ROYAL COMMISSION INTO MISCONDUCT IN THE BANKING, SUPERANNUATION AND FINANCIAL SERVICES INDUSTRY FINAL REPORT – DETAILED ANALYSIS AND RESPONSE

5 FEBRUARY 2019

The Final Report of the Banking Royal Commission pulls no punches, with Commissioner Hayne starting the Introduction on Page 1 by saying "...in almost every case, the conduct in issue was driven not only by the relevant entity's pursuit of profit but also by individual's pursuit of gain…"

At first glance some may feel that the report didn't go far enough in terms of the consumer lending space. However, what the Commissioner quite rightly said is that the legal protections are there for consumers, in the form of legislation and codes of conduct. Consumer advocates have grappled with how these protections apply in practice as they have rarely been tried in Court. The Commissioner has formed the view that it is up to the regulator, ASIC, to litigate these questions. This in turn will then provide certainty to industry and consumer groups as to how consumer credit laws should be applied. If any gaps are uncovered by the litigation, it would then be up to the legislature to amend the offending provisions. This is how the law has evolved in Australia since it was introduced, and there is no good reason that we should depart from this now. To expect a former Justice of the High Court to have concluded otherwise was perhaps slightly ambitious for us consumer advocates at CCLSWA.

Although there were very few recommendations made in amending laws related to consumer and small business lending, the recommendations were still there to protect consumers, at a much higher level. At pages 8-9, Part 1.5.1, the Commissioner says:

> "At their most basic, the underlying principles reflect the six norms of conduct I identified in the *Interim Report*:
>
> - obey the law;
> - do not mislead or deceive;
> - act fairly;
> - provide services that are fit for purpose;
> - deliver services with reasonable care and skill; and
> - when acting for another, act in the best interests of that other.
>
> These norms of conduct are fundamental precepts. Each is well-established, widely accepted, and easily understood."

We agree with these principles as minimum standards of conduct. Should these higher level principles be applied, there should be fewer occurrences of misconduct.

The Commissioner then goes on to say: "Of course, when these norms are stated in the terms I have, it will be said that borderline cases can be identified. And applying the norms to some of those borderline cases may not be easy. <u>But real or imagined cases testing the boundaries of a rule do not show that the rule has no content.</u> Debate about whether the wire runs one side or the other of one or more fence posts must not obscure the size of the field the fence encloses." [CCLSWA emphasis]

This is really the first observation in the report where the Commissioner states that it is the litigation of test cases that determines how the law is to be applied.

At page 16, the Commissioner noted Treasury's submission on the need for caution before recommending change. The Commissioner goes on to state that there are 2 parts in relation to simplifying the laws that can and should inform, what is done in response to the Report:

> "First, it is time to start reducing the number and the area of operation of special rules, exceptions and carve outs. Reducing their number and their area of operation is itself a large step towards simplification. Not only that, it leaves less room for 'gaming' the system by forcing events or transactions into exceptional boxes not intended to contain them.
>
> Second, it is time to draw explicit connections in the legislation between the particular rules that are made and the fundamental norms to which those rules give effect. Drawing that connection will have three consequences. It will explain to the regulated community (and the regulator) *why* the rule is there and, at the same time, reinforce the importance of the relevant fundamental norm of conduct. Not only that, drawing this explicit connection will put beyond doubt the purpose that the relevant rule is intended to achieve. And, the further consequence will be to highlight the fact that exceptions and carve outs like grandfathered commissions constitute a departure from applying the relevant fundamental norm. Emphasising the fact of departure may assist in reducing both the number and the extent of these qualifications."

We support the Commissioner's approach in simplifying the laws and reducing the many loopholes. Specifically, in relation to the grandfathering provisions, the Commissioner observes at page 18 that:

> "Whenever change is mooted, someone will suggest that changing the permitted forms of remuneration would lead to constitutional difficulties because it would amount to an acquisition of property otherwise than on just terms.
> …
> It is time to ignore the ghostly apparition of constitutional challenge conjured forth by those who, for their own financial advantage, oppose change that will free advice about, or recommendation of, financial products from the influence of the adviser's personal financial advantage."

The Commissioner also warns against scare campaigns and fear mongering at pages 18-19:

> "A third point is sometimes made in attempting to justify preserving grandfathered commissions. It is said that prohibiting this form of remuneration once and for all will carry with it unintended consequences and the advice industry will be disrupted.
>
> Generalised fears of this kind should not be heeded.
>
> 'Disruption' and similar terms can be used, and in some submissions to the Commission were used, as little more than pejorative synonyms for 'change'.
> …
> If an exception to the rules prohibiting grandfathered commissions is to be preserved, the exception must be closely and cogently justified. Saying only that there may be 'disruption' or 'unintended consequences' is nothing but a naked appeal to fear of the future."

