Royal Commission super insights

Observations on the implications for superannuation from the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Final Report

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Introduction

Commissioner Kenneth Hayne has handed down his long-awaited report into Misconduct in the Banking, Superannuation and Financial Services Industry and, based on KPMG's initial analysis, the *Final Report* will have far-reaching effects on superannuation funds and the financial services industry more broadly.

In the Commission's *Interim Report* in 2018, the Commissioner identified the following six norms of conduct:

1. obey the law;
2. do not mislead or deceive;
3. act fairly;
4. provide services that are fit for purpose;
5. deliver services with reasonable care and skill; and
6. when acting for another, act in the best interests of that other.

In the *Final Report* (Report) the Commissioner expands further and introduces some general rules that support and entail the six norms of conduct. These general rules are:

1. the law must be applied and its application enforced;
2. industry codes should be approved under statute and breach of key promises made to customers in the codes should be a breach of the statute;
3. no financial product should be 'hawked' to retail clients;
4. intermediaries should act only on behalf of, and in the interests of, the party who pays the intermediary;
5. exceptions to the ban on conflicted remuneration should be eliminated; and
6. culture and governance practices (including remuneration arrangements) both in the industry generally and in individual entities, must focus on non-financial risk, as well as financial risk.

These principles and general rules highlight the importance that the Commission has placed on the areas of governance, culture and accountability (enforced through remuneration arrangements) in financial services.

Focus on trustees' obligations, members' interests, and changes to distribution and insurance

For the superannuation industry, the Report's recommendations emphasise trustees' obligations to their members, seek to adjust the regulatory framework to clarify the roles of the Regulators, and of more significance, enforce accountability through the introduction of civil penalties and the extension of the Banking Executive Accountability Regime (BEAR) to superannuation.

The Report's recommendations are likely to significantly impact the business models and operations of a range of superannuation funds in the industry. Recommendations calling for a person to have only one default account and a ban on the unsolicited offer or sale of superannuation (and insurance) products will impact how many funds acquire new members, as will the proposed amendments to commission arrangements in respect of superannuation products. The additional restrictions on the payment of advice fees out of MySuper and choice products will also put considerable pressure on many financial advice businesses.

The Report also calls for the Insurance in Superannuation Voluntary Code to become enforceable through law, and seeks to improve the handling of insurance claims within superannuation. KPMG has focused our analysis on what we consider to be the four broad themes that are likely to have the most impact on superannuation funds and providers to the industry as a result of recommendations or commentary from the Report. These areas are:

1. Distribution models in superannuation;
2. Governance and culture;
3. The regulatory environment; and
4. Insurance in superannuation.

These insights complement KPMG's full overview of the *Final Report* which can be found here.

Distribution models in superannuation

A single default account and changes to distribution models

A single default account for life

KPMG recognises the benefits associated with the Report's recommendation to reduce the unintended multiple accounts within the industry through the implementation of a single lifetime default. However, we remain concerned as to the manner in which this will be implemented. As detailed in our submission to the Productivity Commission,[1] KPMG is not supportive of proposals around the use of a 'Best in Show' shortlist of default funds for new members. Rather, we see the merit of adopting some form of 'elevated MySuper licence', consistent with ASFA's recommendations, as a more effective means of driving better outcomes for members over the longer term.

Restrictions on fund expenditure and incentives

A further issue highlighted in Commission hearings was the use of members' funds for what may be considered less-than-ideal outcomes, such as sponsorship, corporate entertainment and other promotional activities. Whilst the Commissioner indicated that he is not seeking to prohibit fund advertising, the Report states that fund assets (comprising members' funds) should only be applied in ways that directly benefit members and should not, in any way, be used to influence employer decisions on fund selection. With many funds offering a range of sponsorships and other forms of support, it is vital for trustees to regularly review this spending.

Anti-hawking provisions

KPMG supports the recommendations in the Report banning the hawking of superannuation and insurance products. These prohibitions will apply to all superannuation products (including MySuper, choice and retirement products) as well as insurance cover provided through superannuation. We acknowledge the Commissioner's view that "the person to whom an unsolicited offer is made will very often not be in a position to judge the merit of what is offered". For funds that utilise outbound calling campaigns to engage members, particularly in relation to the potential purchase of retirement products, trustees will need to keep a close eye on any supporting legislation to ensure that such contact with members does not fall foul of the anti-hawking provisions. However, the Report makes it clear that the anti-hawking provisions will not apply to intra-fund advice or online direct marketing of products, where the client initiates and makes the purchasing decision.

