Review and the expectations of APRA, financial performance measures do have a role in managing risk.

FOFA grandfathering

- The banking industry accepts the inherent conflicts of interest connected with grandfathered conflicted remuneration and supports legislation to repeal the conflicted remuneration grandfathering provisions set out in ss 1528, 1529 and 1531 of the Corporations Act.

Mortgage broking

- Mortgage broking is critical to competition in home lending and the banking industry supports a sustainable, vibrant and viable mortgage broking industry.
- ABA members are adopting the recommendations of the Sedgwick Review (through the Combined Industry Forum) and have accepted that commissions paid to mortgage brokers need to be structured to minimise the risks of mis-selling.

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Fees

- ABA members will only charge fees for the provision of ongoing advice where the specific services agreed to in an ongoing service agreement are delivered.
- ABA members will adopt three new principles to make fees for ongoing advice fairer and more transparent.
- ABA members support legislation to remove the grandfathering of pre FOFA clients under the opt-in regime.
- The ABA, on behalf of its members, will apply to ASIC to include new provisions to the Banking Code of Practice to change the requirements for managing fees to deceased estates.

Business structures and vertical integration

- ABA members believe that institutions should retain flexibility to determine the extent of vertical integration in their businesses and do not support prohibiting vertical integration in financial services.

Banking services and industry practice

Responsible lending

- The current responsible lending legislation is appropriate and fit for purpose.
- ABA members believe there is a clear role for the continued use of an appropriately developed expense benchmark.
- ABA members support the current flexibility to scale inquiries as it is an important feature of the responsible lending framework and should be maintained.

Protections for small business lending

- The new ASIC approved Banking Code of Practice provides a significant increase in additional protections for small business and agricultural lending customers and should be allowed to operate and be reviewed before any further changes are made.
- ABA members agree with the Commission that additional regulation for small business loans, should not be recommended by the Commission.
- The definition of small business in the new Code is fit for purpose, noting any change could have a significant impact on smaller lenders and lessen competition.

Agricultural lending

- Valuations should be based on market value and conducted by suitably qualified and experienced external valuers or internal appraisers. This is international best practice.
- ABA members agree that distressed loans should be managed by suitably qualified bank professionals, either agribusiness bankers or specialist staff.
- ABA members do not support legislative or regulatory prescriptions on the charging of default interest as this would impede the flexibility that should be exercised by banks in difficult circumstances for agribusiness customers.
- ABA members continue to support a nationally consistent model for Farm Debt Mediation.

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Assisting low income and vulnerable customers

- ABA members agree that more should be done to promote fee-free accounts to eligible customers, particularly to customers with no other substantial income other than Centrelink benefits.
- ABA members agree that banks who offer informal overdrafts in basic bank accounts should have policies in place to ensure customers do not get into any significant amount of debt or exacerbate financial hardship and comply with the Code of Operation.
- The Banking Code of Practice provides a sound basis for ABA members to put in place appropriate policies and procedures to assist Aboriginal and Torres Strait Islander customers, including a flexible approach to identification.

Add-on insurance

- The banking industry has implemented an important protection through the deferred sales model in the new Banking Code of Practice and does not believe that consumer credit insurance (**CCI**) should be banned as it is appropriate for some customers, particularly for home loans.

Conduct risk, governance and risk management

Accountability in banks

- ABA members believe the Banking Executive Accountability Regime (**BEAR**) should apply consistently across APRA's regulated population, to include other financial services providers such as insurance and superannuation, not just banks.
- The ABA believes there is merit in considering how the elements of the Conduct Background Check Protocol could apply across the industry as such community owner banks.
- ABA members support making the ABA Reference Checking and Information Sharing Protocol compulsory for the entire financial advice industry.
- ABA members support an expanded obligation for licensees to report significant breaches or other significant misconduct by an employee or representative to ASIC.

Remediation

- To address the issues of inconsistency, ABA members propose that ASIC Regulatory Guide 256: Client Review and Remediation Conducted by Advice Licensees should be expanded to all financial advice and products.

Duties of intermediaries – mortgage brokers

- ABA members agree that the best way to manage the conflicts of interest is by imposing a duty on mortgage brokers to put their clients' interests ahead of their own.
- If a Best Interests Duty is proposed, ABA members believe this duty should be performed by:
  - The customer obtaining a loan that is appropriate (in terms of size and structure), is affordable, applied for in a compliant manner and meets the customer's set of objectives at the time of seeking the loan, and
  - The customer's interests are prioritised over the brokers.

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Future regulatory reform

Banking codes of practice

- Self-regulation through an industry code is an important supplement to the regulatory framework and sets a higher minimum standard of practice. Banking codes can set standards that are subsequently legislated but codes as a whole should not be given legislative status as this would remove or reduce the advantages of self-regulation.
- The advantages of self-regulation are retained under the co-regulatory model proposed by the ASIC Enforcement Review, and to which ABA members will already in effect commit, when they subscribe to the ASIC-approved Banking Code of Practice.

Regulation and the Regulators

- ASIC's approach to enforcement should encompass the commencement of legal proceedings where justified by reference to public interest considerations, including deterrence and the character of the conduct, but its discretion to choose the appropriate response from its regulatory toolkit should not be arbitrarily restrained.

Simplification

- The regulatory regime for financial services is complex and simplification could, where appropriate, provide benefits for customers, regulators and the industry.
- Any program of reform should be targeted and progressive, and appropriately limited in scope. Large scale reform would be complex, costly and time-consuming, and paradoxically, risk increasing the burden to all parties. The burden of legislative reform can fall disproportionately on non-major banks and have a detrimental impact on competition.

Consistent consumer protection

- ABA members support consistent customer protection across the industry. It shouldn't matter which institution a customer chooses, they should enjoy the same protections and standards of service.

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1. Background

1.1 Purpose of banking

The banking industry must serve and treat its customers fairly, and perform key functions to contribute to economic wellbeing, through efficient, resilient and fair operation. Such purposes are of clear interest to the public.

Many ABA members[2] have developed and articulated this purpose by publishing the bank's corporate values and purpose, centred on their contribution to the wellbeing of their customers and the communities in which they operate.[3] Many banks publicly recognise their obligations to customers, communities, staff and shareholders.

The Final Report of the Financial System Inquiry (**FSI**)[4] explained that the financial system's ultimate purpose is "to facilitate sustainable growth in the economy by meeting the financial needs of its users, through efficient, resilient and fair operation."[5] The recommendations of the FSI offered a blue print for "an efficient and resilient financial system…, characterised by the fair treatment of users".[6]

ASIC[7] has described the financial system's purpose as "to serve core functions for everyday Australians" and quoting Professor John Kay[8] describes four key functions:

- capital allocation
- inter & intra generational transfers of wealth
- hedging and insuring against risks, and
- the payment system.

1.1.1 Why does purpose matter?

The banking industry should be defined by:

- **A service culture focused on the customer**
- **Efficient performance of key functions that serve the public,**
- **Enabling the Australian economy and contributing to the economic wellbeing of Australians, and**
- **A strong focus on risk and compliance with the law.**

[2] ABA members are listed on our website: https://www.ausbanking.org.au/about-us/members/. The views expressed are those of AMP Bank, rather than AMP Group.
[3] For example, ANZ's purpose is to "shape a world where people and communities thrive". Bank Australia states "While we are a profitable bank, that's not why we exist. We're here to provide Australians with a responsible banking alternative". Bendigo and Adelaide Bank's vision is "to be Australia's bank of choice and our purpose is to feed into the prosperity of our customer and their communities, not off it." CommBank state "We have a simple purpose: to improve he financial wellbeing of our customers and communities. Our purpose guides our strategy." Suncorp's purpose is "to create a better today for our customers, communities, people and shareholders." Westpac's purpose is "To be one of the world's great service companies, helping our customers, communities and people to prosper and grow."
[4] The Australian Government the Treasury, *The Financial System Inquiry Final Report*, 7 December 2014, available at http://fsi.gov.au/publications/final-report/, EXHIBIT 2.1.24 - ASIC.0902.0001.0581 - Exhibit PK - 22 Financial System Inquiry – Final Report]
[5] *The Financial System Inquiry Final Report*, Page XV. EXHIBIT 2.1.24 - ASIC.0902 0001.0581 - Exhibit PK - 22 Financial System Inquiry – Final Report]
[6] *The Financial System Inquiry Final Report*, EXHIBIT 2.1.24 - ASIC.0902.0001.0581 - Exhibit PK - 22 Financial System Inquiry – Final Report]
[7] ASIC, *The Trust Deficit and Corporate Australia Keynote address by James Shipton, Chair, Australian Securities and Investments Commission Australian Council of Superannuation Investors Annual Conference (Sydney, Australia),* 17 May 2018, available at https://asic.gov.au/about-asic/news-centre/speeches/the-trust-deficit-and-corporate-australia-acsi-conference-2018/
[8] John Kay, Other people's money: The real business of finance, Public Affairs, 27 September 2016.

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Failing to recognise an ethical public purpose can lead to misconduct. The Commission has noted "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".[9]

The Royal Commission is an opportunity for the banking industry to reconnect with the public purpose of banking to define (and redefine) its objectives and culture.

Most importantly the banking industry should recognise that the provision of financial products and services "is a means to an end, not an end in itself".[10]

1.1.2 The role of banking for customers

Australia's banks have an important and privileged role in the community. Banks are rightly held to a higher standard than other service providers and must balance their obligations to customers, communities, staff and shareholders.

Banks enable everyday Australians to buy a house, start a small business, pay a bill and meet their savings goals.

Banks employ over 130,000 people and make significant community investments through financial contributions to research and community organisations, community grants and scholarships, financial support to micro finance and no interest loan providers.

Australia's banks play an important role in the economy. As noted in the Interim Report, the banking system is a central artery in the body of the economy.[11] The finance and insurance sector are the biggest contributor to the Australian economy with 9.5 per cent of GDP in 2017-18 which equates to an economic contribution of $155 billion.

Given the importance of banks, when things go wrong, the impacts on the community - whether it be a business, farmer or individual - can be significant.[12] The fair and efficient operation of banking is essential for customers, for the economy and for meeting wider public policy objectives.

Banking services can be complex, unfamiliar and often difficult for consumers to understand. Customers may not be engaged and may not be able to identify errors. Banks knowing more than the customer, therefore creating an unintended power imbalance, is long standing and difficult to overcome. Therefore, customers tend to (and should be able to) rely more on banks to provide this information and advice about their banking.

1.2 Benefits and importance of a stable and competitive banking system for customers

Competition can discipline banks to serve their customers well, to innovate and to drive better customer outcomes. Competition within the banking industry should continue to be strengthened, and reforms in the industry should promote competition.

The regulation of banks should reflect the purpose of banking and the banking industry's role as a critical enabler of the economy. Banks should also be regulated in a way that promotes competition innovation and product differentiation. Such an approach contrasts with the regulation of basic utility services which are highly commoditised and generally only differentiated on price.

ABA members believe that regulatory changes considered by the Commission should seek to promote competition. Competition generates incentives to act efficiently while meeting the needs and

[9] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Interim report, 28 September 2018, available at https://financialservices.royalcommission.gov.au/Documents/interim-report/interim-report-volume-1.pdf, Page 54.
[10] ASIC, Keynote speech: A new era for conduct regulation in Australia. A speech by James Shipton, Chair, Australian Securities and Investments Commission at the Thomson Reuters Australian Regulatory Summit (Sydney, Australia), 11 April 2018, available at: https://asic.gov.au/about-asic/news-centre/speeches/keynote-speech-a-new-era-for-conduct-regulation-in-australia/
[11] *Interim report*, Page1
[12] *Interim report*, Page 14

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preferences of customers. The terms of reference reflect this importance by noting competition specifically as a factor to be considered by the Commission when making recommendations.[13]

Competition creates rivalry between providers that is necessary for customers to share fully in the benefits of having a strong financial system. Competition shows customers that they have many choices and can shop around. More than just price rivalry, competition drives innovation and overall value for customers.[14] Examples of how innovation has changed Australian financial services are clear. Australians have ready access to funds at all hours of the day, can get rapid home loan approvals, quickly and safely move money between accounts and pay for products with the tap of a card, smartphone or watch.

The overall service offering of banks is not homogenous and is continually changing to better meet customer needs as a result of competition. These practices have been done in different ways that suggest a fair level of service competition among ADIs.[15] For example, larger banks offer a broader suite of products and a national branch network, this is attractive to consumers due to its convenience. Some smaller banks and credit unions provide services that are tailored to the needs of their local communities, as well as their regional focus.

Products are also significantly differentiated. For example, while all mortgage lending serves the same purpose to access credit secured by a property, the product features across different lenders can vary significantly. These features have been developed to meet specific customer needs. For example, some mortgages provide offsets, lines of credit, and can be linked to small business finances.

1.2.1 Competition law compliance

The industry is limited in the ways it can agree to change its practices as a result of competition law. Many of the recent changes in the banking industry, such as elements of the ABA banking reform program, the commitments through the Combined Industry Forum (**CIF**) and the changes to industry practice through the new Banking Code of Practice are industry led.

ABA members prioritise industry led changes. These changes are often designed using industry expertise and experience, can be well targeted and delivered more quickly than legislated changes. However, there are limits to the way and extent to which changes in industry practice can be agreed. The requirements of Competition and Consumer Act mean that banks cannot generally agree to detailed changes to how products and services are priced or offered, or the features of a product or service, even when those features are intended to improve consumer protection.