Unfortunately we have already seen this type of language used in campaigns from industry lobbyists in the first 24 hours since the release of the report.

RESPONSIBLE LENDING

The first substantive section of the report is dedicated to responsible lending.

Use of Benchmarks

Firstly, the Commissioner examines the use of benchmark figures, from pages 56 onwards. He discusses the use of the Household Expenditure Measure and he notes that at pages 57-58: "while the HEM can have some utility when assessing serviceability – that is to say, in assessing whether a particular consumer is likely to experience substantial hardship as a result of meeting their obligation to repay a line of credit – **the measure should not, and cannot, be used as a substitute for inquiries or verification**." [CCLSWA emphasis]

We very satisfied with the Commissioners observations. This is a win for WA consumers and will go some way to preventing unsuitable loans being provided to borrowers who cannot afford the repayments.

Unfortunately, the Commissioner did not comment on the validity of the use of HEMS to determine a borrower's ability to service loans, in previous cases, due to the current court proceedings between Westpac and ASIC. The Commissioner quite rightly stated at page 57 that: "The court processes must play out without commentary from me." However, the Commissioner went on to say that "**If the court processes were to reveal some deficiency in the law's requirements to make reasonable inquiries about, and *verify,* the consumer's financial situation, amending legislation to fill in that gap should be enacted as soon as reasonably practicable."**

This therefore leaves open the possibility for amendments to the responsible lending laws, upon the Court handing down judgment in the case.

At page 58, The commissioner goes on to say that:

> "I consider that the steps that I have referred to above – steps taken by banks to strengthen their home lending practices and to reduce their reliance on the HEM – are being taken with a view to improving compliance with the responsible lending provisions of the NCCP Act. **If this results in a 'tightening' of credit, it is the consequence of complying with the law as it has stood since the NCCP Act came into operation**." [CCLSWA emphasis].

This comment is in line with the argument put forward by consumer advocates for some time. Industry lobbyists have been quick to pick up on the word "credit crunch", when really all it means is that the lenders have to provide credit in accordance with the responsible lending provisions. If lenders had been doing this since the laws came into operation, then there would be no "credit crunch" or "tightening of credit". It is not new law. The use of this type of language falls squarely within the realm of fear-mongering that the Commissioner warned against.

Not Unsuitable Test

CCLSWA together with consumer advocacy groups, Financial Rights Legal Centre (NSW), and Consumer Action Law Centre (VIC), advocated for the introduction of a suitability assessment that reversed the onus of proof on the lender to ensure the product was suitable than not unsuitable.

At page 59, the Commissioner acknowledges our submission, being referenced at footnote 32, however goes on to state that "I am not persuaded that the test should be changed." The reason being that there was no requirement on the lender to assess "whether there was any benefit to the borrower", only to assess financial obligations. Whilst we understand and respect the Commissioner's view, we do disagree, in that lenders do have an obligation to make inquiries into a borrower's requirements and objectives, and we repeat our position that lenders therefore need to assess whether the loan is suitable for meeting those requirements and objectives, even though we were unable to persuade the Commissioner.

The first recommendation of the Report is therefore that:

Recommendation 1.1 – The NCCP Act
The NCCP Act should not be amended to alter the obligation to assess unsuitability.

Although this is not the outcome we had advocated for, the positive outcome of this is that there will be no immediate amendments to the NCCP Act, meaning that consumers and consumer advocacy groups continue to have certainty in the laws. We can expect credit providers and credit assistance providers to now act within the current laws with no excuses. Where there is still uncertainty in relation to the application of particular laws, it will be up to the regulator to test these uncertainties in order to determine which side of the fence they should fall.

INTERMEDIATE LENDING

From page 84 onwards the Commissioner examines consumer lending by intermediaries for vehicles and other consumer goods. The Commissioner has identified that the reliance of lenders on the retail dealer to provide accurate information about the borrower's financial situation provides an adverse outcome for the borrower. CCLSWA has long held concerns about the practices of car-yard intermediaries when providing credit or acting as agents for credit providers, as previously they had not had to hold a credit licence or comply with any obligations under the law.

Recommendation 1.7 – Removal of point-of-sale exemption
The exemption of retail dealers from the operation of the NCCP Act should be abolished.

This is a win for consumers as means that they know they can obtain loans with certainty that car yard intermediary required to act within the laws.

SMALL BUSINESS LENDING

From page 94, the Commissioner goes on to say that he does not favour amending the existing laws that relate to small business lending as this is likely to increase the cost of lending to small businesses.

Recommendation 1.9 – No extension of the NCCP Act
The NCCP Act should not be amended to extend its operation to lending to small businesses.