Financial advice models and fee recovery

KPMG recognises that the poor behaviour associated with the 'fees for no service' issues resulted in a material focus on the provision of advice and the remuneration structures under which advice is provided within the superannuation industry. Against this backdrop, the Commissioner has proposed material changes to the advice regime for both MySuper and choice products. The prohibition on the payment of advice fees out of MySuper products is significant. This prohibition, in effect, means that superannuation fund trustees will only be able to provide intra-fund advice to members with MySuper products. Of equal significance is that financial advice businesses will no longer be able to receive advice fees paid out of MySuper products (except in relation to intra-fund advice). This will materially affect the ongoing viability of many advice businesses, who depend on these fees as a significant part of their remuneration.

At the heart of the recommendations in relation to choice products is the placing of greater onus on superannuation trustees (rather than advice providers, which is currently the case) in relation to the provision of advice to members. The Commissioner recommended a ban on the payment of advice fees from a choice product unless the fund provides the member with written confirmation of the advice services to be provided by the financial adviser, along with the fee to be charged, and the member approves the payment of the fee from their choice product.

[1] Superannuation: Assessing Efficiency and Competitiveness Stage Three Productivity Commission Draft Report 2018

In addition, for ongoing advice relationships, advisers must annually renew the advice arrangement and seek confirmation from the member of the advice services to be provided, and the fee to be charged before the fee can be paid from the member's choice product.

In addition to this, the Commissioner has confirmed the removal of all grandfathered commission arrangements as soon as practicable, and ideally by no later than 2021, to enable ASIC to undertake a post-implementation review of commission arrangements.

Whilst KPMG understands that the recommendations will have a significant impact on financial advice businesses, and an increase in the administrative burden associated with the provision of advice, we believe that the improved transparency will be of long-term benefit to superannuation fund members. KPMG also recognises the benefits that independent financial advice can provide to members and believes there remains a key role for financial advice within the superannuation industry.

In order to prepare for the likely passage of the advice recommendations into legislation, trustees will need to consider which form(s) of financial advice they wish to offer to members of the fund (whether intra-fund advice within MySuper, comprehensive advice within choice products, or both) and the manner in which this will be offered (online, phone based or face-to-face) to maximise the amount of advice provided, whilst also minimising, as much as possible, the ongoing cost of providing advice.

Governance and culture

Effective discharge of duties is good governance

One of the key messages of the Report is to refocus the attention of trustees and their directors on the proper discharge of their best interests and related duties. The Commissioner considered that these fundamental responsibilities of trustees are properly framed to protect members' interests without the need for further legislative change to them.

However, the Commissioner did recommend that a superannuation fund trustee should be prohibited from acting in any other role because of the potential conflicts inherent in doing so. The Report gives the example of where the one entity is both the trustee of a superannuation fund as well as the responsible entity of a managed investment scheme. However, the recommendation is not limited to this example and is intended to apply more broadly.

The Commissioner made it clear that this "no other role" prohibition would not prevent a trustee from using related administrators, investment managers or insurers, where the trustee outsources the performance of those functions to related parties.

While the Commissioner was critical of such related party arrangements, as examined in the case studies, he did not recommend the prohibition, structural separation or further regulation of them. Rather, the Commissioner considered that the existing best interests and conflicts duties, if properly applied by trustees, are broad enough to protect members against the conflicts inherent in related party arrangements. The only exception is the recommendation that trustees will need to obtain and provide to the Australian Prudential Regulation Authority (APRA), an independent certification that the arrangements and policies with a related party insurer are in the best interests of members, and otherwise comply with legal and regulatory requirements.

The Commissioner made the point that while related party policies, contracts and procedures may "exist on paper", that was not enough to protect members' interests – the critical issue is how those arrangements are implemented in practice. The Report was critical of APRA in failing to test such related party practices, a point that was conceded by APRA, which has subsequently commenced enforcement proceedings.