Depending on the type of change considered, it may only be open to industry to agree a general principle or seek legislative reform.

1.3 Recent changes to banking industry practice

Banks are determined to create an industry which better balances customer protection, competition and system stability. The greatest opportunities to effect change are through:

- A shared industry purpose
- An industry wide and individual bank commitment to implement in full the Banking Code of Practice
- A renewed focus on the new Banking Code of Practice's Statement of Guiding Principles – Trust and Confidence, Integrity, Service, Transparency and Accountability, and
- Implementing the recommendations of the Sedgwick Review to change remuneration structures and governance culture and performance management.

[13] Governor-General of the Commonwealth of Australia, *Letters Patent No 52 page 67*, 14 December 2017, available at: https://financialservices.royalcommission.gov.au/Documents/Signed-Letters-Patent-Financial-Services-Royal-Commission.pdf, Section (k).
[14] Productivity Commission, *Competition in the Australian Financial System, Report No. 89*, Canberra, 29 June 3 August 2018, available at https://www.pc.govs.au/inquiries/completed/financial-system/report/financial-system.pdf Page 3
[15], *Competition in the Australian Financial System, Report No. 89* Page 113.

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There is much work to be done on these initiatives however the industry has not stood still and is already implementing a reform program to address these issues.

The Banking Reform Program, announced in July 2016, identifies six key areas for reform. The importance of these reforms has been highlighted throughout the public hearings of the Royal Commission and in the Interim Report.

These key reforms are:

1) Reviewing product sales commissions and product-based payments (Sedgwick Review)
2) Dedicated Customer Advocates in banks to ensure a 'customer lens' is applied to everything from product design to resolving complaints
3) Whistleblower protections. The ABA has published new guidelines to ensure banks meet the highest whistleblower standards and promote a 'speak out' culture
4) Removing individuals from the industry for poor conduct. The industry has implemented a Conduct Background Check (CBC) process to identify poor conduct and stop it moving around the industry
5) Industry funded ASIC model. A user pays model means the costs of regulation are borne by those entities that have created the need for it
6) The new Banking Code of Practice. Approved by ASIC in July 2018, the Code sets a new standard in customer protections. The Code will be strictly monitored and enforced by a strengthened oversight committee.

The Banking Reform Program comes on top of an era of immense regulator change for the industry. Across the board the Government has made significant industry changes to regulation, the complaints handling process (through the creation of the 'one-stop shop' Australian Financial Complaints Authority) and tax arrangements.

ABA members have announced several changes in products, processes or procedures that had been the subject of inquiry. As noted in the Interim Report "as the Commission went on with its work, entities and regulators went on about theirs."

In July, the ABA received ASIC approval for the Banking Code of Practice which offers increased customer protections for individuals, small business and agricultural customers.[16]

1.4 Submission structure

This submission addresses the issues raised by the Interim Report using a thematic structure covering:

- Financial benefits and conflicts of interest
- Banking services and industry practice
- Conduct risk, governance and risk management, and
- Future regulatory reform.

This structure allows the submission to consider the common themes that arose across the case studies presented in hearing rounds 1-4.

[16] The Australian Banking Association, *A new higher standard in Australian banking*, Media Release 31 July 2018, available at https://www.ausbanking.org.au/media/media-releases/media-release-2018/a-new-higher-standard-in-australian-banking

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2. Financial benefit and conflicts of interest

The Commission observed that "the conduct identified and criticised in this report was conduct that provided a financial benefit to the individuals and entities concerned."[17] The Interim Report noted that the culture and conduct of banks was driven by, and was reflected in, their remuneration practices and policies.[18]

The issues addressed below are:

- Remuneration
- Fees
- Business structures – Vertical integration

2.1 Remuneration

ABA members accept that remuneration structures need reform to address conflicts of interest while providing appropriate incentives to attract and retain well qualified staff who contribute to the long-term profitable performance of the bank. This process is underway through reforms announced in April 2017 in response to the Retail Banking Remuneration Review (Sedgwick Review).

Evidence before the Commission shows that some of the industry's remuneration practices have led to misconduct and conduct falling below community standards and expectations.[19] As noted by the Commission, some remuneration structures can allow greed and self-interest to trump acting in the best interests of the customer. Not all banks have these remuneration practices, however many banks subject to this inquiry have changed or are in the process of changing these arrangements.

Variable remuneration in banking developed to provide incentives for staff to grow the bank business and contribute to the profitability of the bank. However, these incentives were overly weighted to sales and growth, and did not reward good customer service.

Often the discussion of conflicted remuneration infers that if a bank is profitable, it must be associated with bad behaviour and poor customer outcomes. This is not borne out by the evidence heard by the Commission. Instead, it shows that it is how a bank goes about achieving its profitability, such as having a short-term focused culture rather than a long-term focus, which leads to poor conduct.

2.1.1 Why does profit matter?

Australia's banks must be profitable, but profit is a tool to achieve the interests of all stakeholders and is not an end in itself.

The Commission rightly identified the perils of pursuing profit through short-term market growth strategies. These strategies did not serve the existing loyal customers, or the reputation of the bank. As noted by APRA, "the fundamental principle underlying the (prudential) remuneration requirements is that performance-based components of remuneration must be designed to encourage behaviour that supports the regulated institution's long-term financial soundness."[20]

While remuneration needs to be reformed, bank profitability is important to both mutual and publicly owned banks. Consistently strong and profitable institutions can be beneficial for consumer and investor confidence, which, in turn, lowers the cost of funds and return required on investment.[21]

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[17] Royal Commission into Misconduct in the Banking, *Superannuation and Financial Services Industry*, Interim report, 28 September 2018, available at https://financialservices.royalcommission.gov.au/Documents/interim-report/interim-report-volume-1.pdf, Page 301.
[18] *Interim report*, Page 340.
[19] The following banks do not have volume and value incentives for their frontline staff: Citi Bank Australia, Bendigo and Adelaide Bank, ME Bank, Rabobank and Bank of Australia.
[20] APRA, *Information Paper: Remuneration practices at large financial institutions*, April 2018, available at https://www.apra.gov.au/sites/default/files/180328-Information-Paper-Remuneration-Practices.pdf.
[21] Productivity Commission, *Competition in the Australian Financial System*, Report No. 89, Canberra, 29 June, available at https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf, Page 12.

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Both shareholders and customers benefit from a strong and profitable banking system to:

- **Secure reasonable borrowing costs:** The current level of offshore funding is $520 billion (ABS National Accounts) which is about 20% of banks' funding.
- Australian banks source on average around 20 per cent of their funding from offshore.[22] This funding is used to provide mortgage, business and agricultural loans and other forms of credit. **Access to these funds, and the price at which they can be sourced affects interest rates for Australian borrowers**.
- **Provide for prudential strength and stability:** Profits allow banks to meet regulated capital requirements that underpin the strength and security of the system.
- **Reinvest in customer benefits:** Investment in banking is critical to ensure banking systems, security protections and technology functionality for 24/7 service is continuously improved for the benefit of individual and business customers. Australian banks compete on and lead the way internationally on digital and payments innovation and service.
- **Build the retirement funds of Australians:** Around 75 per cent of banks' post-tax profits are paid out in dividends to shareholders with $25.6 billion being paid in 2016. About three quarters of the major banks' shares are owned by domestic shareholders. Some of the largest shareholders in Australian banks are superannuation funds. Strong returns to these shareholders build the retirement security of Australians.

2.1.2 Industry remuneration reforms – implementation of the recommendations of the Sedgwick Review

The banking industry's implementation of the recommendations of the Sedgwick Review provides an essential and effective basis for remuneration reform in the industry.

In 2016 ABA members recognised that remuneration practices needed to change. The ABA commissioned former Australian Public Service Commissioner Stephen Sedgwick AO to undertake the Retail Banking Remuneration Review[23] (**Sedgwick Review**) to examine practices across ABA members. The Sedgwick Review was published in March 2017 and found that some of the remuneration practices (as they stood on March 2017) "carry an unacceptable risk of promoting behaviour that is inconsistent with the interests of customers and should be changed."[24]

ABA members accepted that remuneration needed to be reformed and made individual decisions to implement all 21 recommendations, overhauling remuneration, performance measurement, incentives and culture.[25]

Implementing the recommendations of the Sedgwick Review means:

- No longer paying retail bank employees incentives based directly or solely on sales.
- Where incentives are paid, they are based on a range of measures of which financial measures is not the dominant component.
- Incentives paid are product neutral and no longer include payments related to additional products or cross-selling products.
- Aligning variable pay of all senior and middle level executives with the objectives of the recommendations for front line staff, and with customer oriented, ethical behaviour and non-financial measures being the dominant factors in variable pay.

[22] Australian Bureau of Statistics, *Australian National Accounts: Finance and Wealth Catalogue No 5232.0*, June 2018, available at http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/5232.0Jun%202018?OpenDocument
[23] Stephen Sedgwick AO, *Retail Banking Remuneration Review Report*, 19 April 2017, available at https://www.betterbanking.net.au/wp-content/uploads/2018/01/FINAL_Rem-Review-Report.pdf EXHIBIT 3.34.163, [BOQ.0001.0051.0001
[24] *Retail Banking Remuneration Review Report*, Page I
[25] *Retail Banking Remuneration Review Report*, Page 7

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- Examining workplace culture and leadership frameworks to ensure they are aligned with good customer outcomes.
- Increasing transparency of remuneration arrangements with third parties, such as mortgage brokers, including stopping payments directly linked to loan size and introducing more robust performance management like that used with employees.

Implementation is well underway and will be completed no later than the performance year that begins in 2020. This 2020 date is recommendation 1 of the Sedgwick Review and was set having regard to the scale of adjustment and the potential need transitional arrangements.[26]

2.1.3 Repeal of ADI exemption for conflicted remuneration

ABA members are committed to implementing the recommendations of the Sedgwick Review, which include the removal of incentives directly linked to sales, the reduction of financial measures within balanced scorecards, and variable reward payments being based on an overall assessment against a range of factors.

ABA members believe the Commission should consider the repeal of the FOFA ADI exemption, provided any changes are consistent with the continued use of balanced scorecards where financial measures are allowed but are not the dominant factor and are in line with the Sedgwick recommendations.

The Commission questioned why the exceptions to the conflicted remuneration prohibitions should be maintained.[27] The intention of the FOFA reforms was to reform remuneration and conduct of financial advisers. The FOFA reforms provided a limited exemption to the conflicted remuneration requirements for ADIs (s963D).

The Sedgwick Review built upon the FOFA reforms and made recommendations to further strengthen the alignment of retail bank incentives, commissions and bonus payments (variable reward payments), with good customer outcomes.

2.1.4 The role of financial measures in variable pay

When aligned with recommendation 13 of the Sedgwick Review and the expectations of APRA, financial performance measures do have a role in managing risk and should be part of a balanced scorecard. This balancing will require removing certain conflicted remuneration, managing remaining conflicts through good conduct and governance processes, and incentivising employees to advance and protect the financial health of both the bank and their customers.

Recommendation 13 of the Sedgwick Review requires the variable reward payment and performance management arrangements of all senior and (retail bank) middle level executives to be based on overall performance against several measures, and for non-financial measures to be dominant in that assessment. BEAR is also reforming the remuneration structures for senior executives. To respond to the Sedgwick Review and to manage conduct risks related to variable pay, banks are strengthening existing performance measures to ensure good customer outcomes are forefront in any criteria by which staff and managers are assessed.

The language varies, but consistently banks are including ‘gateways’ where staff are assessed on meeting and exceeding the bank’s values and conduct standards. Typically, once a staff member passes that gateway successfully, their performance is then assessed on a balance scorecard which includes measures on:

- Customer outcomes
- Risk Management

[26] Stephen Sedgwick AO, *Retail Banking Remuneration Review R*eport, 19 April 2017, available at https://www.betterbanking.net.au/wp-content/uploads/2018/01/FINAL_Rem-Review-Report pdf, Page 12. EXHIBIT 3.34.163, BOQ.0001.0051.0001].
[27] Royal Commission into Misconduct in the Banking, *Superannuation and Financial Services Industry*, Interim report, 28 September 2018, available at https://financialservices.royalcommission.gov.au/Documents/interim-report/interim-report-volume-1.pdf , Page 93.

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- Financial performance, and
- Leadership and people.

Cognisant of the concern the Commission had on the link between financial incentives and poor customer outcomes, banks are actively addressing this concern at all staff levels in their banks and there is a strengthening of the tangible financial consequences when these expectations are not met.

APRA recently[28] emphasised that while significant attention has been placed on governance and culture within banking institutions, equally important for the long-term prosperity of the Australian community is the strength and resilience of our banking system.

Australia's banks need to be 'unquestionably strong'[29] to withstand shocks and future financial crises and protect their customers and deposit holders. Rewarding staff when they contribute to the prudent wellbeing and financial health of the bank is appropriate but should not be the dominant factor and should not be done at the expense of a customer.

2.1.5 FOFA grandfathering

The banking industry accepts the inherent conflicts of interest connected with grandfathered conflicted remuneration and supports legislation to repeal the conflicted remuneration grandfathering provisions set out in ss 1528, 1529 and 1531 of the Corporations Act.

