

Hayne Royal Commission, 4 February 2019

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Royal Commission Final Report highlights

Graham Hand

The [Final Report](#) of the Royal Commission will not force radical changes to the financial services landscape, such as separating wealth and insurance from banks or merging regulators, but it does include many recommendations with wide-ranging implications.

Commissioner Kenneth Hayne started his Report by saying financial institutions and their staff focus too much on the pursuit of profit and personal gain:

"Providing a service to customers was relegated to second place. Sales became all important. Those who dealt with customers became sellers. And the confusion of roles extended well beyond front line service staff. Advisers became sellers and sellers became advisers."

The Final Report makes 76 recommendations, and both the Government and Opposition have already promised to 'take action' to implement all of them, with one exception. The Treasurer said the Government would not immediately accept the ban on upfront commissions paid by banks to mortgage brokers, due to competitive implications.

Here are some highlights of Hayne's recommendation:

Mortgage brokers and best interests duty

The law should be amended to provide that mortgage brokers must act in the best interests of the intending borrower. The obligation should carry a civil penalty provision.

The borrower, not the lender, should pay the mortgage broker a fee for acting in connection with home lending.

Changes in brokers' remuneration should be made over a period of two or three years, by first prohibiting lenders from paying trail commission to mortgage brokers in respect of new loans, then prohibiting lenders from paying other commissions to mortgage brokers.

After a sufficient period of transition, mortgage brokers should be subject to and regulated by the law that applies to entities providing financial product advice to retail clients.

Financial advice ongoing fees

The law should be amended to provide that ongoing fee arrangements:

- must be renewed annually by the client
- must record in writing each year the services that the client will be entitled to receive and the total of the fees that are to be charged

- may neither permit nor require payment of fees from any account held for or on behalf of the client except on the client's express written authority

Financial adviser disclosure of lack of independence

The law should be amended to require that a financial adviser who would contravene the Corporations Act by assuming or using any of the restricted words or expressions including 'independent', 'impartial' and 'unbiased' must, before providing personal advice to a retail client, give to the client a written statement explaining simply and concisely why the adviser is not independent, impartial and unbiased.

Grandfathered commissions

Grandfathered provisions for conflicted remuneration should be repealed as soon as practicable.

The Government subsequently announced this would be implemented from 1 January 2021. Many financial planners who borrowed money to buy trail commissions books have two years to adjust their businesses to a loss of this revenue.

Hayne added:

"the time when the initial advice was given and the initial conflict arose has passed. The influence of the commission has already done its work once. But the problem remains. The influence continues. Advisers have an incentive to keep their clients in products with grandfathered commissions rather than advise them to move to better products. There can be, and is, no justification for maintaining the grandfathering provisions."

Superannuation trustee obligations

The trustee of an RSE (Registrable Superannuation Entity) should be prohibited from assuming any obligations other than those arising from or in the course of its performance of the duties of a trustee of a superannuation fund.

Fees on MySuper accounts

Deduction of any advice fee (other than for intra-fund advice) from a MySuper account should be prohibited.

Deduction of any advice fee (other than for intra-fund advice) from superannuation accounts other than MySuper accounts should be prohibited unless the requirements about annual renewal, prior written identification of service and provision of the client's express written authority (as above) are met.

No hawking of super products

Hawking of superannuation products should be prohibited. That is, the unsolicited offer or sale of superannuation should be prohibited except to those who are not retail clients and except for offers made under an eligible employee share scheme.

One super default fund

Consistent with the Productivity Commission's proposal, it's recommended that a person should have only one default account. To that end, machinery should be developed for 'stapling' a person to a single default account.

Retention of 'twin peaks' regulation and superannuation

The 'twin peaks' model of financial regulation should be retained (that is, separation of APRA and ASIC).

The roles of APRA and ASIC in relation to superannuation should be adjusted to accord with the general principles that:

- APRA, as the prudential regulator for superannuation, is responsible for establishing and enforcing Prudential Standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by superannuation entities APRA supervises are met within a stable, efficient and competitive financial system; and
- as the conduct and disclosure regulator, ASIC's role in superannuation primarily concerns the relationship between RSE licensees and individual consumers.

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. Graeme Samuel has already been appointed to run this function.

Other details

The Report makes 24 referrals of institutions for misconduct which may involve civil or criminal proceedings, but contrary to expectation, it does not name any individual. The only major bank to escape mention is Westpac. Regulators need to decide the next steps, including the potential for criminal charges. Hayne says regulators have failed to prosecute when given an opportunity:

"Very often, the conduct has broken the law. And if it has not broken the law, the conduct has fallen short of the kind of behaviour the community not only expects of financial services entities but is also entitled to expect of them. Too often, financial services entities that broke the law were not properly held to account."