The Commissioner also made certain observations regarding the conduct of fund mergers, and reminds trustees that matters of board composition, and who nominates board and management positions, should be determined by reference to serving the best interests of members, rather than retaining control by other stakeholders.

Directors will need to think more deeply about their fiduciary obligations under the SIS Act as well as the covenants within the governing rules of the RSE. Further, recommendations within the Report (no other role or office [3.1], BEAR [3.9] and the roles of APRA and ASIC [3.8]) will support clarity in the application of Director's duties in day to day decision making.

The refocus on the best interests and conflicts duties, and how they are applied in practice, particularly in relation to related party arrangements, are clear signals to trustees and their directors to re-examine their governance and decision-making processes.

The Commissioner is also supportive of the proposed law reforms before Parliament to impose civil and criminal penalties for breaches of these duties and related obligations, and to empower both APRA and ASIC to take enforcement action for such breaches. As both regulators have been emboldened by the Commissioner to take more enforcement action, and the Federal Government is set to give them more resources to do so, now is the time for funds to get their house in order before the regulators come knocking.

The Report also recommends that over time, provisions modelled on the BEAR should be extended to all APRA-regulated entities and financial services providers, with APRA responsible for the prudential aspects, and ASIC responsible for the consumer protection aspects, of that extended regime. This will bring Australia in line with the UK regime and impose greater responsibility and accountability on those managing superannuation funds and their service providers. Further information in relation to the implications of extending BEAR to superannuation funds can be found here.

Culture

In the past, neither APRA nor ASIC have been drawn to define a 'culture check list', arguing, as the Commissioner noted, that cultural considerations are often unique to each organisation, and therefore cannot be prescribed or regulated by legislation.

However, the Commissioner raised concerns about the integrity of the regulatory framework, the culture at various financial institutions, and their ability to proactively identify, manage and resolve conduct related issues.

It is easy to dismiss the underlying cultural themes emanating from the evidence presented to the Commission as only applying to banks. As the hearings showed, there are conflicts inherent in many parts of the superannuation industry because of corporate structures, sponsoring organisations and the involvement of employers in default fund selection.

The interests of these stakeholders can influence the culture and decision making within different types of superannuation funds across the industry. Individuals within these funds face decisions on a daily basis that can affect competing interests and potentially favour one stakeholder group over another, potentially to the detriment of fund members.

The Commissioner made the point that "there are dangers in leaving questions of culture to financial services entities". Thus, the Report stresses the important role that regulators play in supervising culture.

Rather than asking what boards are doing in terms of culture, the Commissioner calls for APRA to receive additional funding so that it can supervise culture itself. This is in addition to revising its prudential standards and guidance, to focus more directly on culture and mitigating the risk of misconduct.

As the APRA CBA inquiry report shows, a careful and detailed assessment of the culture of an entity can be of great value. The Report is a timely reminder for trustees to continue to examine the culture and sub-cultures of their organisations. This cultural examination should equally apply when issues arise, where cultural insights can be gained from examining their underlying causes, and action taken to either change or enrich the organisational culture.

The regulatory environment

Enhanced supervision and more effective enforcement

Regulators

The Commissioner acknowledged that there is complexity and overlap under the current regulatory framework that has created some uncertainty as to which regulator should respond in any given circumstance. The Commissioner does not favour the creation of a single superannuation regulator. Rather, he preferred the current 'twin peaks' model but recommended that the current model be "adjusted" to extend and clarify the role of each regulator.

Based on our initial analysis, KPMG believes that the proposed "adjustments" in the roles of the regulators may continue to cause confusion and produce sub-optimal outcomes for the industry and consumers. For example, if there is a unit pricing error affecting superannuation fund members, it is proposed that:

- ASIC will be responsible for the remediation of members (consistent with its consumer protection remit), and
- APRA will be responsible for the testing of the trustee's policies, practices and the effectiveness of its control environment (consistent with its prudential remit).

On first examination, this approach would seem to make sense. However, on further analysis, there is a risk that this approach will add further complexity and cost to the remediation of such issues. The reason is because both regulators will need to be involved in these incidents because of their different remits. If this plays out in practice, it will require a number of changes to existing remediation programs because of the involvement, and different approaches, of both regulators.

Supervision of culture and governance

The Commission has also made a number of recommendations extending APRA's responsibility to the supervision of non-financial risks.