The legislation to repeal the conflicted remuneration grandfathering provisions should:

- **Capture all types of grandfathered conflicted remuneration including, among other things, trail commissions, platform rebates, shelf space fees, and asset-based fees on borrowed amounts.**
- **Enshrine a principle that where ascertainable and practicable, the benefits of the changes for grandfathered commissions are passed onto customers.**

Practical implications should be considered, and a reasonable implementation period should be set by Government.

Westpac, Macquarie, NAB, CBA, ANZ have each announced changes to the way they pay, retain and rebate grandfathered payments. AMP has not paid commissions to salaried advisers since 2014. The changes are intended to reduce conflicts of interests and pass on benefits to customers. However, due to the variations in pre-existing contracts, different approaches have been taken to stop the payment and receipt of grandfathered payments:

- Several ABA members have announced the ending of grandfathered payments attributable to their own products (and in some cases external products) to employed advisers
- Some ABA members have also announced they will cease to receive grandfathered payments they are entitled to receive as platform operators, and
- Some ABA members have committed to ensure the value of grandfathered payments that would have been deducted from customers' accounts will be returned to the customer.

The scope of payments and advisers has varied between members and is affected by contractual arrangements. Variation is driven by different arrangements for:

- Payments from product manufacturers within the corporate group, and external to the corporate group
- Payments to advisers in salaried channels and self-employed channels, and

[28] APRA, *Good banking, by good bankers, Speech by the APRA Chair Wayne Byres, FINSIA Summit 2018*,11 October 2018, Sydney, available at https://www.apra.gov.au/media-centre/speeches/good-banking-good-bankers.
[29] The Australian Government the Treasury, *The Financial System Inquiry Final Report*, 7 December 2014, available at http://fsi.gov.au/publications/final-report/, Page 41. EXHIBIT 2.1.24, [ASIC.0902.0001.0581]

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- The complexity of the numerous payments and the time required to implement system changes.

There are limits to the extent that the industry led change can stop grandfathered payments, and pass on the value of grandfathered payments to customers where possible.

A legislated approach will provide a more efficient approach to implementation and consistent benefits for consumers.

2.1.6 Mortgage broking remuneration reform

ABA members believe the mortgage broking industry should do more to promote higher standards of conduct and improve remuneration structures.

Writing over half of all home loans every year, it's clear that mortgage broking is critical to competition and valued by the majority of customers.

The banking industry supports a sustainable, vibrant and viable mortgage broking industry.[30] On average over 55 per cent of mortgages are facilitated by mortgage brokers. However, this differs across the banking sector, with some banks with a small or non-existent branch footprint relying more heavily on this channel. For example:

- ING and Citigroup originate over 90 per cent of their loans through mortgage brokers.[31]
- Members Equity, Bank of Queensland (**BOQ**) and Suncorp originate over 60 per cent of their loans from mortgage brokers.

The Productivity Commission calculated that, on average, each smaller lender would have needed to open 118 new branches to generate the equivalent market share achieved through the use of brokers.[32]

In adopting the recommendations of the Sedgwick Review, ABA members have accepted that commissions paid to mortgage brokers need to be structured to minimise the risks of mis-selling.

ABA members also acknowledge that in mortgage broking, remuneration conflicts primarily emerge as product strategy conflicts and lender choice conflicts.[33]

Changes for the remuneration of mortgage brokers and other intermediaries are set out in recommendations 16 – 18 and 20-21 of the Sedgwick Review. Recommendations 16 – 18 provide:

> *16) In respect of remuneration of Mortgage Brokers:*
>
> *a) Banks cease the practice of providing volume-based incentives that are additional to upfront and trail commissions;*
>
> *b) Banks cease non-transparent soft dollar payments in favour of more transparent methods to support training etc.; and*
>
> *c) Banks cease the practice of increasing the incentives payable to Brokers when engaging in sales campaigns;*
>
> *17) Banks adopt, through negotiation with their commercial partners, an 'end to end' approach to the governance of Mortgage Brokers that approximates as closely as possible a holistic approach broadly equivalent to that proposed for the performance management of equivalent retail bank staff;*

[30] Stephen Sedgwick AO, *Retail Banking Remuneration Review Report*, 19 April 2017, available at https://www.betterbanking.net.au/wp-content/uploads/2018/01/FINAL_Rem-Review-Report.pdf, see "An overarching principle, however, must be that competition and the viability of mortgage broking is preserved", EXHIBIT 3.34.163, [BOQ.0001.0051.0001]
[31] Productivity Commission, *Competition in the Australian Financial System*, Report No. 89, Canberra, 29 June, available at https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf, Page 312.
[32] *Competition in the Australian Financial System, Report No. 89*, Page 19
[33] ASIC, *Review of mortgage broker remuneration, Report No 516*, 16 March 2017, available at https://download.asic.gov.au/media/4213629/rep516-published-16-3-2017-1.pdf

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18) *Banks adopt approaches to the remuneration of Aggregators and Mortgage Brokers that do not directly link payments to loan size and reflects a holistic approach to performance management (see Recommendation 17):*

a) *To establish in a timely fashion how best to address Recommendations 17 and 18, banks with a significant recourse to the Broker channel, but at least the four major banks, each report regularly to ASIC on their progress; and*

b) *With enhanced oversight by ASIC (and other regulators as necessary) to monitor market responses;*

Commentary on recommendation 18 noted that:

> *"An overarching principle, however, must be that competition and the viability of mortgage broking is preserved. Accordingly, any fees for service must be lender rather than customer funded. Although a new payment structure may emerge and the impact of some broad parameters examined, prices consistent with it should be left to commercial negotiations between the parties, as currently."*

Industry led changes

ABA members have chosen to progress the implementation of recommendations 16-18 through the Combined Industry Forum (**CIF**). The structure of the CIF was designed to manage compliance with competition laws. The CIF was formed to enable a cross industry approach on policy, and reform to strike the right balance between improving consumer protections while maintaining and promoting competition. Striking the right balance is critical - the strength and wellbeing of the mortgage broker industry is integral to healthy competition in home lending.

The CIF has identified a number of risks relating to remuneration practices in mortgage broking:

- the potential for financial incentives to put good customer outcomes at risk where they encourage customers to borrow more than they need
- the potential for volume-based bonus commissions, campaign-based commissions and volume-based bonus payments paid by lenders and aggregators to brokers or by lenders to aggregators to put good customer outcomes at risk, and
- that certain soft dollar benefits can increase the risk of poor customer outcomes and can undermine competition.

To respond to these risks, the CIF made the following commitments to change industry practice:

- **Changing the standard commission model:** The industry has adopted the principle that "to the extent that remuneration relates to loan size, remuneration should relate to the funds drawn down and utilised by a customer." This commitment directly addresses product strategy conflicts for brokers (i.e. encouraging the borrower to borrow more than they need) and ASIC's call for structures that do not encourage "the creation of large offset balances".[34]
- Industry participants have unilaterally chosen to implement the principle by paying the broker based on value of funds drawn down by the customer net of offset account balance. This change removes the financial incentive to recommend larger loans with high initial offset balances and is due to be implemented by end 2018.
- **Moving away from bonus commissions and bonus payments:** The industry has recognised ASIC's expectation that the industry moves away from these commission and payment structures. In response, CIF members (including ABA members) have made individual decisions to cease these payments by 31 December 2018. Ceasing these payments meets ASIC proposal 2 and recombination 16(a) and 16(c) of the Sedgwick

[34] ASIC, *Review of mortgage broker remuneration*, Report No 516, 16 March 2017, available at https://download.asic.gov.au/media/4213629/rep516-published-16-3-2017-1.pdf.

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review and addresses both lender choice and product strategy conflicts, by removing financial incentives to encourage customers to borrow more to meet a volume bonus hurdle, or recommend loans with a particular lender based on campaign based bonus payments.

- **Moving away from soft dollar benefits:** The industry has undertaken to make specific changes to non-monetary benefits including changes to tiered servicing (Broker Clubs), conferences and professional development events and entertainment and hospitality. These changes meet ASIC proposal 3 and recombination 16(b) of the Sedgwick review and address the lender choice conflict, by removing benefits that encourage brokers to recommend loans with a particular lender.

These targeted changes will substantially lessen the lender choice and product strategy conflicts identified by ASIC and therefor reduce the risks of mis selling.

Value based commissions

Recommendation 18 of the Sedgwick Review requires banks to adopt approaches to the remuneration of aggregators and mortgage brokers that do not directly link payments to loan size and reflect a holistic approach to performance management. The Sedgwick Review identified the importance and the difficulty of replacing commissions based on loan size. It recognised that there are few global examples and understood that the combined industries of banking and mortgage broking should work on this challenge together. Potential reforms should support the ongoing viability of the mortgage broking industry.

In designing new arrangements, several considerations emerge:

- There is no precedent internationally for a lender paid model that is not directly linked to value.
- Customer paid fees may eliminate the issue of conflicted remuneration but are likely to put the viability of the industry at risk.[35]
- The only international example identified to date that clarifies the issue of "who the broker works for" is the Netherlands where customers pay a fee for service to brokers, thereby clarifying for whom the broker works. However, this cost is tax-deductible – transferring the costs to taxpayers which is unlikely to be acceptable in the Australian context.
- Other conflicts of interests can arise with alternative remuneration models, such as the risk of brokers structuring or splitting loans to maximise flat fees.
- Unintended consequences also arise, creating market distortions and impacting competition.

Despite these challenges, **ABA members remain committed to and are continuing to work on implementing recommendation 18 of the Sedgwick Review, to adopt approaches to remuneration that do not directly link payments to loan size and reflect a holistic approach to performance management.**

Introducers and referrers

The banking industry remains committed to the implementation of recommendation 20 of the Sedgwick Review and is continuing its work to respond to this recommendation.

2.2 Fees

The financial benefits criticised by the Commission did not only relate to conflicted remuneration for individuals, but also financial benefits to the bank. Three issues arose from the hearings:

[35] Stephen Sedgwick AO, *Retail Banking Remuneration Review Report*, 19 April 2017, available at https://www.betterbanking.net.au/wp-content/uploads/2018/01/FINAL_Rem-Review-Report pdf] EXHIBIT 3.34.163,

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1) Charging fees for no service
2) The fairness and transparency of fees for ongoing advice, and
3) Charging fees to deceased estates.

Charging fees for no service is wrong and the way fees are managed for deceased estates needs to change as soon as possible. The ABA is working with its members to address these problems and these actions are detailed below.

2.2.1 Charging fees for no service

ABA members have adopted the principle that banks will only charge fees for the provision of ongoing advice where the specific services agreed to in an ongoing service agreement are delivered.

It is intended that individual banks will unilaterally apply the principle in their own businesses. In implementing the principle banks will unilaterally consider:

- The timing implications for charging fees before or after the service is delivered
- Specific processes to identify where services are not delivered and stop charging / refund fees, and
- Impacts for managing deceased estates.

The principle will apply to banks and third parties who provide financial advice through bank branches. Each bank should consider how to implement the principle in third party arrangements.

2.2.2 Fairer and more transparent advice fees

The Commission has outlined a series of observations about the causes of the fees for no service issue. The banking industry agrees that beyond addressing fees for no service, further changes should be made to make fees for ongoing advice fairer and more transparent.

ABA members have agreed to adopt principles relating to the fair and transparent charging of fees for ongoing advice as follows:

1) **Where it is appropriate based on the client's circumstances and advice strategy, ABA members will give the client a choice to pay for advice on a one off or transactional basis, or an ongoing basis.**
2) **ABA members accept that basing ongoing service arrangements, and charging ongoing fees, based on the offer of the advice service puts good customer outcomes at risk. ABA members will not base ongoing service arrangements on the offer of an advice service.**
3) **ABA members will update or implement processes to initially and periodically assess whether an ongoing service arrangement is the right thing for the client, having regard to the clients' needs and objectives, the subject matter of the advice and whether the advice strategy requires ongoing services.**

These principles will apply to banks and third parties who provide financial advice through bank channels. Each bank will consider how to implement the principles in third party arrangements.

ABA members also support legislation to remove the grandfathering of pre FOFA clients under the opt-in regime.

Practical implications should be considered, and a reasonable implementation period should be set by Government.

ABA members have reflected on the other observations of the Commission regarding fees for no service and ongoing service arrangements. Recently, ABA members have updated and improved

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practices regarding setting up ongoing service arrangements (**OSA**) and provide the following additional information these changes:

1) Services under an OSA:
   a) Members have processes in place to define and communicate the services to be provided under an OSA.
2) Deducting fees from product:
   a) Consent for fees for ongoing advice to be deducted from is required as part of establishing the OSA, and by product issuers through application forms.
   b) Rules for deducting fees from superannuation are governed by the Sole Purpose Test.
   c) Additional measures relating to the fair and efficient charging of fees for ongoing advice will address the culture of automatic periodic payments and provide greater protections for customers.
3) Adequate resources to provide the services under OSAs.

2.2.3 Helping with deceased estates

The banking industry will apply to ASIC to include new provisions in Chapter 45 of the Banking Code of Practice, substantially as follows:

- ***Once notified of a customer's death, we will identify fees that are for products and services that can no longer be provided, or will not be provided to the deceased estate, in the circumstances, and we will stop charging those fees and refund as appropriate.***
- ***We will treat you, the deceased person's representative, with sensitivity, respect and compassion.***
- ***We will publish specific information and contact points for you to contact us to notify us of a customer's death.***

The ABA will work with members to consult on these changes with consumer representatives and ASIC and agree the best way to integrate these provisions into the current banking code Chapter 45 – Helping with deceased estates.