He draws attention to sales techniques in branches, saying:

"That is why the attempts by ANZ and CBA to sell superannuation in bank branches under a 'general advice' model may have contravened the law."

Concluding comments

Kenneth Hayne has passed the baton to legislators and regulators to act on his recommendations, including enforcing existing laws and giving far greater priority to customer needs over profits.

One of the fears behind the impact of the Royal Commission is the reduction in lending by banks to all sectors of the economy, especially small business. There is no news in the Final report to suggest it will become worse than it already is, and Treasurer Josh Frydenberg said,

"Let me be clear. Personal responsibility for financial decisions rests with those who make them. However those who suffer harm as a result of misconduct will have access to redress."

If looking for the most damning criticism of any company or people, it is probably NAB's Ken Henry and Andrew Thorburn who appear most exposed. Hayne said of them,

"I am not as confident as I would wish to be that the lessons of the past have been learned ... Overall, my fear – that there may be a wide gap between the public face NAB seeks to show and what it does in practice – remains."

Like the consequences for the entire report, the real improvements to the financial system after a year of unprecedented scrutiny, are ahead of us.

Graham Hand is Managing Editor of Cuffelinks.

8 problems the Royal Commission missed

Graham Hand

Commissioner Kenneth Hayne and his staff have done a good job, and rightly, he now has an exalted place in Australian financial markets history. It's almost sacrilege to criticise, but either due to the limited time allowed, the mandate or his focus, the work was not perfect.

The lack of time was somewhat self-inflicted. Many months ago, as someone who watched maybe 100 hours of hearings, I became frustrated with the amount of time the Commission was spending on a few issues. I wrote this editorial on 10 August 2018:

"Okay, we get it, please move on. The Royal Commission is doing great work uncovering poor practices in financial services, but after nearly three days on superannuation, it had interviewed only one company. The witness list has 16 entities on it. We already know from Round 2 in April that there is a systematic problem with advice fees. I have listened to a dozen hours of the Commission this week and we have run around in circles with two MLC/NAB witnesses, and one has returned for more questions today on Day 4 ..."

There's so much else it should address: performance reporting, fee calculations, rates paid on cash, valuations of unlisted assets, definition of 'defensive' assets (credit, property, alternatives), performance fees, active managers hugging the index, risk versus return, bid/offer prices, etc. And what about the dubious banking practices which have changed little in the 20 years since I wrote [Naked Among Cannibals](#)?

These issues will have more long-term impact on the vast majority of customer returns than charging fees for no advice or to dead people. I hope the Commission does not run out of time."

How Hayne rewrote the rules and achieved strong results

Hayne set new standards of enquiry which will lead the way for regulators. We knew something was unique from the moment the Commissioner aggressively pointed his finger at National Bank's counsel, Neil Young QC, who was questioning why his client needed to return the next day. Young had said, "*On our instruction, her answer will be that she had no involvement in these matters.*" Hayne hit the roof.

"You will not give her her answer, Mr Young. You will not. Do you understand me?"

And barely a peep was heard from any QC for the rest of the year.

The Royal Commission struck gold with a simple approach. Prior to the commencement of hearings, financial institutions were given the opportunity to come clean with their past mistakes. Hundreds of pages of misdemeanors flooded into the Commission, and thereafter, the skilled QCs assisting Hayne played back the admissions before embarrassed executives. Rowena Orr's '*Let me show you a document*' became a chilling phrase. Witnesses were forced to admit the sins of themselves, their companies and colleagues, and along the way, many did not survive. Sam Henderson, Terry McMaster, Chris Kelaheer, Craig Mellor, Catherine Brenner, Andrew Hagger, the four majors, AMP, IOOF and many more became victims.

Major issues missed by the Commission

Acknowledging the Royal Commission did a great job in shining light into dark corners, what did it miss, touch on or struggle with?

1. How banks price their products

Banks and other financial institutions offer a vast array of services. They are effectively the 'plumbing system' of the economy, especially in providing payment systems and intermediating between borrowers and lenders. Yet it is not difficult to find vital services which received little or no Commission attention.

Take the example of the way banks price their products. Why do the banks rollover the term deposits of existing customers at sub-market rates, forcing loyal customers to make a phone call to achieve a better rate? The vast majority can't be bothered or don't know the benefits, and what banks call 'retail inertia' makes a major contribution to interest margins. Why have credit card rates remained above 20%, when the poorest customers without the ability to pay off their cards each month suffer the most? Why do new customers receive lower mortgage rates than existing? Ross McEwan went to RBS in the UK after he missed the CBA CEO job to Ian Narev, and he said in 2014 that he found it,

"... absolutely abhorrent that you would give a new customer a better deal than someone who has been with you for 30 years."