The recommendations support APRA being charged with the supervision of culture and governance and, in undertaking its supervision, to focus on cultural drivers and reducing the risk of misconduct.

APRA, as the prudential regulator responsible for the supervision of remuneration systems, will be required to revise its standards and guidance to include the management of non-financial risks, including the risk of misconduct.

The Commissioner provides further guidance confirming, "In looking at culture and governance, every entity must consider how it manages regulatory, compliance and conduct risks, with close attention needed to be paid to remuneration practices." The Commissioner emphasised that the responsibility for proactively managing governance, culture and accountability, including remuneration, rests with directors and senior management.

However, the Commissioner also stated that APRA should be required to actively supervise organisational culture and the management of the risk of misconduct. The Report is a timely reminder to re-examine and enhance existing frameworks as part of the ongoing monitoring, reporting and the process of continuous improvement within superannuation funds.

Insurance in superannuation

Strengthening insurance obligations

Suggested reforms reasonable but consultation is necessary

KPMG recognises that the key focus of the recommendations from the Report are designed to strengthen the obligations of superannuation fund trustees in managing the insurance arrangements offered to their members. The recommendations cover a broad range of issues identified including claims handling, unfair product terms, amendments to APRA's Prudential Standard (SPS250) and the ability by regulators or third parties to impose and enforce standards prescribed in the Insurance in Superannuation Voluntary Code (Code).

The Commission has highlighted the importance of ensuring that insurance arrangements (including the product terms offered, governance frameworks and operational processes) remain appropriate and in the best interests of members. KPMG looks forward to further detail of suggested application of the Report's recommendation that the Code be enforceable in law.

KPMG has worked closely with the Insurance and Superannuation Working Group (ISWG) and believes the recommendation to give the Code enforceability in law is an important step to enhancing member experience (including claims handling and treatment of vulnerable customers), and ensuring the insurance offer is appropriate for members. KPMG believes that the proper implementation of the Code by funds, supported by the proposed consolidation of multiple accounts, contained within the Protecting Your Super Package (PYSP), will resolve the majority of issues in relation to default insurance within superannuation, rather than the Federal Government's proposed removal of cover for many fund members (also contained within the PSYP bill), which will result in a material number of unintended consequences.

Aligned with the proposed changes to claims handling outlined within the Code, the recommendation to remove the exemption of claims handling under the definition of 'financial services' from the Corporations Act also highlights the need to improve claims handling by superannuation funds.

KPMG also agrees with the recommended amendments to SPS250 in relation to the need to provide independent certification to APRA that a group life contract entered into with a related party remains in the best interest of members, aligned to good business practice. Furthermore, KPMG supports the second recommendation of amendment to SPS250 requiring RSE licenses to be satisfied that the rules by which a particular status is attributed to a member in connection with insurance is fair and reasonable.

One area of the Report that KPMG believes warrants further consideration is the recommendation in relation to the potential use of universal terms within default MySuper insurance offerings. KPMG agrees extensive industry consultation is required to avoid potential unforeseen consequences and recognises that the tailoring of insurance offerings by funds can often lead to better outcomes for certain categories of members. Whilst we understand the objective of legislating universal terms to enable greater comparability for consumers, we believe consideration needs to be given to the potential pricing impacts, suitability for all members, implementation issues, and how such a change may impact the ability for the funds to tailor products and evolve their offerings.

Whilst we are broadly supportive of the recommendations, KPMG would suggest trustees continue to review their existing governance frameworks and holistically consider their future state insurance arrangements (as they are already doing to comply with the Code) to balance member outcomes and operational risks.

Looking forward

The winds of change are blowing in superannuation

The Report's commentary and recommendations follow the public release of the Productivity Commission's *Stage 3 Superannuation: Assessing Efficiency and Competitiveness* report earlier this year. While the Productivity Commission's recommendations are not replicated in the Report, there is significant commonality.

Both reports have been released as the Federal Parliament considers a range of superannuation legislation, and as the industry continues to consider the December 2018 release of APRA's *Strengthening Superannuation Member Outcomes paper*, and associated prudential standards.

Regardless of how, and in what form, the Report's recommendations are implemented, they will undoubtedly have a significant impact on the structure of the superannuation industry for many years to come.

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