2.3 Business structures – Vertical integration

Consistent with the Productivity Commission's finding, **ABA members believe that institutions should retain flexibility to determine the extent of vertical integration in their businesses and do not support prohibiting vertical integration in financial services.**

The recent Productivity Commission (**PC**) Report considered vertical integration in financial services and it did not find that it contributed to conflicts of interest. The PC report noted:

> *"…that the range of competition problems in these industries (such as transparency and the incentives to offer appropriate advice) it is more assertion than evidence that indicates these problems are based on, or even exacerbated by, vertical integration."*[36]

As a result, the PC finding 9.2 states that forced separation is not likely to prove an effective regulatory response to competition concerns in the financial system, specifically not in either home loan or wealth management markets.

ABA members have different strategies in relation to the range of services they offer and the extent of vertical integration in their business. Some ABA members are taking steps to simplify their businesses

[36] Productivity Commission, *Competition in the Australian Financial System*, Report No. 89, Canberra, 29 June, available at https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf, Page 260.

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and sell or demerge some of their vertically integrated structures. Banks should retain the flexibility to determine these strategies without regulatory intervention.

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3. Banking services and industry practice

The Commission has highlighted examples of bank conduct that does not comply with the law and falls below community standards. The Interim Report has raised questions about how banks deliver services to individuals, small businesses, and agricultural businesses.

The issues addressed below are:

- The operation of responsible lending obligations
- Protections for small businesses under the banking codes
- Agricultural lending, and
- Access to banking services for more vulnerable customers.

3.1 Responsible lending

The banking industry supports consistent and robust standards for responsible lending across the industry.

The Interim Report notes that in complying with the responsible lending requirements, "credit licensees too often have focused only on serviceability rather than a focus on the inquiries and verification required by law".[37] The Interim Report suggests that the Commission's interpretation of what is required under the NCCP Act differed from responsible lending practices, including:

- **Verification of expenses:** to comply with responsible lending obligations, the Commission believes that lenders must not only verify income but must also take active steps to verify a customer's expenses and that relying only on a benchmark such as the Household Expenditure Measurement (**HEM**) is not a valid form of verification.
- **Scalability of requirements:** The Commission raised a number of concerns on the level of scaling by some credit licensees for certain products.

While cognisant of the concerns raised by the commission, **the ABA believes that the current responsible lending legislation is appropriate and fit for purpose and that ASIC's RG 209 (Responsible Lending) and APRA's APG223 (Residential Mortgage Lending) are appropriate mechanisms to ensure a consistent application of the responsible lending laws and prudential requirements respectively.**

ASIC has indicated that it will undertake a review of RG 209 in the latter part of 2018 and the ABA and banks will support and participate in that review.

3.1.1 How the banking industry approaches its responsible lending obligations

ABA members take their responsible lending obligations seriously to ensure they are doing the right thing by customers and complying with the law. ABA members have developed their own internal policies to ensure responsible lending across their institution. In developing these policies, banks have regard to a number of factors, including:

- The customers' needs, financial information and financial standing
- Benchmarks
- ASIC guidance including RG 209, and
- Outcomes of Financial Ombudsman Service (**FOS**) determinations.

And also for banks providing home loans:

- APRA guidance APG 223 – Residential Mortgage Lending.

[37] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim report*, 28 September 2018, available at https://financialservices.royalcommission.gov.au/Documents/interim-report/interim-report-volume-1.pdf, Pages 23-24.

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Further guidance will be provided by APRA upon completion of its review of bank lending practices. APRA has been auditing and providing guidance to several small and large ADIs on the "effectiveness of controls to ensure the completeness and accuracy of borrower financial information used in loan serviceability assessments".[38] APRA has stated that this work has helped to "drive an improvement in standards".[39]

The use of benchmarks (HEM)

ABA members believe that there remains a clear need for the continued use of an appropriately developed expense benchmark that can be used as an indicator for customer living expenses and can be used as a tool for comparison against declared customer expenses.

The Commission questioned the industry's reliance on the use of expense benchmarks, most notably the use of HEM, as a benchmark measure of household expenditure on the basis that HEM that it does not constitute verification of a borrower's actual expenditure.

ABA members believe that independent expense benchmarks, such as HEM, provide a useful expenses indicator, particularly if there are gaps in the information provided by customers to the bank. This approach is consistent with the ASIC guidance on using benchmarks when verifying customer living expenses and by APRA as part of the serviceability assessment contained in APG 223 for home loans.

While banks are able to access some data for their existing customers, those customers will quite often have accounts with other financial institutions. In those circumstances, no single financial institution will have a complete view of a customer's expenditure.

The HEM may appear low for many customers as the benchmark is intended to reflect actual cost of living, including health, education, clothing and ad hoc expenses. ADIs scale up for higher incomes and thus income scaled HEM acts as a rising indicator of expenses (upwards scaling is also required under APRA's APG 223 for home lending). Where the Commission has a concern about the underestimation of discretionary and non-basic expenditure, experience has shown that items of discretionary expenditure are ones which the majority of new home owners adjust or forgo when they purchase a new home. If a customer were to adjust their expenses to align with HEM, we do not expect that the customer would be in substantial hardship. These discretionary expenses are also commonly reduced when a customer's financial situation changes.

Scalability

The Parliament intended inquiries to be scalable as stated by the Explanatory Memorandum (Para 2.107) accompanying the NCCP Act.[40] ASIC guidance has also recognised that the responsible lending obligations are scalable. **ABA members believe that the current flexibility to scale inquiries is an important feature of the responsible lending framework and should be maintained.**

3.1.2 How Comprehensive Credit Reporting and Open Banking can improve responsible lending

Government reforms to enhance competition and consumer choice have the potential to enhance the capacity of the credit industry to meet responsible lending obligations in a more efficient manner. Two reforms, strongly supported by ABA members, stand out:

- Comprehensive Credit Reporting (CCR), and
- Open Banking.

[38] Australian Prudential Regulation Authority (APRA), *Written Submissions on Round 1: Consumer Lending*, available at https://financialservices.royalcommission.gov.au/public-hearings/Documents/Round-1-written-submissions/Australian-Prudential-Regulation-Authority-APRA.pdf
[39] APRA, Written Submission on Round 1: Consumer Lending.
[40] Explanatory Memorandum, National Consumer Credit Protection Bill 2009 (Cth) (Austl.)

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Comprehensive Credit Reporting

Comprehensive credit reporting will allow credit providers to have a much broader insight into a customer's financial situation and their past behaviour in meeting their credit obligations. This will enable a bank to make a more informed credit assessment of a loan applicant and their suitability for credit.

Mandatory comprehensive credit reporting has passed the House of Representatives but has not been listed in the Senate due to a lack of consensus around customers in hardship arrangements and how they should be reported. Despite the fact that mandatory legislation has stalled in the Parliament, Australia's major banks are participating in credit reporting and sharing positive data with credit bureaus.

Currently the major banks are not reporting repayment history information for customers who have hardship arrangements with their banks. The Attorney General's Review of Financial Hardship arrangements[41] is currently reviewing the hardship framework and how it should intersect with the consumer credit reporting framework. This review will provide guidance to the banking sector for how to report these cases in the future.

Other banks are participating in credit reporting. HSBC is currently participating in the credit reporting system using the CCR data to aid its credit decision process. Suncorp is preparing to commence work on consumption of CCR data during this financial year.

Open banking

From 1 July 2019, all four major banks will make data available on credit and debit card, deposit and transaction accounts. Mortgage data will become available by 1 February 2020 and data on all other products will be available on 1 July 2020. All other Australian banks will be required to make their data on credit and debit cards, deposit and transaction accounts available on 1 July 2020.

Open banking benefits for customers

Open banking is one tool in a suite to enhance the responsible lending process as it will allow customers to share information with credit providers more easily. The reforms will assist credit providers to assess suitability by including income and expense data passed from a customer's other financial institutions. While the reform is dependent on a customer electing to share their information with a new credit provider, it allows credit providers to access reliable and detailed data about the customer.

Open banking is not a silver bullet, as the right to share (or not share) data always belongs to the customer. Importantly, a decision by a customer not to share their data as part of a credit application should not preclude them from accessing suitable credit via more manual processes.

Changes in industry practice and regulatory guidance

ABA members consider the current provisions regarding responsible lending in the NCCP Act are appropriate, fit for purpose and that regulatory guidance is the appropriate tool to ensure consistency across the entire industry.

Both CCR and Open Banking will require changes to industry practice, as the industry considers information that has not historically been available. ASIC has indicated that it will undertake a review of RG 209 in the latter part of 2018 and the ABA and member banks will participate in that review.

In relation to the ASIC review of RG 209 in the latter part of 2018, CCR and Open Banking, the ABA suggests that any changes be guided by the following principles:

- **Flexibility:** The future availability of new customer data sets (CCR & Open Data) will mean all credit providers can adopt different approaches in their responsible lending systems and processes, this will be a good outcome for both competition and customer choice.

[41] Attorney-General for Australia, *Review of financial hardship arrangements*, Media release, March 2018, available at https://www.attorneygeneral.gov.au/Media/Pages/Review-of-financial-hardship-arrangements-28-March-2018.aspx

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- **Enabling automation:** Automation enables credit assessments to be made more quickly and accurately than a manual review of data and helps to promote more consistent decision making. Credit licences need to ensure systems are well designed and audited regularly to ensure they are delivering the desired outcomes.
- **Future-minded:** Constant advances in technology underpin the modern banking environment and can further improve responsible lending processes and compliance and requires a technology neutral approach from regulators.

3.2 Protections for small business in the banking codes of practice

ABA members strongly believe that the new ASIC approved Banking Code of Practice (new Code) provides a significant increase in additional protections for small business and agricultural lending customers. These protections limit the circumstances of enforcement actions, improve transparency, and clarify the minimum standards to be applied to borrowers in times of financial difficulty. These include:

- Removing non-monetary defaults with limited exceptions.
- Additional protections for guarantors.
- Increasing the notice period for renewal or rollover of credit facilities to three months.
- 30-day notice period for unilateral variation of terms in small business loans or other credit agreements (with limited exceptions, e.g. interest rate changes).
- Requirements of a bank when a small business customer experiences financial difficulty and requires assistance.
- Requirements for banks to be fair and transparent when using an external property valuer or appointing an investigating accountant or insolvency practitioner.
- The new Code codifies obligations about farm debt mediation and the use of alternative external dispute resolution (i.e. AFCA).

The Interim Report noted that further small business regulation should not be recommended by the Commission. **ABA members agrees with this position and does not support the extension of the National Consumer Credit Protections to small business lending.**[42] This is consistent with the recommendation in the Khoury Review.[43] Mr Khoury found that:

> *"the National Consumer Credit Protection (NCCP) Act's responsible lending provisions would restrict flexibility in a way that I think would be undesirable. I am not recommending that the Code mandate this for small business customers."*

The protections for small business and farmers under the banking codes of practice have substantially increased and the new Code should be allowed to operate and be reviewed before further changes are made. The new Code will be reviewed after three years of operation.

[42] The Australian Banking Association, *Submission to the Royal Commission, Round 3 - Small Business lending, 8 June 2018*, available at https://financialservices.royalcommission.gov.au/public-hearings/Documents/Round-3-written-submissions/ABA-written-submission.pdf
[43] Phil Khoury, *Independent Review Code of Banking Practice*, 31 January 2017, http://cobpreview.crkhoury.com.au/wp-content/uploads/sites/2/2017/02/Report-of-the-Independent-Review-of-the-Code-of-Banking-Practice-2017.pdf , Also Ex 3.144.30 AB-1-58 [ABA.001.001.5280 at 106] (Khoury review)

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3.2.1 Small business definition

The definition of small business in the banking code is fit for purpose and should be maintained, noting that the definition will be reviewed based on industry data after 18 months of operation as a condition of ASIC's approval of the Code.

Any change in the definition could have a significant impact on smaller lenders and lessen competition for small business lending.

The ABA notes that the Commissioner has not been persuaded about the adequacy of the small business definition included in the new Code[44] , specifically how it applies to agricultural lending customers. The Commission has also noted a preference for a simplified definition rather than the multi-tiered criteria adopted in the new Code.

The industry has considered at length the definition of a small business and upholds the view that a $3 million total credit exposure (**TCE**), 100 full-time equivalent employees and $10 million turn over figure is an appropriate definition. The definition will extend the protections included in the new Code to the vast majority of the small business sector in Australia while ensuring ongoing competition in the small business lending market and the availability of competitively proved credit.

The objective of having a multi-tiered definition is because no single criteria would be adequate, and that a $10 million turnover figure is prudent based on profiling of sophisticated businesses. There would be cases where sophisticated large or medium size businesses carry little debt and modest employee numbers, but their true size and sophistication is reflective in their turnover. Therefore, a multi-tiered definition was developed so that if a business exceeded any of these thresholds, they would be classified as sophisticated and not captured by the Code definition.

In the past many banks used their internal definitions of small business in the assessment of loan applications with the majority using lending thresholds of less than $2 million (consistent with the previous FOS definition) and less than 20 employees.

After the Commission's public hearings on this matter, detailed data demonstrating the coverage of lending to small business was provided to ASIC by the ABA in a letter dated 9 July 2018. This data is provided in the tables below.