I have written extensively on the subject of how banks price their products to protect profits, including in [this article](#). For me, failing to address this was Hayne's biggest shortcoming, because it affects millions of Australians in their everyday banking. Instead, the Commission spent day after day on financial advice and issues such as 'charging fees to dead people' which impact a relatively small number of people.

2. Difficulty pinning down culture

The complex subject of 'culture' seems at the heart of the problem in banks, but like many before him, Hayne struggled to define and grasp it. The most common phrase in response to the Commission will be 'rebuilding trust', which is convenient because there's no real way to measure it.

In the Final Report, Commissioner Hayne said:

"Too little attention has been given to the evident connections between compensation, incentive and remuneration practices and regulatory, compliance and conduct risks."

But what to do about such a culture?

A significant problem is how to define community expectations. A leading law firm, Allens, told *The Australian Financial Review* that while Hayne was extremely well placed to opine on matters of the law, he had no special expertise in deciding a benchmark for community standards. Banks do not have one dominant type of culture, although Hayne said poor behaviour could be traced to the pursuit of profit over other purposes.

We have written more on culture [here](#).

3. Accessing the financial advice that people need

It's well established that most people are unwilling to pay enough for financial advice to cover the cost of providing the full service. Many financial advice groups are thriving by servicing wealthy clients, willing to pay 1% or \$20,000 a year for advice on a \$2 million portfolio (and of course, much more). But charge 1% on \$50,000 and \$500 pays for two hours with a decent adviser, which is barely enough time to crank up the spreadsheet let alone have a decent conversation and produce the obligatory 70-page Statement of Advice.

The large banks addressed this problem by cross subsidising, selling their own products such as managed funds to help pay for advice. This led to the claims of not putting the clients' best interests first and favouring in-house products.

The end result of the criticism is banks stepping away from providing financial advice and fewer Australians having access to the services they need. Long-term planning and retirement incomes are likely to suffer as a result. Financial advisers do not only focus on investing, but they address aged care, social security entitlements, superannuation structures, estate planning ... on it goes. Is it better that the bank teller will send the bank client to the adviser in the office above the real estate agent, and hope the conflicts are less there?

The unclear mix of a sales culture with provision of financial advice confused the best interest duty of advisers for their clients. The revelations at the Royal Commission have further undermined public confidence in financial advisers, and are no doubt partly responsible for the outflow from retail funds to industry funds. But most industry funds have modest advice businesses, often focussed on limited or 'scaled' advice given the difficult economics of servicing members with low balances.

4. Fund commissions remain in certain sectors

Hayne has come down hard on commissions paid by product manufacturers to financial advisers, recommending a banning. But what about commissions by another name, such as paid by new issuers in Initial Public Offerings (IPOs) on the ASX? Commonly, the issuer will pay the lead broker and other brokers a 1% or more selling fee. Some brokers then offer this to financial advisers to sell the IPO to their clients, and while some advisers may reimburse it to clients, many do not. Why is a financial adviser prohibited from accepting a commission from a fund manager for an unlisted fund under the Future of Financial Advice rules and now Hayne's recommendations, when a Listed Investment Company from the same manager indirectly pays the adviser a fee?

5. Underestimating the competitive role of mortgage brokers

According to a Momentum Intelligence survey of 5,782 borrowers, 79% were not concerned that brokers are paid commissions by banks. The report, called *Consumer Access to Mortgages*, found 96% of people who use or intend to use a mortgage broker would be unwilling to pay the average upfront commission of \$2,000 that banks pay to settle a mortgage. There was a perception among those surveyed (who may not represent the entire population) that brokers source the best loans and deliver the widest choice. Of course, the Royal Commission and some bank CEOs have offered different examples of brokers acting in their own best interests with poorly-structured incentive schemes.

If the service were not available, a competitive force would be removed with borrowers dealing directly with the banks with the biggest branch networks. A KPMG survey says mortgage brokers have helped reduce net interest margins of the banks by up to 20% in the last 10 years through increased competition.

In the interests of full disclosure, it should be noted that Momentum Intelligence is part of a media group that publishes titles aimed at mortgage brokers and real estate professionals. Nevertheless, with brokers now commanding a market share of mortgage origination of over 50%, it's easy to see how a ban on payments by banks to mortgage brokers will increase the power of the big banks.