This relates particularly to guarantors of small business loans, at pages 98 – 99, the Commissioner comments that the general law provisions, citing principles set out in the High Court cases Amadio and Garcia, coupled with the 2019 Banking Code of Practice, should provide sufficient protections to guarantors of small business loans. Again, it is difficult to disagree with the Commissioner's approach, and should have come as no surprise given the Commissioner sat on the High Court at the

time of the decision in Garcia. This is established law and it would be up to the High Court to change the precedent.

ADD-ON INSURANCE

From page 288 onwards, the Commissioner recommends the introduction of the deferred sales model for add-on insurance, as set out in ASIC's proposal. This proposal was also set out in our submission which is referred to at page 289, footnote 121.

Recommendation 4.3 – Deferred sales model for add-on insurance
A Treasury-led working group should develop an industry-wide deferred sales model for the sale of any add-on insurance products (except policies of comprehensive motor insurance). The model should be implemented as soon as is reasonably practicable.

The Commissioner also goes further to say there should be a cap on commissions that may be paid to dealers, which we wholeheartedly support.

Recommendation 4.4 – Cap on commissions
ASIC should impose a cap on the amount of commission that may be paid to vehicle dealers in relation to the sale of add-on insurance products.

For too long we have seen unscrupulous dealers bundling add-on products into loans, incentivised by the commission they will receive.

THE REGULATOR

CCLSWA is pleased to read the Commissioner's recommendation from page 421 onwards that the current regulatory structure be maintained.

Recommendation 6.1 – Retain twin peaks
The 'twin peaks' model of financial regulation should be retained.

We are very satisfied with this recommendation. We agree with the Commissioner's observations that "detaching significant parts of ASIC's remit would disrupt the processes of responding to what … has now been brought into the public gaze by the Commission's work."

The commissioner goes on to say that the enforcement culture of ASIC and not the size of ASIC's remit should be the focus of change.

In regard to ASIC's approach to enforcement the Commissioner recommended at page 446 that:

Recommendation 6.2 – ASIC's approach to enforcement
ASIC should adopt an approach to enforcement that:

- takes, as its starting point, the question of whether a court should determine the consequences of a contravention;
- recognises that infringement notices should principally be used in respect of administrative failings by entities, will rarely be appropriate for provisions that require an evaluative judgment and, beyond purely administrative failings, will rarely be an appropriate enforcement tool where the infringing party is a large corporation;

- recognises the relevance and importance of general and specific deterrence in deciding whether to accept an enforceable undertaking, and the utility in obtaining admissions in enforceable undertakings; and
- separates, as much as possible, enforcement staff from non enforcement related contact with regulated entities.

Finally, the Commissioner also recommends the establishment of an oversight authority who would in effect, regulate the regulator. At page 480:

Recommendation 6.14 – A new oversight authority
A new oversight authority for APRA and ASIC, independent of Government, should be established by legislation to assess the effectiveness of each regulator in discharging its functions and meeting its statutory objects.

The authority should be comprised of three part-time members and staffed by a permanent secretariat.

It should be required to report to the Minister in respect of each regulator at least biennially.

Other Important Steps

The final chapter in the report deals with other matters. One of these matters is to look at funding for legal assistance and financial counselling. At page 493 Commissioner says "**I offer no views about the most appropriate sources, level or mix of funding. However, the desirability of predictable and stable funding for the legal assistance sector and financial counselling services is clear and how this may best be delivered is worthy of careful consideration.** Such consideration should look at all options that may be available to supplement existing funding."

CCLSWA welcomes this observations, as for years, financial counsellors and consumer advocates have struggled on shoestring budgets and threats of funding cuts, which all detract from being able to provide proper services. Although no recommendation was made, as the Commissioner did not ask for submissions on this issue, the Federal Government did address this issue in its response to the report. We stress to the Government to ensure funding for community legal centres is included in its review of funding to our sector.

Finally, the Commissioner recommends a compensation scheme of last resort at page 487. This recommendation will assist consumers who have been unable to obtain remedies where the financial institution is unable to pay compensation.

Recommendation 7.1 – Compensation scheme of last resort
The three principal recommendations to establish a compensation scheme of last resort made by the panel appointed by government to review external dispute and complaints arrangements made in its supplementary final report should be carried into effect.

CCLSWA welcomes this recommendation as it goes some way to providing peace of mind to consumers, knowing that their chances of obtaining a remedy will not be affected by the solvency of the institution.

CCLSWA CLOSING COMMENTS

We also wish to take this opportunity to thank all of our clients who have had the courage to share their stories with us. We acknowledge that without your trust in us, we would not have been able to advocate for the recommendations that were released today.

This is only the first step. It's now up to us, consumer advocates, government and industry, to work together to implement these recommendations so that the stories we heard at the commission, we never hear again.

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