Figure 1 – Number of Business Customers

	Less than $3m %	$3m to less than $5m %	$5m and over %
Major banks	98.0	0.8	1.2
Other ABA member banks	97.8	0.9	1.3
All banks	98.0	0.8	1.2

[44] Royal Commission into Misconduct in the Banking, *Superannuation and Financial Services Industry, Interim report*, 28 September 2018, available at https://financialservices.royalcommission.gov.au/Documents/interim-report/interim-report-volume-1.pdf, Page 181.

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Figure 2 – Value of Business Loan Exposures

	Less than $3m %	$3m to less than $5m %	$5m and over %
Major banks	22.5	5.3	72.2
Other ABA member banks	49.6	8.2	42.0
All banks	23.8	5.4	70.8

The data in Figure 1 shows that 98 per cent of the number of customers of all banks have a TCE less than $3 million, with another 0.8 per cent of customers having TCE of between $3 million and $5 million. There is little difference between major banks and others.

There is however a significant difference between major and non-major banks when the value of exposures, is considered. The data in Figure 2 shows **for non-major banks, a shift to a $5m threshold in the definition would expose 57.8 per cent of the value of their business loan book to 'covenant light' contracts. A change of $3m to $5m would represent a material increase of 16.5 per cent for these banks and may affect competition in the market.**

23.8 per cent of the value of TCE for all banks are less than $3 million, with majors recording only 22.5 per cent exposures by value less than $3 million and another 5.3 per cent between $3 million and $5 million, while in comparison the non-majors (dominated by the 3 regional banks) have a much larger 49.6 per cent less than $3 million and a further 8.2 per cent between $3 million and $5 million. By value, the major banks have a much higher share of TCE at and above $5m (72 per cent versus 42 per cent).

As part of ASIC's approval of the new Code banks will be required to provide small business lending and IDR data quarterly so that ASIC can monitor small business access to finance. This will provide an evidence base for an independent review of the new Code small business definition. The review will occur after 18 months of the implementation date. Following the review, ASIC and the ABA will consider the review outcomes and data collected to determine whether the definition needs to be further amended.

Given the significant exposure of non-major banks, and the importance of this to competition in the small business market, ABA members believe that a cautious approach in the first years of these new contracts is warranted.

Additionally, APRA's review of its capital framework is likely to have an impact on whether the definitions total credit limit is appropriate.[45] The core of APRA's capital framework is currently under consultation following the finalisation of the BCBS revisions to the Basel III capital framework.[46] APRA expects to make to make changes the risk-based capital requirements for all ADIs using advanced and standardised approaches to credit, market and operational risk.

APRA proposes to segment the standard eligible mortgage portfolio into lower-risk and higher-risk exposures in addition to assigning risk weights according to the loan to value ratio (**LVR**). Small business exposures secured by residential property that meet certain serviceability criteria would be included in the same category of higher-risk exposures as residential mortgages for investment purposes and interest-only loans.

Given the potential significance of these APRA reforms on small business lending (including agricultural lending), the ABA would consider that APRA's capital framework must be finalised ahead of any other

[45] The Australian Government the Treasury, *The Financial System Inquiry Final Report*, 7 December 2014, http://fsi.gov.au/publications/final-report/, Recommendation 1, EXHIBIT 2.1.24, [ASIC.0902.0001.0581]
[46] Bank for International Settlements, *Basel Committee on Banking Supervision Basel III*: Finalising post-crisis reforms, December 2017, https://www.bis.org/bcbs/publ/d424.htm

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reforms. This will enable banks to better assess the impact of any further changes to the small business definition and better regulatory certainty.

3.2.2 The duty of a diligent and prudent banker

ABA members consider the definition of a diligent and prudent banker set out in Clause 51 of the new Code sets an appropriate standard of conduct. The standard is deliberately principle-based, and its interpretation is subjective. This provides important flexibility and enables banks to consider the context of each lending decision, for example in agriculture which include long climatic and production cycles. Banks have credit policies and use their internal credit assessment methods to form an opinion of a company's financial position. While a bank should reasonably question information provided by the small business borrower, it is not the role of the bank to act as an auditor when assessing the information provided by the borrower. Ultimately, the bank needs to be satisfied that the business's financial position, plan and security are adequate to repay the credit facility. This could include requiring the business to provide regular financial reports and demonstrate that the business is meeting its business goals.

Principle-based requirements allow AFCA or the courts to reflect current practices and circumstances on a case-by-case basis. It also avoids the potential unintended consequences which can result from more prescriptive regulation being applied to processes that experience continual innovation and change. Note, it is likely that a more prescriptive standard with additional and more detailed inquiries would add time and cost to the loan assessment process.

3.2.3 Guarantors

ABA members consider that the new provisions of the Banking Code will go some way to providing additional protections for guarantors.

The Khoury Review identified guarantors as an important issue and it needed to be addressed as part of the new Code.[47] The guarantor provisions of the new Code require the bank to inform a guarantor and their adviser about the suitability of the loan applicant and provide additional time for the prospective guarantor to consider giving a guarantee where legal advice has not been sought. In the unfortunate event that a borrower's loan goes into default the guarantors will be informed, as well as by the initial default notice, if the borrower remains in continuing default for two months, and generally the borrower's security will be used by the bank to pay off the loan before using the security provided by the guarantor, such as a home.

These provisions in the Code are set out to protect prospective guarantors to ensure they are informed about the borrower's loan contract and current situation.

Further information about the ABA's position on guarantors and the new Code are included in the ABA's submission on the round 3 hearings.[48]

3.2.4 The powers of the Australian Financial Complaints Authority (AFCA)

ABA members consider that the policy on how and when AFCA uses these powers should be determined by AFCA in consultation with stakeholders such as consumer advocates and industry associations.

As the regulation currently stands, AFCA has the power to award both compensation for direct and indirect financial loss and non-financial loss. Consistent with the objectives and character of external dispute resolution, punitive, exemplary or aggravated damages cannot be awarded. Further, under the

[47] Phil Khoury, *Independent Review Code of Banking Practice*, 31 January 2017, http://cobpreview.crkhoury.com.au/wp-content/uploads/sites/2/2017/02/Report-of-the-Independent-Review-of-the-Code-of-Banking-Practice-2017.pdf , Also Ex 3.144.30 AB-1-58 [ABA.001.001.5280 at 106] (Khoury review)
[48] The Australian Banking Association, *Round 3 Submission to the Royal Commission on Small Business lending*, 8 June 2018, available at https://financialservices.royalcommission.gov.au/public-hearings/Documents/Round-3-written-submissions/ABA-written-submission.pdf.

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AFCA Complaint Resolution Scheme Rules, an AFCA Decision Maker can award compensation where a Financial Firm has breached its contract with the consumer. This includes:

> *"Waiver or variation of a fee or other amount paid to or owing to the Financial Firm..."*[49]

Customers may raise a complaint against a bank with AFCA. AFCA will use the Banking Code of Practice as the benchmark for bank practice and consider if a bank has breached the Code and therefore its contract with the consumer. In this case, the consumer may be entitled to compensation for any loss they suffer as a result of the breach. The AFCA has increased jurisdiction to consider small business disputes (credit facilities of up to $5 million) so there will be scope for more businesses to access EDR.

3.3 Agricultural lending

The Interim Report poses several questions on the use of property valuations and whether 'market value' is an appropriate basis for assessing security, and industry practices around the treatment of impaired loan and customers in financial distress. Each of these issues is considered below.

3.3.1 Valuations

The Interim Report questioned how valuations of agricultural property should be made by banks and whether the current valuation methods are adequate for agricultural lending.

Conduct of valuations

ABA members consider that the value of a property used as security for an agribusiness loan should be assessed by a suitably qualified and experienced external or internal property appraiser.

The ABA *Industry Guideline*: *Appointing property valuers when lending to small businesses and primary producers* outlines the minimum standards customers can expect of banks when they appoint a property valuer to assess the market value of a commercial or agricultural property for loan security purposes.[50] This includes the qualifications and experience of valuers. Further, APRA Prudential Standard APS 220 on Credit Quality (APS 220) sets out the requirements for how property is to be held as security against loans should be valued.[51]

ABA members consider that it is appropriate that banks are allowed to conduct internal appraisals of rural properties. Internal appraisals should be undertaken by suitably qualified and experienced appraisers and appropriate internal controls need to be in place. Any changes to APS 220 would require careful consideration. Requiring appraisers to be independent of the loan origination could present practical challenges e.g. the limited availability of suitably qualified appraisers in very remote areas or specialised industries.

3.3.2 The use of market value

ABA members support following the internationally recognised standards for property valuations and does not support fixing valuations. Bank property valuations are currently conducted in accordance with the International Valuation Standards set by the International Valuation Standards Council (**IVSC**). Market value is the amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.[52] The use of 'market value' is seen as international best practice by IVSC. Using market

[49] Australian Financial Complaints Authority, *Complaint Resolution Scheme Rules*,1 November 2018, https://www.afca.org.au/custom/files/docs/20180920-afca-rules.pdf , Section D Part 2.
[50] *Complaint Resolution Scheme Rules*
[51] APRA, *Prudential Standard APS 220 Credit Quality*, ,available at https://www.apra.gov.au/sites/default/files/141120-APS-220.pdf
[52] The Australian Bankers' Associa ion, *Industry guideline: Appointing property valuers when lending to small businesses and primary producers*, available at http://www.ausbanking.org.au/images/uploads/ABA-132351-v1-Industry_guideline_-_Appointing_property_valuers.PDF , EXHIBIT 3.144.37, [ABA.002.001.0027].

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values means there is a large and verifiable store of information against which direct comparisons can be made. It is therefore the most transparent and simplest methodology available.

The use of a measure that does not give the customer the benefit of any uplift in value of property used as security for a loan will disadvantage a large majority of customers and potentially restrict access to credit.

3.3.3 Natural disasters

ABA members have a long history of working with the agricultural sector and have in place appropriate credit policies and a risk management framework to identify and manage external events that may adversely impact agribusiness customers. This includes natural disasters.

Banks who lend to agriculture offer a range of services and hardship arrangements to help customers experiencing circumstances outside their control. The type of assistance is offered on a case-by-case basis as it **will depend on individual circumstances**, but may include:

- A deferral of scheduled loan repayments
- Waiving fees and charges
- Interest free periods or no interest rate increases
- Debt consolidation to help make repayments more manageable, and
- Allowing early redemption of farm management deposits without break costs being charged.

Individual banks have provided their policies and examples of application of these policies to the Commission. This approach is well demonstrated by bank responses to the current drought conditions being experienced by large sections of rural and regional Australia.

3.3.4 Management of impaired loans

ABA members agree that stressed loans should be managed by suitably qualified bank professionals, either agribusiness bankers or specialist staff within bank asset management units.

All agribusiness lenders have specialised agribusiness bankers and support teams who understand the needs of agribusiness customers. Agribusiness specialist bank staff are essential in helping their customers build knowledge about their financial and business circumstances.

Some banks refer impaired loans to asset management units. These units include staff who have a mix of skills in agribusiness banking, accounting, business restructuring, commercial management, insolvency and legal expertise. The units will assess the customer's financial and business situation with a view to restoring the credit facility to a satisfactory position or minimising the potential loss (to the customer and bank). Importantly, these units are supported by policies and procedures which take into account the unique circumstances of differing customer groups. For example, staff dealing with agricultural loans have a clear mandate to take a long term 'through the cycle' perspective in implementing work out strategies.

3.3.5 Default interest

The ABA does not support legislative or regulatory prescriptions as this would impede the flexibility that needs to be exercised by banks in what are difficult circumstances for agribusiness customers.

Hardship can lead to a customer getting behind with payments. This can incur default interest. The application of default interest to those in hardship was questioned by the Commission.

The cost of default interest has a direct relation to cost of the increased risk incurred. APRA's capital adequacy framework requires that a bank hold a minimum amount of regulatory capital as a proportion

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of its total risk-weighted assets (**RWAs**). Assets where the risk of loss (i.e. non-payment) is low, typically receive a low risk weight, while assets with high exposure to loss, such as impaired loans, tend to have a higher capital charge reflective of the higher risk. Impaired loans in being of a higher risk therefore carry an increased cost to the bank and additional administration costs. For this reason, banks sometimes apply an increased interest rate margin where the customer has defaulted.

That said, many banks provide relief on default interest in the event of natural disasters (in particular drought) or unexpected events, for example, the 2016 dairy price fall and the most recent fruit tampering crisis.

Moratorium and similar relief measures put in place by banks are voluntary and tailored to meet the particular circumstances faced by customers. Such tailored moratoriums allow the customer time to wait out the adverse events, until business conditions improve and facilitate the return of the business to financial health. Ultimately, it must be the commercial decision of individual banks as to whether, and when, moratoriums on charging default interest and enforcement should be applied.

3.3.6 Appointment of external administrators

Banks endeavour to work with agribusiness customer's in financial distress to address the reasons for the underperformance in their business so that the loan can be rehabilitated to a performing loan. As the Commission has noted in other areas of the Interim Report there is no financial incentive for a bank to deliberately undervalue an asset or foreclosure on a business.