In the Final Report, mortgage brokers will be subjected to a best interests duty and a ban on trail commissions from July 2020. Many brokers argue they provide a significant ongoing service, but Hayne rejected this, saying:

"The chief value of trail commissions to the recipient, to put it bluntly, is that they are money for nothing."

In the only exception to agreeing to implement all 76 recommendations, Josh Frydenberg said the Government would delay its decision on Hayne's call for upfront commissions to be banned and replaced by a customer-paid fee.

In response to the Final Report, Peter White, the Finance Brokers Association of Australia Managing Director, said,

"If a user-pays model was implemented, we know that most borrowers wouldn't pay, and banks would make more money and standards would drop further. It's very disappointing that the Royal Commission wants to destroy some 20,000 small businesses for the monetary gain of the big banks, and we trust the government will see clearly on this and continue to work extensively with our industry to improve consumer outcomes."

6. Industry funds escape detailed scrutiny

If the Productivity Commission recommendation on choosing the 10 'Best in Class' superannuation funds as defaults is adopted, industry funds are likely to dominate and their success will be further consolidated. Retail funds will struggle to compete. As the dominant institutional provider of retirement savings, Hayne should have explored some of the criticisms levelled at them more.

Instead, we are left wondering if the claims of competitors such as retail funds have merit. Examples include the methods used to value unlisted assets, which carry a higher weight in industry fund portfolios than in retail funds. The role of union members as directors of the boards of industry funds and the extent to which their board fees are paid to their unions and ultimately to assist the Labor Party, was overlooked. There was some scrutiny of entertaining at major events and industry funds spending millions a year on The New Daily publication, but the not-for-profit sector enjoyed the Royal Commission.

7. Financial advisers have a right to charge 'fees to dead people'

It's a great headline and the type of phrase people can easily recall, and on the surface, it sounds terrible to charge 'fees to dead people'. But the profession (the legal people at the Commission) arguing financial advisers should not victimise dead people is the same profession that often charges 'fees to dead people'. When a lawyer handles the will of a dead person and helps to administer the estate, do they do so with a feeling of sadness and benevolence and not charge fees? Of course they don't, it's a major part of many legal practices.

Financial advisers often have considerable work involved with an estate. Accounts remain open until probate, the process of proving and registering the will of a deceased person with the Supreme Court. When a person dies, many people are involved with their estate, and the executor of the will administers the estate and handles the disposal of assets and debts. Is the financial adviser the only one who is not supposed to be paid?

8. Lack of financial literacy taught in schools

At the heart of many issues uncovered by the Royal Commission is a community with poor overall financial literacy. Many people do not know which superannuation fund they are in, its cost and features, they pay for insurance they don't need or can't claim on and hold multiple accounts with duplicate fees. They carry credit card debt costing 20% and buy properties off-the-plan from spruikers.

Okay, this was a 'misconduct' Commission, but with both the Government and Opposition promising to implement recommendations, it was an opportunity to direct funds to education and help better-informed people make educated decisions and reduce the misconduct opportunities in future.

Finally, back to the earlier point, what about ...

... performance reporting, fee calculations, rates paid on cash, definition of 'defensive' assets (credit, property, alternatives), performance fees, active managers hugging the index, risk versus return, bid/offer prices, etc.

Feel free to add any comments on other issues the Royal Commission could have addressed.

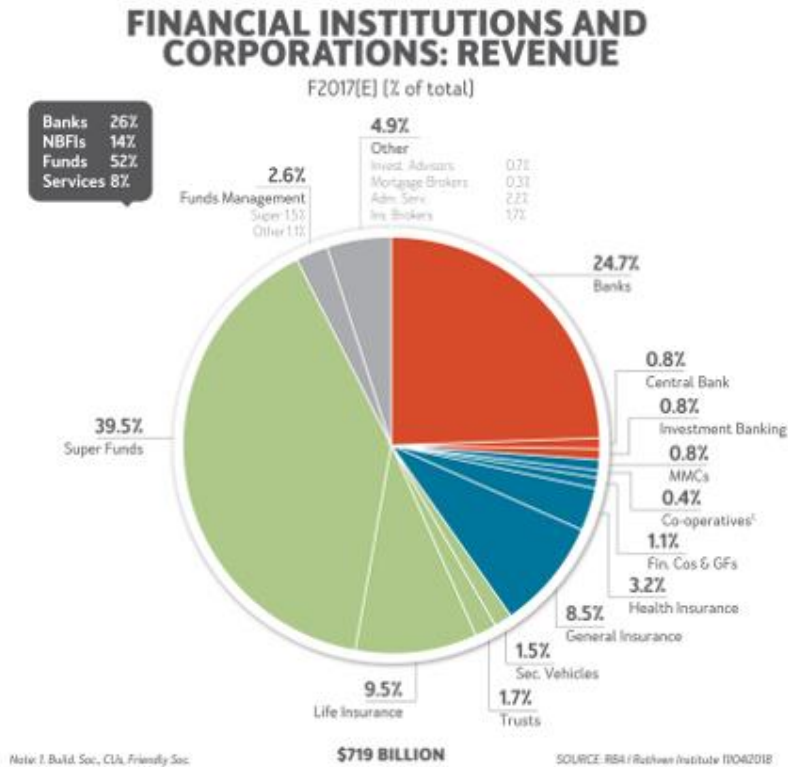
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The bank trouble started decades ago