Only a very small proportion of distressed loans result in enforcement action. **The ABA and member banks agree that the appointment of a receivers or external administrators should be an option of last resort.** However, it is one which must be available to lenders, as acknowledged by APRA in its written submission to the Commission in Round 4 'Experiences with financial services entities in regional and remote communities' (at paragraph 13): "…*an ADI should not be expected to provide forbearance to a borrower in financial difficulties where it is clearly apparent that doing so will generate a larger economic loss for the ADI relative to the likely outcome of enforcement action."*

Each case will be unique to the customer's individual circumstances with the bank considering factors such as the viability of the agribusiness; potential turnaround options; the customer's obligations to other creditors; and consideration of APRA's prudential obligations.

The ABA and member banks have introduced industry guidelines for circumstances where a bank appoints an investigating accountant, receiver or voluntary administrator for small businesses or farmers. The guidelines require:

- open and transparent communication between the bank and the customer
- treating the customer with respect and allowing the customer time
- trying to resolve the financial problems early and by negotiation
- helping the customer to understanding the role of third parties, and
- only appointing appropriately qualified and experienced practitioners.

Many of the case studies considered by the Commission pre-dated the implementation of the industry reform package.

3.3.7 Farm debt mediation

ABA members support the introduction of a national and uniform Farm Debt Mediation (FDM) model. The ABA considers that the recently reviewed and amended NSW scheme should be adopted as the national model. This will provide more regulatory certainty. The NSW model has been in place since 1994 and has an established track record of decision making, streamlined processes and a cooling off period.

There is concern among ABA members that ninety days past due may be too early a trigger point to initiate mandatory FDM. Given the reality of cyclical and the seasonal nature of agriculture, it is

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conceivable that well-run farming businesses will at some point in time be in a situation where their loan is ninety days past due. Some banks support earlier mediation as ninety days past due may be too late to be an effective triggering event. What is important is regular communication between the farmer and the bank so both parties understand the financial position of the business and can put in place arrangements to assist the business (and the loan facility) turn around performance. Ninety days past due may be an appropriate time for a conversation between the customer and the bank. The current legislated FDM schemes (in NSW, QLD and Victoria) encourage mediation before default occurs and allow for farmer-initiated mediation. Farm debt mediation has also recently been enacted in South Australia.

It should be noted that all but one of the case studies were either from states without mandatory FDM or pre-dated the legislated Queensland FDM arrangements**.**

3.4 Assisting low income and vulnerable customers

Banking services are an essential part of everyday life, however, some Australians have difficulty accessing these services. This can cause financial disadvantage and negative social and emotional consequences.

The industry acknowledges there is more work to be done to improve access to banking services for indigenous communities, customers with disabilities and for customers with low financial literacy.

3.4.1 Access to banking services

ABA members are committed to making their services accessible to all Australians.

The ABA's Banking Code of Practice (Chapter 13 – Inclusive and accessible banking), affirms the commitment of our members to providing banking services which are inclusive of all people including people with disabilities and Indigenous Australians, including those in remote locations.

ABA members recognise for some Australians, the closure of some bank's branches has increased the difficulty of accessing banking services.[53] While digital banking has caused a revolution in how Australians access banking services, the banking industry is committed to maintaining face-to-face retail banking services (such as through Australia Post). Further, the ABA Branch Closure Protocol, provides for a minimum standards of service delivery in the event of branch closures.[54]

Recently the ABA undertook a thorough review of our Accessibility Principles designed to promote best practice for people with a disability. These Principles were endorsed by the ABA Council in September 2018 and will now be applied across all products and services of ABA members. Once launched, these will replace the previous accessibility standards, created in 2002.

Financial literacy is one of the banking industry's long-term priorities. ABA member banks produce publications and tools, as well as offer education seminars and workshops, which customers can use to assist them in making financial decisions. We also support the work of ASIC and its National Financial Capability Strategy.

3.4.2 Access to fee-free bank accounts

The banking industry strives to ensure that all Australians have access to the right banking services however, believe that more should be done to promote fee-free accounts to eligible customers. All Australians who are eligible for and want a basic bank account should be able to open one.

The circumstances of all customers are different. While not common, some customers with no substantial income other than Centrelink benefits may have a mortgage or enough cash to warrant a term deposit account.

[53] Not all banks have reduced their branch numbers. For example, Bendigo is actively increasing its branch network.
[54] The Australian Bankers' Associa ion, *Branch Closure Protocol*, available at https://www.ausbanking.org.au/images/uploads/ArticleDocuments/149/Branch%20Closure%20Protocol%20Oct%202015.pdf, EXHIBIT 4.204.1, [ANZ.800.737.0039].

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ABA members agree that in the majority of cases where a customer has no substantial income other than Centrelink benefits, a basic, low or no fee account is the most appropriate product.

In new the Code (Chapter 16) ABA members commit to inquire about the source of income of all new customers and offer a basic, low or no fee account for all who qualify. The Code also commits members to raising awareness of affordable banking products and train their staff to recognise that a customer may qualify.

3.4.3 Informal overdrafts on basic bank accounts

Informal overdrafts in basic bank accounts (without any fees) can be a useful tool for customers who need flexibility to manage the timing of ingoings and outgoings. Banks that offer this service should have policies in place to limit these arrangements so that customers do not get into any significant amount of debt or exacerbate financial hardship.

Basic bank accounts are available (at a minimum) to customers who hold a Pensioner Concession Card, Health Care Card or a Commonwealth Seniors Health Card. A number of ABA members also offer basic bank accounts to all customers. Basic bank accounts allow customers to set up direct debits, but do not charge overdrawn or dishonour fees. Although, not all banks will allow a basic bank account to become overdrawn / go into arrears.[55]

3.4.4 Access to banking for Aboriginal and Torres Strait Islanders

ABA members accept that they haven't always had the best policies in place to help Aboriginal and Torres Strait Islander customers. To address this issue the Banking Code of Practice provides a sound basis for ABA members to put in place appropriate policies and procedures to assist Aboriginal and Torres Strait Islander customers.

Chapter 13 promises that our members will take reasonable steps to make information about our banking services accessible to customers in remote communities, including remote Indigenous communities, and provide cultural awareness training to staff who regularly assist customers in remote Indigenous communities.

We encourage the rest of the financial services industry to adopt similar provisions.

The ABA and its members support AUSTRAC's flexible approach to identifying Aboriginal and Torres Strait Islander customers.

3.4.5 Code of Operation (90 per cent arrangements)

The ABA is a party to, and a strong supporter of, the Code of Operation. ABA members enshrined this support in the new Banking Code of Practice.[56.]

A '90 per cent arrangement' ensures that customers can repay overdrawn amounts while retaining at least 90 per cent of their Centrelink payment in any fortnightly period. These arrangements only apply to overdrafts, not other forms of credit.

ABA members believes that 90 per cent arrangements should be applied to all customers who are eligible for them, as a default position, unless the bank has come to another more appropriate arrangement with the customer or has reason to believe the arrangement would not be appropriate for that customer's circumstances. The ABA recognises this has not always been the case and some customers have been harmed as a result.

The Commission has asked should these arrangements occur automatically without customer notification. In principle the ABA supports the idea that all customers who are eligible should be placed

[55] The ABA noticed in the process of preparing our response to the Commission that while our website is clear that basic bank accounts do not charge overdrawn fees it does not explicitly say that there will be no fees on dishonour fees. We will ensure this is changed to make this clear.
[56] The Australian Banking Association, *Banking Code of Practice*, 2019, available at https://www.ausbanking.org.au/images/uploads/Banking_Code_of_Practice_2019_web.pdf , Paragraph 181. [EXHIBIT 3.144.4 - ABA.001.008.0434 - EXHIBIT AB-1-4 - ABA-#133505-v1-Banking_Code_(all_changes_reflected_-_ASIC_approval_process)]

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on a 90 per cent arrangement, however automating this could create a number of adverse consequences and is a challenging thing for banks to implement.

Some ABA members are exploring the possibility of creating an automated notification system which tells the customers they might be eligible for a '90 per cent' arrangement. However, other members feel this is better dealt with through their existing hardship channels.

We believe automatic application of 90 per cent arrangements could have a number of adverse consequences:

- Automatic application of these arrangements would be very confusing for customers. For example, if a customer's account is in overdraft by $200 and they receive an income support payment of $100, the aggregate balance of their account will appear as negative $100, likely leading the customer to think they have no funds available to them. However, under a 90 per cent arrangement, the customer has $90 available to them (90 per cent of their payment) and a remaining debt of $190. Practice varies, but some banks deal with this by opening a new account for the customer so these two balances are more clearly separated and setting up automatic payments to repay the overdraft. However, opening a new account for a customer requires the customers consent. In addition, it could lead to the same situation once a debit card is linked, the new account could become overdrawn.
- Under automated arrangements, customers miss out on having a conversation with their bank that could allow the bank to provide them with additional hardship support if they are having difficulties making payments on other types of credit. The customer may also be experiencing other issues which the bank may be able to provide help with for example, family and domestic violence.
- The customer may require retention of more than 90 per cent of their Centrelink payment to meet their basic living expenses. Currently, this would be established during a call with a customer to discuss set up a 90 per cent arrangement.
- In cases where the customer is paying fees relating to their overdraft, and they are able to repay the full overdraft, they may be financially be better off not utilising a 90 per cent arrangement.

In addition to the possible adverse consequences of automating these arrangements, automation of this service is challenging and complicated because:

- The industry has not been able to find a way to resolve the customer experience issues noted above so that the arrangements can be applied automatically without significantly confusing the customer.
- Identifying eligible customers automatically may be quite complex. While a person manually reviewing a customer's account can identify that a negative balance has arisen from an overdraft and that the customer is receiving one of many different kinds of income support payments, it is not simple to automate this process.
- Although outside of these arrangements, further complexity arises with new kinds of Centrelink / government payments, for example those from the National Redress Scheme, for people who have experienced institutional child sexual abuse. In this case, banks acknowledge the purpose of these payments and will not require these payments to be used to pay down existing debts. However, the customer will have the choice to pay down debt. While this is a separate issue, this complicates the process of identifying relevant payments and is something that many ABA members are considering together with issues around the Code of Operation.

3.4.6 Add-on insurance

The ABA and its members recognise that some consumers have been inappropriately sold consumer credit insurance (**CCI**), a type of add-on insurance. The ABA's members recognised the risks related to selling CCI and will implement a 4-day deferred sales model for CCI on credit cards and personal loans,

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sold on the phone or in a branch. This commitment is set out in Chapter 18 of the new Banking Code of Practice.

In implementing the deferred sales model, ABA members have recognised the risks associated with selling CCI and have provided customers with enough time to think about whether the product is right for them.

The industry has implemented an important protection through the deferred sales model and does not believe that CCI should be banned as it is appropriate for some customers, particularly for products such as for home loans.

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4. Conduct risk and governance

Managing conduct risk ensures that banks do the right thing for their customers while keeping the customer's interests, and the integrity of the markets in which they operate, at the heart of everything that they do.

4.1 Increased accountability in banks

Three significant reforms have been implemented in banks to drive increased accountability of individuals and improve the sharing of information about individual conduct to stop poor conduct moving around the industry. These reforms are:

- The Banking Executive Accountability Regime (BEAR)
- The ABA Conduct Background Check Protocol
- The ABA Reference Checking and Information Sharing Protocol for financial advisers.
- The banking industry also supports improved information sharing with ASIC about individual conduct.

4.1.1 Banking Executive Accountability Regime

The purpose of BEAR is to ensure that accountability for actions that impact the prudential standing and prudential reputation of the bank rests clearly with the senior executives. These 'accountable persons' must act with honesty and integrity, must act with due skill, care and diligence, and deal with APRA in an open, constructive and cooperative way.

ABA members support enhanced responsibility and accountability of all banks and support the BEAR's stated policy intent to "provide greater clarity in relation to responsibilities and impose heightened expectations of behaviour in line with community expectations".

4.1.2 Should the BEAR be altered?

The BEAR makes the most senior staff accountable and altering the BEAR (extending to all staff) would risk destroying its purpose - 'if everyone is accountable, then no one is accountable'. [57]

The BEAR is expressly targeted at the most senior executives in banks.

The focus on senior executives and prudential focus of the BEAR means it is likely not the right tool to regulate the intersections between remuneration and culture more generally across all the staff in a bank.

The BEAR has applied to the four major banks since 1 July 2018. All other ADIs will be brought into the regime on 1 July 2019. The BEAR legislation includes a requirement to conduct a post-implementation review three years following commencement of the BEAR[58]. The BEAR has triggered clear improvements in systems of governance, responsibility and accountability, but given the infancy of the regime the ABA considers that any recommendations to alter the BEAR should form part of the terms of reference of the legislated post-implementation review.

[57] The Australian Government the Treasury, *Banking Executive Accountability Regime Consultation*, July 2017, available at https://static.treasury.gov.au/uploads/sites/1/2017/08/c2017-t200667-BEAR_cp.pdf Page 4.
[58] Revised Explanatory Memorandum, Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Bill 2017 (Cth), available at https://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r6000_ems_f8dec954-bcff-4408-b8dd-258f0b02288b/upload_pdf/Treasury%20Laws%20Amendment%20(Banking%20Executive%20Accountability%20and%20Related%20Measures)%20Bill%202017_Revised%20EM.pdf;fileType=application/pdf

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4.1.3 Should the BEAR be extended in application?

ABA members believe the BEAR should apply consistently across APRA's regulated population to include other financial service providers such as insurance and superannuation, not just banks. APRA has indicated that this is something they are already considering.[59]

The BEAR should operate to preserve competition, promote consistent consumer protection, enhance accountability, and lift standards across the entire financial services industry. ABA members strongly believe that consumers should have confidence that the BEAR ensures the financial services industry operates at the highest standard.

For example, a standalone APRA-regulated insurer should be held to the same standard as an insurer within a banking group.[60] This would give customers of non-ADI entities equal protections. The current inconsistency creates competitive and regulatory distortions, but also results in a gap in the consumer protection framework.

There are international examples of a similar regime being extended to all financial services. The UK Senior Manager and Certification Regime (**SMCR**) will be extended to cover the entire financial services industry from 2018. The UK rationale for applying the SMCR to the whole financial services industry is to enable the effective and efficient regulation of groups with a variety of financial services firms within them, to support a level playing field for competition, and to remove opportunities for regulatory arbitrage.[61]

4.1.4 Conduct Background Check Protocol

The banking industry Conduct Background Check Protocol (CBC Protocol) has driven a material improvement in the frequency and type of information shared about prospective bank employees.

The ABA is currently conducting a post implementation review of the CBC Protocol with the intention of extending the CBC Protocol to members of COBA. ABA members believe there is merit in applying the CBC Protocol across the industry

The CBC Protocol introduced on 1 July 2017 is intended to promote good conduct and ethical behaviour by formalising obligations for subscribing banks to ask a series of fact-based questions as part of the hiring process.[62] The CBC Protocol sets minimum standards for subscribers regarding:

- A reciprocal obligation to give and receive Conduct Background Checks
- Standard format, process and timeframes for requesting and responding to Conduct Background Checks
- Fact-based, Conduct Background Check questions about why the applicant left the previous bank, and
- Record keeping and confidentiality obligations.

[59] APRA, *Submission to Senate Economics Legislation Committee Inquiry into the Treasury Laws Amendment (banking Executive Accountability and Related Measures Bill) 2017*, 1 Nov 2017, available at https://www.aph.gov.au/DocumentStore.ashx?id=120b95ec-0d78-4fde-9f02-335fdc9b886f&subId=561386

[60] This was the effect of the UK Prudential Regulation Authority (PRA*) Senior Insurance Manager Regime (SIMR)*, which came into effect at the same time as the Senior Manager Regime (SMR).

[61] Her Majesty's Treasury, *Senior Managers and Certification Regime: extension to all FSMA authorised persons*, October 2015, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/468328/SMCR_policy_paper_final_15102015.pdf, Page 3 [1.3]:

[62] The Australian Bankers' Association, *Promoting good conduct and ethical behaviour*, available at https://www.ausbanking.org.au/images/uploads/ArticleDocuments/127/ABA_Conduct_Background_Check_Protocol_and_Consent_final_120517.pdf EXHIBIT 2.117, [RCD.0021.0003.0009].

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4.1.5 ABA Financial Adviser Reference Checking and Information Sharing Protocol

ABA members support making the ABA Financial Adviser Protocol compulsory for the entire industry.

The ABA Financial Adviser Reference Checking and Information Sharing Protocol[63] introduced on 20 September 2016 (**Financial Adviser Protocol**) made material changes to the way the subscribing Australian Financial Services Licensees (subscribing licensees) share information about financial advisers when those financial advisers apply to be appointed by another subscribing licensee.

The information exchanged under the Financial Adviser Protocol relates to the character, competency and conduct of a financial adviser as demonstrated through their compliance, risk management and advice quality. This exchange has substantially increased the level of transparency and information sharing between subscribing licensees when financial advisers move between subscribing licensees, going some way to improving the protection of the customers of subscribing licensees.

However, ABA members believe that more can be done to minimise the risk that financial advisers with a history of poor conduct are able to move around the industry.

4.1.6 Reporting individual conduct to ASIC

ABA members support an obligation for licensees to report significant breaches or other significant misconduct by an employee or representative of licensees.

The ABA supports position 2 of the ASIC Enforcement Review Taskforce: The obligation for licensees to report should expressly include significant breaches or other significant misconduct by an employee or representative.[64] The ABA believes that this obligation would assist licensees to report the conduct of representatives that would not otherwise constitute a significant breach.

The obligation should be separate to s912D obligations, be accompanied by protections to promote procedural fairness, be linked to ASIC's role in overseeing and banning financial advisers and credit representatives where applicable, and work together with ASIC's current powers to request details of an individual who has allegedly engaged in breach behaviour.

4.2 Measures to manage conduct risk

Consumers should have confidence that the financial services industry operates at the highest standard. The BEAR sits beside a number of existing prudential and legal duties for bank staff, including:

- APRA's Fit and Proper and Governance obligations as set out in APRA Prudential Standards CPS 520 Fit and Proper[65] and CPS 510 Governance.[66]
- APRA's risk management and risk culture obligations set out in APRA Prudential Standard CPS 220 Risk Management.[67]
- Directors' and officers' duties under the Corporations Act and common law.[68]

[63] The Australian Bankers' Associa ion, *Promoting good conduct and ethical behaviour*, available at https://www.ausbanking.org.au/images/uploads/ArticleDocuments/127/ABA_Conduct_Background_Check_Protocol_and_Consent_final_120517.pdf , EXHIBIT 2.117, [RCD.0021.0003.0009]
[64] The Australian Government the Treasury, *Response to the ASIC Enforcement Review Taskforce*, April 2018, available at https://static.treasury.gov.au/uploads/sites/1/2018/04/Aus-Gov-response-ASIC-Enforcement-Review-Taskforce-Report.docx
[65] APRA, *Prudential Standard CPS 520 Fit and Proper*, July 2017, available at https://www.apra.gov.au/sites/default/files/Prudential-Standard-CPS-520-Fit-and-Proper-%28July-2017%29.pdf
[66] APRA, *Prudential Standard CPS 510 Governance Consultation Draft*, February 2018, available at https://www.apra.gov.au/sites/default/files/CPS%2520510%2520Governance%2520including%2520PHIs.pdf
[67] APRA, *Prudential Standard CPS 220 Risk Management, July 2017*, available at https://www.apra.gov.au/sites/default/files/Prudential-Standard-CPS-220-Risk-Management-%28July-2017%29.pdf
[68] Corporations Act 2001 (Cth)

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- Licensing requirements, including obligations of an Australian Financial Services Licence holder under the Corporations Act and the obligations of a holder of an Australian Credit Licence under the National Consumer Credit Protection Act.[69]

These prudential and legal duties set out obligations for banks and their staff. Evidence before the Commission showed that some of the industry's past remuneration practices led to conduct falling below community standards and expectations. As noted by the Commission, some remuneration structures allow greed and self-interest to trump acting in the best interests of the customer.

4.2.1 Variable remuneration and conduct risk

The role of financial measures in variable remuneration is discussed at paragraph 2.1.4.

Recommendation 13 of the Sedgwick Review and the remuneration provisions of BEAR are both changing the way banks can use financial measures in variable pay. BEAR is also reforming the remuneration structures for senior executives.

Cognisant of the concern the Commission had on the link between financial incentives and poor customer outcomes, banks are actively addressing this concern at all levels (see also Sedgwick & BEAR) in their banks and there is a strengthening of the financial consequences when these expectations are not met.

4.2.2 Financial performance measures have a role in managing conduct risk

APRA recently emphasised that while significant attention has been placed on governance and culture within banking institutions, equally important for the long-term prosperity of the Australian community is the strength and resilience of our banking system.

Banks need to be 'unquestionably strong' to withstand shocks and future financial crises and protect both their customers and deposit holders. Rewarding staff when they contribute to the prudent wellbeing and financial health of the bank is appropriate, but not at the expense of a customer. The ABA believes that financial performance measures do have a role in managing conduct risk and should be part of a balanced scorecard.

4.2.3 Remuneration models to manage conduct risk'

All ABA members are working to better align staff incentives with good customer outcomes by implementing performance management that focuses on the customer and the longer term.

While the principles are the same, there is no one model. The ABA would caution against any black letter approach to remuneration practices in Australia. The ABA membership comprises of a diverse range of banks, Australian owned, subsidiaries of foreign banks or branches of foreign banks. Some have Non-Operating Holding Company (**NHOC**) structures, other banks are part of a larger corporate group.

We note and support the Commissions observation[70]

> *"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."*

ABA members believe that APRA already has all the necessary powers required to impose further changes on remuneration practices within banks to require measures and incentives to focus on the

[69] National Consumer Credit Protection Act 2009 (Cth).
[70] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim report*, 28 September 2018, available at https://financialservices.royalcommission.gov.au/Documents/interim-report/interim-report-volume-1.pdf , Page 320

customer and the longer-term prudential health of the entity. APRA have already committed[71] to a review of the relevant prudential standards and guidance on remuneration.

4.2.4 Certain internal roles

Following on from the earlier point that financial performance measures have a role in remuneration, the ABA would hold that in any commercial entity (not just banks) there will always be internal roles where the financial health of the entity must be a dominant performance measure. For banks, this could typically include the Treasury staff tasked with managing the prudent financial health of the bank.

4.3 Remediation

To address the issue of consistency in remediation approaches, ABA members propose that ASIC Regulatory Guide 256: Client Review and Remediation Conducted by Advice Licensees should be expanded to all advice and products.

The interim report shows that even where some banks' complaint handling and dispute resolution approaches complied with the law, in many cases an overly technical and legalistic approach did not deliver on the spirit and intention of the law and did not meet community standards and expectations.

Banks did not invest in finding problems and when they were found banks did not invest enough or act quickly enough to respond and put the customer right. The interim report made the following observation.

> • *"… 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."*[72]

Banks are already upgrading systems and putting better procedures in place to ensure there is no repeat of the circumstances considered by the Commission. Any part of a regulatory solution to this issue should contain clear, standard advice from regulators to ensure customers are treated fairly and consistently.

The ABA also supports a prospective compensation scheme of last resort for retail clients of financial advisers.[73]

4.4 Duties of intermediaries – mortgage brokers

The service provided by brokers is different to the service provided through a bank branch. Brokers differentiate themselves from branches on the basis that they 'shop around' on behalf of the customer, and customers have different expectations between channels. Brokers also operate in a different risk environment, with different remuneration conflicts and different supervision controls.

The mortgage broker performs tasks for the customer, including an investigation and comparison of products on the broker's lender panel and explaining how the features of the loan will operate. The mortgage broker also performs tasks for the lender including collecting information about the customer and arranging the distribution of the lender's loan product.

Given the mortgage broker's role in performing tasks for the customer and the lender, questions arise as to who the broker owes their duty to, and who's interests (the customer's, the lender's, or the broker's) the mortgage broker should prioritise in performing those tasks.

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[71] APRA, *APRA seeks improvement in executive remuneration practices*, Media Release of 4 April 2018, available at https://www.apra.gov.au/media-centre/media-releases/apra-seeks-improvement-executive-remuneration-practices (4 April 2018)
[72] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim report*, 28 September 2018, available at https://financialservices.royalcommission.gov.au/Documents/interim-report/interim-report-volume-1.pdf , Page 67
[73] Providers of personal financial advice on tier 1 financial products.

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4.4.1 Current obligations

The activity of mortgage brokers and the obligations they must fulfil are currently stipulated in the NCCP Act and certain provisions of the ASIC Act.

The obligations in the NCCP Act relate to:

- Conduct: performing responsible lending obligations including conducting reasonable inquiries and completing a preliminary assessment that the loan is not unsuitable.[74]
- Disclosure: providing credit guide, credit proposal and copy of preliminary assessment.[75]

Mortgage brokers also make representations about their services through marketing materials and advertising and this material cannot be misleading or deceptive or likely to mislead or deceive

4.4.2 Conflicts of interest

Notwithstanding the remuneration changes facilitated by the CIF, ABA members accept that the standard commission model presents a conflict of interest for brokers. This is why the banking industry is continuing to develop a response to recommendation 18 of the Sedgwick Review. Some brokers who are accredited by lender owned credit licensees (aggregators and/or broker groups) face additional related party conflicts.

The Commission has identified that all the conduct identified and criticised in the Interim Report was conduct that provided a benefit to the entities and individuals concerned. The conflicts driven by remuneration structures are best described by ASIC as the Product Strategy conflict and Lender Choice conflict.

Put simply, the standard commission model provides a financial incentive to recommend a larger loan, and/or recommend a specific lender.

4.4.3 Customer First Duty

ABA members believe that the best way to manage these conflicts of interest is by imposing a duty on mortgage brokers to put their clients' interests ahead of their own.

The CIF has described this requirement as a Customer First Duty, which the ABA has been involved in developing and supports.

The Customer First Duty is intended to operate in a similar way to the obligations outlined in s961J of the Corporations Act, which states that "the provider must give priority to the client's interests when giving the advice".

A rule to prioritise the customer's interest ahead of the broker's directly addresses financial conflicts of interest and the Commission's observations that these kinds of financial conflicts are at the heart of the misconduct identified in the Interim Report.

The Customer First Duty is intended to operate together with a new measure for 'good customer outcome', as follows:

> *The customer has obtained a loan which is appropriate (in terms of size and structure), is affordable, applied for in a compliant manner and meets the customer's set of objectives at the time of seeking the loan.*

The measure can be broken down into four elements and used to assess the quality of the outcome of the broking service. The measure will be used by authorising credit licensees and lenders to assess the performance of the broker.