Phil Ruthven

The profitability of Australia's finance industry – dominated by our big banks – has trended down over recent decades. The return on shareholder funds peaked in the early 1990s after the recession of 1991 and the crash of several banks.

The big players could see non-bank finance sectors growing much faster than banking revenues, and the exhibit below shows their concern eventuated. These days, banking accounts for less than a quarter of the industry's total revenue of over \$700 billion.



So, the big players diversified into the growth and other finance sectors which they did not understand. They became *theme conglomerates* and hoped that concentric marketing to existing customers would create greater profits.

They didn't and, like all conglomerates, were difficult to manage. The diversified sectors require different IP, different cultures, semi-autonomy and face different competitors.

The gains began to go to the employees, especially C-suite execs, salespeople, business development executives and brokers more than the shareholders. As competition grew, greed and cheating began and followed the apocryphal 'boiling frog' syndrome over the past decade in particular.

Our regulators have been shown to have abrogated their responsibilities, making us wonder what \$5 billion taxpayers' money has achieved over a decade or so. Many if not most boards at the big end of town are red-faced.

The Hayne Royal Commission has been thorough, fearless and reformative. The big financial institutions may now go back to being more focused than conglomerates, more ethical, easier to manage, and more transparent to their boards. Just in time to face the new challenge – which isn't faster growth on the other side of the fence appearing to be greener – but digital disruption. These include online financial services, blockchain and other daunting challenges.

Phil Ruthven is Founder of [IBISWorld](#) and is recognised as one of Australia's foremost business strategists and futurists.

How banks may have saved their wealth businesses

Graham Hand

When I go into a Toyota dealer, I expect to buy a Toyota. I don't want the sales person to act in my best interests and go through a check list and verify why I am not buying a Mazda. Or whether I should buy a car at all. Or whether I need two cars. Or give me a Statement of Car Advice to show they checked all my needs.

Let's also establish that wealth management businesses can be profitable. According to a PwC Report called [Banking Matters](#) released in November 2018, "*Wealth management income was also up at \$5.0 billion on a continuing basis, up 8.8% yoy (year on year) and 6.6% hoh (half on half), reflecting growth in average funds under management.*" PwC Australia's Banking and Capital Markets Director, Jim Christodouleas, said:

"It would be incorrect to suggest that banks divested wealth purely because of concerns about the profitability of these businesses."

Why is wealth management different than cars?

Let's take a quick look at the law.

The Corporation Act 2001, Section 601FC(1), under 'Duties of a responsible entity', says:

"In exercising its powers and carrying out its duties, the responsible entity of a registered scheme must ... (c) act in the best interests of the members and, if there is a conflict between the members' interests and its own interests, give priority to the members' interests."

For example, Colonial First State (CFS) is the wealth management division of CBA and the responsible entity for the funds offered to retail clients. Currently it's within the group, but soon to be sold. CBA manages billions of dollars of assets across all sectors through Colonial First State Global Asset Management. This 'vertically-integrated' structure in the wealth industry has been subject to intense scrutiny and criticism by the Royal Commission.

CFS is a good example because, along with AMP and perhaps NAB, CBA and CFS came in for most criticism at the Commission. CFS even admitted to being the gold medallist among the Big Five in 'fees for no service'.

Did CFS take its role responsibly?

When I worked at CFS, from 2001 to 2012, the 'best interests' responsibility was taken very seriously. It was common for the in-house legal representatives in meetings to divert management from a preferred course of action because, in their view, the action was not in the best interests of clients. There was often a lively debate about how to structure a product or communicate with clients, but someone always made sure the fiduciary duty was front and centre.

That's the irony for me. Wealth management is taking much of the culture blame, but in my personal experience, in product development and relationship management, the fiduciary obligation was well understood and respected.

How does this reconcile with the problems the Royal Commission has revealed? Much of it comes down to the economics of providing financial advice to a mass market. Only 20% of Australians have a financial adviser, and most people are unwilling or unable to pay for full-service advice. With a qualified adviser costing say \$300 an hour, with onerous compliance obligations on client discovery and Statements of Advice, a decent plan costs say \$3,000. That is 3% on \$100,000 or 6% on \$50,000 and beyond most people.

Advice versus sales

So the banks cross subsidised their advice with product margins, and this is where the sales culture advice model and best interests started to break down. Banks and wealth managers confused advice with sales. I believe there was an opportunity to remove the ambiguity and go directly and openly to the point. Just call it sales.

A good CBA product sold to a CBA customer could meet the best interests test of a reasonable fiduciary with the right design and disclosure process. Instead, CFS decided to lobby governments to retain commissions and tough it out and the rest, as they say, is history. At one stage around the implementation of FoFA, CFS could have tried the following:

1. A CBA customer who goes into a CBA branch to speak to a CBA teller and is directed to a CBA adviser will not mind being given a CBA wealth product. They are happy with a CBA loan and a CBA credit card, and for the vast majority, CBA funds are appropriate. The 'vertical integration' model was not the problem.

2. However, CFS needed clients to understand what was happening to meet the fiduciary duty. A 'manifesto' could have been handed to every client. It would say something like:

"Our Financial Advice Undertaking To You, the Commonwealth Bank Customer

In meeting your investment needs, many of the funds recommended to you will be provided by related parties of CBA.

We make this undertaking to you:

- 1. The fund will be competitively priced for the quality of the product and overall service provided.*
- 2. We will ensure the portfolio managers are highly experienced and skilled in funds management, and supported by the resources needed to do their jobs well.*

CBA is confident investments in these funds are in your best interests because we provide the services, technology and capital for our fund managers to deliver a quality product. We understand our own products best. Few external fund managers can back up their products with this level of support. We will also ensure our financial advisers are trained to understand your needs and act in your best interests. By taking responsibility for all parts of the value chain provided to you, CBA can monitor the quality and deliver value to you."

In other words, CBA/CFS could have made greater merit of the vertical integration model and highlighted its strengths rather than apologising for it. And if that meant the staff in branches were no longer called 'financial advisers', I believe few Commonwealth Bank customers would have cared. They borrow from and lend to CBA without knowing the rates are the best. Although the Royal Commission has rocked the industry, this month's Roy Morgan Research survey shows [rising satisfaction levels](#) for Australian banks.

Example of a competitive retail fund available to all investors

CFS spent considerable resources selecting the best fund managers and designing products to meet investor demand. Without wanting this to sound like a promotion for CFS or retail funds, let me illustrate with one CFS fund from the FirstChoice Multi-Index Series of six funds designed to match different risk appetites. Briefly, the Diversified Fund invests in eight different asset classes across Australian shares, global shares, infrastructure, emerging markets, bonds and cash. Its total management fee (with no performance fee) is 0.65%, with CFS handling rebalancing, manager selection using smart beta (not cap-weighted indexing) and access to a call centre, complete tax reporting, online transactions and regular newsletters. The minimum investment parcel is only \$5,000 with none of the weekly administrative fees charged by industry funds. It's a competitive product.

In fact, there is even a so-called 'A Series' available with a minimum of \$25,000 and a management fee of 0.47%, yet the public perception of retail funds is they are all too expensive.

Along with other funds in the Series, the Diversified Fund is a good in-house solution to offer to CBA customers.

Now, in the wake of the damning Royal Commission, CFS will be sold and the bank will exit wealth management. And who will provide financial advice to the millions of people who need it?

Graham Hand is Managing Editor of Cuffelinks.

Hayne struggles to address bank culture

Graham Hand

(Sections of this article are republished and updated from a piece first published in 2018).

The Financial Services Royal Commission has done an excellent job uncovering poor behaviour, including conduct that is already contrary to the law. It has exposed negligent practices, particularly in financial advice and insurance. Some parts of banking, such as the use of mortgage brokers and loans to small businesses, have been examined in detail.

It was evident during the final weeks of the Commission, as bank CEOs took the stand for the first time, that Kenneth Hayne was struggling with how to define culture. *The Australian Financial Review* counted 471 mentions of 'culture' in the final 10 days of hearings. It might be the most important question but one that will attract little attention, as there are doubts to what he can do in a practical sense. Hayne has already said the laws are adequate, even if regulators have not enforced them.