4.4.4 Best Interests Duty

[74] National Consumer Credit Protection Act 2009 (Cth)
[75] National Consumer Credit Protection Act 2009 (Cth)

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The Commission has asked how the Customer First Duty is intended to differ from the Best Interests Duty for financial advisers, and why the duties owed by mortgage brokers and financial advisers should be any different.

As noted above, the ABA believes the Customer First Duty is a better rule, to set expectations for broker behaviour and to directly address the financial conflicts at the heart of the misconduct identified in the Interim Report.

ABA members acknowledge that there may also be value in expressing the duty as a best interests duty. This form of expression would be understood by customers and act as an important culture signal to the mortgage broking industry.

If a best interest duty is proposed, we believe the duty should be performed by:

- **The customer obtaining a loan that is appropriate (in terms of size and structure), is affordable, applied for in a compliant manner and meets the customer's set of objectives at the time of seeking the loan, and**
- **The customer's interests are prioritised over the brokers.**

This approach combines the Customer First Duty and the elements of the Good Customer Outcome definition, is principles based and focusses on the outcome i.e. what is meant to be achieved through the duty, rather than the process.

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5. Future regulatory reform

Australia's financial sector is strong, however the poor behaviour outlined by the Commission prompts consideration of the effectiveness of the regulatory framework. The evidence presented to the Commission suggests that in many instances community standards and expectations have not been met and misconduct has occurred under the current law. The Commission has rightly asked questions about whether the current law can be better enforced, or whether changes are needed to better protect customers.

ABA members support increased protections for customers, and we believe that important parts of achieving this aim include appropriate enforcement practices by regulators combined with clear and simple legislation that cultivates a focus on outcomes, rather than merely on process.

In response to the Commission's question regarding ASIC's approach to legal proceedings, ABA members believe that ASIC should retain a broad discretion to commence proceedings where there are good prospects of success and it would be in the public interest - in line with the Commonwealth Prosecutions Policy.

Further to this, ABA members believe that the new Banking Code of Practice is an important piece of the puzzle to protect and support customers. ABA members strongly believe the Code works best sitting alongside legislation, rather than sitting within in it. The question of embedding the Code in legislation has already been canvassed by the ASIC Enforcement Review which concluded against the move.

5.1 The Banking Code of Practice

Self-regulation through an industry code is an important supplement to the regulatory framework and sets a higher minimum standard of practice. Banking codes sometimes set standards which are subsequently legislated but the code as a whole should not be given legislative status as this would remove or reduce the advantages of self-regulation.

All ABA members with a retail presence in Australia have agreed to sign the new ASIC-approved Banking Code of Practice and fully implement it by 1 July 2019.

As the Commonwealth Treasury has noted, self-regulation has a number of advantages:

- Industry participants are usually better placed to tailor codes of practice to the business conditions and other circumstances facing an industry.
- Self regulation will often impose lower compliance costs on business than government regulation.
- Self regulation is more flexible, as voluntary codes of conduct can be amended by industry participants as required, independent of governmental and parliamentary processes.
- Self regulation does not impose costs on government in terms of implementation, compliance monitoring and enforcement action.[76]

ASIC's approval of the Banking Code of Practice will mean that changes to the Code will need its approval but this does little to detract from flexibility and helps assure the quality of the code. Subjecting codes to ASIC approval leaves self-regulation largely intact. Mandating code content in legislation, on the other hand, alters the character of codes and brings self-regulation to an end.

This is not to say that individual provisions in should never be legislated. There have been many examples where standards originally included in banking codes have later been legislated, including:

- The original banking code contained multiple provisions on disclosure later incorporated into legislation.

[76] The Australian Government The Treasury, *Policy Guidelines on Prescribing Industry Codes under Part IVB of the Competition and Consumer Act*, May 2011, available at http://archive.treasury.gov.au/documents/2035/PDF/Policy%20Guidelines%20on%20Prescribing%20Industry%20Codes.pdf

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- The obligation for banks to provide access to internal and external dispute resolution, now enshrined in the Corporations Act, first appeared in the banking code.
- Responsible lending obligations appeared in the 1993 code when there were none in legislation.[77]

The advantages of self-regulation are retained under the co-regulatory model proposed by the ASIC Enforcement Review, and to which ABA members will already commit to, when they subscribe to the ASIC-approved Banking Code of Practice.

5.1.1 Enforcement of the Code

The banking codes form part of customers' contracts with banks and are also subject to enforcement monitoring by compliance monitoring committees. Compliance with the new Banking Code of Practice will be monitored by a Banking Code Compliance Committee (**BCCC**), which will have a strengthened enforcement capability including:

- the doubling of time for the making of complaints from 1 to 2 years after the complainant becomes aware of the relevant matter new Charter
- explicit power for the BCCC to refer serious or systemic non-compliance to ASIC, and
- explicit power to appoint a person or a panel of persons, with expertise in small business and/or agribusiness to act as a consultant on small business and agribusiness issues.

Another avenue for code enforcement is internal and external dispute resolution (IDR and EDR). Effective EDR should offer consumers and small businesses a low-cost and flexible process for the resolution of disputes. The EDR process has undergone intensive examination in the Review of the financial system external dispute resolution and complaints framework (Ramsay Review). The subsequent establishment of the Australian Financial Complaints Authority (AFCA), with its significantly expanded remit, will improve the effectiveness of this avenue of redress.

In the Interim Report the Commission raises questions about the enforceability of the banking code and notes, in particular, that remedy for breach of the codes requires action by the customer and not by ASIC.[78] These comments are made in the context of a discussion about SME and agricultural lending. The solution canvassed in the Interim Report is to mandate the Code under legislation. In our view this solution would be counterproductive. If there are particular provisions of the codes that warrant being enforceable by ASIC in the same way as a breach of an Act, then these provisions should themselves be inserted in legislation, rather than seeking to legislate codes in their entirety.

The question raised by the Commission has already been canvassed by the ASIC Enforcement Review which rejected the option of giving codes legislative effect. The Taskforce recommended a co-regulatory model, 'under which industry participants would be required to subscribe to an ASIC approved code that would be binding and enforceable through contractual arrangements with an independent code monitoring body'.[79] Given the recommendations of the ASIC Enforcement Review Taskforce and its in-principle support by the Government, the ABA supports maintaining a self-regulating or co-regulatory framework to apply to the banking codes of practice, consistent with the ASIC Enforcement Review Taskforce outcomes.

5.1.2 Codes under the Competition and Consumer Act

In asking whether the banking code, or other financial services industry codes should be given legislative effect, the Interim Report draws attention to Part IVB of the Competition and Consumer Act

[77] Nicola Howell, "Revisiting the Australian Code of Banking Practice: Is self-regulation still relevant for improving consumer protection standards?" [2015] *UNSW Law Journal* Vol. 38(2), Pages. 559-563
[78] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim report*, 28 September 2018, available at https://financialservices.royalcommission.gov.au/Documents/interim-report/interim-report-volume-1.pdf, Page 292.
[79] The Australian Government the Treasury, *ASIC Enforcement Review Position and Consultation Paper 4 Industry Codes in the Financial Sector* 28 June 2017, available at https://treasury.gov.au/consultation/industry-codes-in-the-financial-sector/ Page 11, EXHIBIT 2.1.42

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(**CCA**). **In our view there are important differences between codes such as the Banking Code of Practice and prescribed codes under the CCA.**

As noted by the ASIC Enforcement Review, industry codes prescribed under the CCA "generally deal with specific issues between firms operating within an industry, which cannot be addressed through self-regulation, rather than with supplier interaction with consumers".[80] In addition, when assessing the CCA code regime, some of its details should be considered. Firstly, there are prescribed codes and non-prescribed codes. Prescribed codes can be 'mandatory codes' or 'voluntary codes'. Mandatory codes apply to all players in an industry. Voluntary codes only apply to those who choose to subscribe.

The statement in the Interim Report that "a contravention of an applicable industry code engages all the remedial provisions of Part VI of the Competition and Consumer Act" requires qualification. The civil penalty and infringement notice provisions of Part VI apply only where the industry code itself contains a civil penalty provision. A minority of CCA prescribed codes contain civil penalty provisions. Further, for prescribed voluntary codes, the code and Part VI will not apply to firms that choose not to subscribe.

5.2 Regulation and the regulators

The Commission questions the effectiveness of the regulation and the regulators. This section addresses the following issues raised by the Interim Report questions:

- the regulatory approach to enforcement
- breach reporting legal sanctions, and
- the benefits of regulatory simplification for customers.

5.2.1 Regulatory approach

ASIC's governing legislation gives it a broad range of regulatory tools from which to respond to misconduct. ASIC's approach to enforcement should encompass the commencement of legal proceedings where justified by reference to public interest considerations, including deterrence and the character of the conduct, but its discretion to choose the appropriate response from its regulatory toolkit should not be arbitrarily restrained.

The Commission criticises or calls into question ASIC's approach to enforcement in a number of respects. Essentially these go to ASIC's use of remediation as a default response to contraventions of the regulatory framework, and to eschew criminal or civil proceedings.

ABA members acknowledge that effective enforcement of financial services laws and regulations is an essential component in restoring trust in the sector and confidence in the regulator. In the main, the ABA agrees with the proposition that, having regard to the range of tools available to it, ASIC's approach should not always privilege negotiation, and where appropriate, ASIC should commence proceedings in respect of contraventions. However, ASIC should retain an overarching discretion to apply the most appropriate of its regulatory tools in response to the circumstances of particular cases.

The approach outlined above should apply equally to ASIC's response to self-reported breaches – i.e. these should be assessed on a case by case basis by ASIC and proceedings taken where justified by reference to public interest considerations, including deterrence and the character of the conduct, but its discretion to choose the appropriate response should not be restrained.

[80] Australian Government, the Treasury, *ASIC Enforcement Review Position and Consultation Paper 4 Industry Codes in the Financial Sector* 28 June 2017, available at https://treasury.gov.au/consultation/industry-codes-in-the-financial-sector/ Page 100, EXHIBIT 2.1.42

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5.2.2 Extent of ASIC's remit

We note the Commission's comments around the size of ASIC's remit. If any of ASIC's functions were transferred to other regulators, the respective roles and regulatory boundaries should be clearly defined so that industry is left in no doubt as to the nature of its obligations.

5.3 Simplification

5.3.1 Reducing complexity

The regulatory regime for financial services is complex and simplification could, where appropriate, provide benefits for customers, regulators and the industry. Any program of reform should be targeted and progressive, and appropriately limited in scope. Large scale reform would be complex, costly and time-consuming, and paradoxically, risk increasing the burden to all parties. The burden of legislative reform can fall disproportionately on non-major banks and have a detrimental impact on competition.

ABA members would, however, support the identification of problematic areas and appropriate and targeted amendments. Any program of reform should be conducted in close consultation with regulators, industry and other stakeholders, and should seek to advance the interests of customers, instil better standards and culture in the financial service sector, and facilitate enforcement.

The Commission highlights the complexity of the regulatory framework governing financial services in Australia and asks whether radical simplification is called for. In the view of ABA members, the case studies outlined in the Interim Report generally do not suggest the misconduct identified arose as a result of complexity. As noted by the Commission, adding a new layer of regulation is unlikely to be the answer. Rather, identifying specific issues with complexity that create customer protection concerns, compliance complications for industry or enforcement issues for regulators, and simplifying and clarifying the law on a targeted basis to deal with these issues would be more valuable.

An example of an area that could be appropriate for a targeted, progressive review, is Chapter 7 of the Corporations Act, which contains the bulk of obligations in respect of the provision of financial services.

A specific example within Chapter 7 where clarity would be helpful is in relation to definitions of financial advice. ABA members support reconsidering the "general" and "personal advice" terms to improve customer (and industry) understanding. Distinctions between 'personal' and 'general' financial advice are confusing for the customer.

Advice definition was identified by the Financial System Inquiry (**FSI**), which observed that the use of the word 'advice' may cause customers to believe the information is tailored to their needs. The FSI recommended that 'general advice' should be replaced with a more appropriate, customer-tested term to help reduce consumer misinterpretation and excessive reliance on this type of information. The ABA supports that recommendation.

5.4 Consistent customer protection

The growth of 'shadow banking' and other non-ADI lenders has resulted in an imbalance in customer protections.

ABA members believe that regardless of which institution a customer chooses to bank with they should enjoy the same protections and standards of service.

ABA members believe retail financial services and credit providers should be subject to uniform customer protection measures. This would provide certainty for customers about what to expect when they purchase a product or take out loan, rather than added complexity from determining what regulatory regime applies to what provider. A uniform regulatory approach would also provide a level playing field for all providers in the markets and not create a regulatory distortion between ADI and non-ADI lenders.

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The expansion of shadow banking into consumer and small business lending means that existing consumer protections applicable to ADI's are often not applicable to shadow banks. The question is whether customers moving from products with the protections of a prudently regulated institution to products that do not offer the same protections is the desired impact of the regulatory changes.

ABA analysis shows that assets of shadow banks are growing faster than non-major domestic banks (regionals and mutuals). Two years ago asset growth was about the same (6.5 per cent versus 6.2 percent). Since then assets of shadow banks have grown by 15 per cent, three times the pace of other domestic banks (5 per cent). As a result, shadow bank assets are now at 6.7 per cent and other domestic banks at 5.9 per cent.

The new Banking Code of Practice and the protections contained in it are a good starting point for non-ADI lenders to adopt.