So is culture the 'the way we do things', the vision, the unwritten rules or personal accountability? Hayne settles on this recommendation in his Final Report:

"Changing culture and governance

All financial services entities should, as often as reasonably possible, take proper steps to:

- *assess the entity's culture and its governance;*
- *identify any problems with that culture and governance;*
- *deal with those problems; and*
- *determine whether the changes it has made have been effective."*

In his Executive Summary in last year's Interim Report, Commissioner Kenneth Hayne was refreshingly honest that simply passing new laws was unlikely to change much:

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

This issue of 'culture' and problems defining it and changing may be the biggest hurdles to achieving long-term, sustainable change. Hayne said in the Interim Report:

*"Changing **culture** in the Australian banks may not be easy and may take time. It cannot be assumed that entities will embrace change willingly or immediately. It cannot be assumed that entities will make desirable changes **at all levels of the organisation.**"*

And there's the critical issue. This is not about the bank CEOs offering apologies and accepting responsibility. It is about the thousands of day-to-day decisions made across the banks which affect millions of Australians which the CEOs never know about. In particular, the most significant impact on loans, deposits and services is what happens in the bank pricing committees.

We've gone down the culture path many times before

The former Chairman of ASIC, Greg Medcraft, did attempt to raise the culture issue and often found critics. For example, at the 2016 ASIC Annual Forum, the overall theme was 'Culture Shock', and Medcraft said:

"Inevitably, it is the stories of poor culture and poor conduct in the financial industry which are splashed across the front page of the newspaper, which pop up in our newsfeeds, and which are the subjects of heated discussion on social media sites."

In response, former CBA Managing Director, Chair of the Financial System Inquiry and current Chair of AMP, David Murray, shot ASIC a cannonball when he told a Fairfax Media event on 5 April 2016 that it was:

"... extraordinarily disappointing that ASIC should go down this culture tangent which will do more damage than good ... It's anticompetitive, it's inefficient, and to be perfectly candid, there have been people in the world who have tried to enforce culture. Adolf Hitler comes to mind."

He later apologised for the Hitler reference, but this illustrates attitudes at senior levels of banking, and it was only a few years ago that Murray's Inquiry was lauded for its work.

The then Prime Minister, Malcolm Turnbull, weighed in with these strong words at a Westpac function on 6 April 2016:

"We expect our banks to have high standards, we expect them always rigorously to put their customers' interests first, to deal with their depositors and their borrowers, those they advise and those with whom they

transact, in precisely the same way they would have them deal with themselves. This is not idealism, this is what we expect ... Wise bankers understand that banks need to very publicly demonstrate that their values of trust, integrity, placing the customers first in every way, they must be lived and not just spoken about."

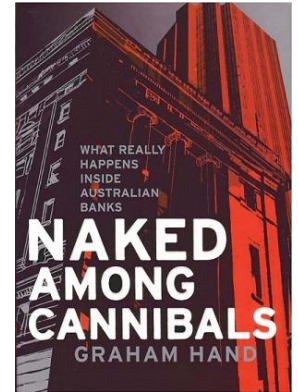
So we've done the culture and behaviour rounds many times before.

... including 300 pages in 2001

I chronicled my experiences in the way banks price their products in a book published by Allen & Unwin in 2001 called *Naked Among Cannibals: What Really Happens Inside Australian Banks*. As recently as 13 March 2016, Noel Whittaker quoted the book in the Courier-Mail:

"Despite the predictable protests from the banks [about rate-fixing and life insurance], there is nothing new in this. In 2001, ex-bank executive Graham Hand published his bestseller Naked Among Cannibals, which contained more than 300 pages about corporate greed and unethical behaviour by Australian banks."

Anyone wanting to take a journey into bank culture 18 years ago can read the contents page and first three chapters for free on [Amazon books here](#) or purchase the 320 page [eBook version here](#).



Banks have no equivalent of best interests duties

The Corporation Act 2001, Section 601FC(1), under 'Duties of a responsible entity' says:

"In exercising its powers and carrying out its duties, the responsible entity of a registered scheme must ... (c) act in the best interests of the members and, if there is a conflict between the members' interests and its own interests, give priority to the members' interests."

These duties apply to superannuation trustees, and therefore much of the wealth management industry, but not banks. There is no legal fiduciary duty in banking, and so culture and ethics must play a greater role in determining appropriate actions. Culture is the combination of beliefs, values and attitudes that guide behaviour.

What are examples of bank culture problems?

In 2003, I presented a Perspectives segment on ABC's Radio National. [The text is linked here](#). It was called 'A Banker's Dictionary'. I explained five terms – **entanglement, milking, mating calls, lagging and parasites** – we used in our Pricing Committee. It's unlikely in these days of political correctness that all the terms are still used.

Do the activities these words describe still exist? Consider the current Westpac term deposit interest rate schedule, as shown below for 28 September 2018.

Term	Interest paid at maturity or yearly
1 < 2 months	1.50%
2 < 3 months	1.70%
3 < 4 months	2.00%
4 < 5 months	1.85%
5 < 6 months	1.85%
6 < 7 months	2.05%
7 < 8 months	1.90%
8 < 9 months	1.90%

The rates highlighted in red are the 'special' offers. Why is the 3<4 month rate 2.00% when the 2<3 month rate is only 1.70%? It does not reflect the shape of the yield curve. Westpac has no particular need for 3<4 month money. It is the rate designed to attract new clients, and if you happen to be an existing client with a rollover for four months, you miss out on the higher rate.

It's an excellent way to extract more profit margin from customers over time. Banks can vary where they offer the highest rates based on where the existing rollovers occur. For example, if a previous special offer means a large volume of maturities occur at a particular time, a lower rate will be set for this maturity. Like all banks, Westpac relies on what we called 'retail inertia'. The majority of investors don't ring the bank for a higher rate, they simply allow the deposit to rollover for the same term.

Is it fair that the 85-year-old who is living on term deposit savings does not realise better rates are readily available from her own bank? Few people want 1.85% for 4 months when 2.0% is available for 3 months. Why should a loyal, existing customer earn less than a new client or one that makes a call or shops around? It's even been called a 'disloyalty premium'. The same thing happens with loans at special rates only for new borrowers. The Commissioner should give Rowena Orr the chance to ask a bank CEO why customers must ring up to receive a market rate. It's highly profitable in interest cost savings with billions of dollars of term deposits rolled over each year.

For the record, if CBA does not hold rollover instructions for a client, it places maturing term deposits into a Term Deposit Holding Facility (earning a rate of 1% for amounts between \$10,000 and \$99,999) until instructions are received from the client. You can judge whether this is a fair policy.

Banks also know that the more a customer is 'entangled' in an account, the less likely they are to leave. The best examples are at-call (cash) transaction accounts which link to direct debits to pay electricity bills, loan repayments, credit card balances etc., and direct credits receiving interest, salaries, dividends, etc. These accounts are so entangled that most clients cannot face the paperwork of changing to another bank or product. So why would the bank bother paying a decent interest rate on the balance? Most money in at-call or cheque accounts receives negligible interest despite all banks or their subsidiaries having more attractive deposit products. Shall we tell the client to switch to the online account that pays 3%? Are you mad?

There are many examples like these: slowly lagging cash rate reductions into lending rates but passing on increases quickly, or charging interest rates on credit cards of over 20% (which have so many embedded direct credits and debits that it's hard for people to leave). And the mysterious calculations of early repayment fees on fixed rate loans, as [previously described here](#).

Will the Royal Commission be a cultural turning point for banks?

Every major bank CEO has responded to the Royal Commission along the lines of this from Westpac's Brian Hartzler:

"The Royal Commission has identified many examples of misconduct across the industry. I apologise to any customers who have been impacted by mistakes that we have made."

Again, there is nothing new in these statements. At the 2015 AGM of the Commonwealth Bank, Chairman David Turner said on the bank's ethics:

"We see it down the road as being an ultimate competitive advantage. We think we will be the ethical bank, the bank others look up to for honesty, transparency, decency, good management, openness. That is exactly where we are trying to go."

And two-and-a-half years ago, the Chairman of National Australia Bank, Ken Henry, said in [a speech on the future of banking on 5 April 2016](#):

"In a successful business the customer drives product design and the suite of products offered. No customer is encouraged to buy something they don't need or charged more than they need to be charged to cover the cost of providing the product. No customer of a successful business buys something that they don't understand well enough to have a high degree of confidence that the product will deliver what they want, when they want it."

That's a high bar to jump. How does it fit with NAB [transaction accounts paying interest of 0.01%](#) and NAB [credit cards with interest rates of 21.74%](#)? I went to university with Ken, and he's a good bloke. But I do wonder if he has closely studied his bank's pricing policies.

Where will changes in ethical culture come from?

The Royal Commission offers no silver bullets on how to change culture, and the CEOs and Chairs of the banks need to find a way to embed a better balance between all stakeholders, not only the 'profit before people' that Kenneth Hayne describes.

Change seems to come only when forced on the banks, as Carl Rhodes, Professor of Organizational Studies at UTS, [summarised](#):

"This is not an ethical responsibility the banks have taken on voluntarily through their 'ethical cultures'. Responsibility was thrust upon them as a result of the actions of citizens, employees, regulators, and journalists. If it wasn't for them, the scandals would remain covered up."

Graham Hand is Managing Editor of Cuffelinks and he sat on the pricing committees of three banks from 1979 to 2001. Sections of this report are republished and updated from an article first published in 2018.

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