

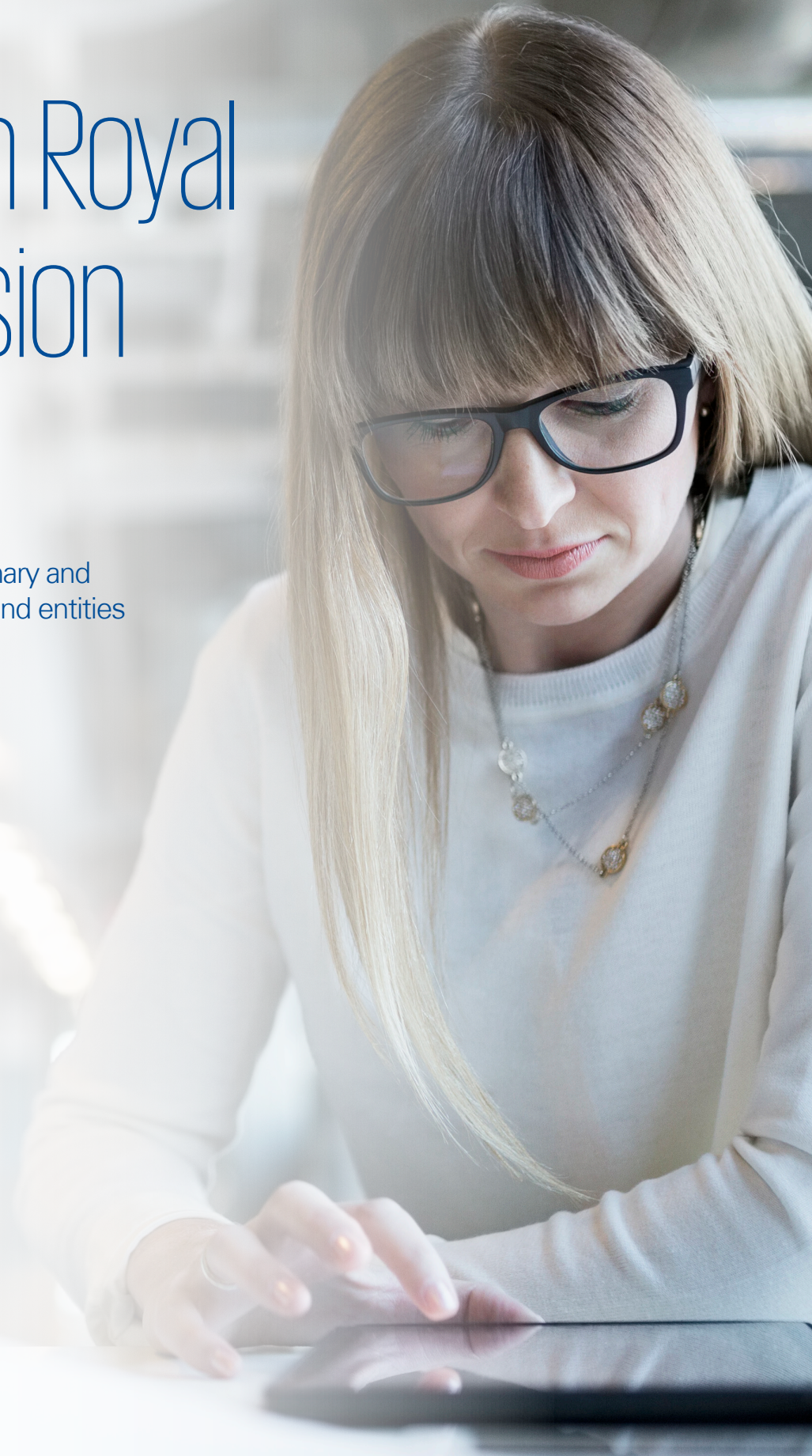


Australian Royal Commission themes

Issue 4: Interim report summary and
considerations for New Zealand entities

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Australian Royal Commission themes

On 28 September, the Australian Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the Commission) published their Interim Report (the Report), summarising the learnings of the first four hearings and highlighting the key questions that have come out of their work to date. The report was an extensive tome, composed of a 347 page first volume summarising the themes and key questions and a 487 page second volume providing details on the case studies discussed during the hearings. KPMG's three previous flyers outlined the specific findings coming out of each hearing across a number of key themes and many of the areas covered in the report have already been considered within them. The purpose of this flyer, as well as providing an overarching summary, is to outline the questions New Zealand's banks and insurers should be considering in light of the interim report.

Report summary key messages



Question 1:

How do you know the extent of misconduct activities?

Before the first hearing had even commenced sitting, the Commission was made aware of its first conduct challenge – the capability of financial services entities to pull together a single, aggregated review of all ‘misconduct’ and conduct related operational incidents over a five year period within their business.

The Report was critical of the Australian banks in this regard, questioning how, for conduct issues, senior management and the board of the bank “could be given any single coherent picture of the nature or extent of information framed by reference to particular events”. This echoes the message by APRA in their April 2018 Prudential Inquiry report, which highlighted how “internal risk systems do not allow for easy amalgamation of risks and incidents across business units”.

For New Zealand entities, the question of conduct data aggregation is just as valid. How confident are boards and senior management in our financial services entities in being able to collate a fully joined-up picture in relation to acts of misconduct? Without this full picture, how can senior management sign off on their responsibilities with respect to both culture and conduct?

Question 2:

Would your business change pro-actively or reactively?

The Report called out instances where the actions of the financial services entities highlighted reactive, rather than pro-active, behaviours. More than once, the Report noted, entities changed their products, processes and procedures upon the announcement by the Commission into hearings covering that type of conduct or product. An example of this was one bank ceasing to sell add-on insurance products days before it was called to provide evidence about them at a hearing.

More widely, the Report noted a fear in entities of being the first mover. Evidence showed that entities were more concerned about the resulting commercial disadvantage if others did not follow suit, than the actual or possible disadvantage to customers.

This question is just as appropriate to challenge New Zealand businesses with. Where your products potentially disadvantage customers, would you have the courage of conviction to change unilaterally, even if your peers did not follow suit? Additionally, if there was no consumer or regulatory focus on the product and you identified an issue, what would drive you to withdraw it from sale?



Question 3:

How well do you oversight those acting on your behalf?

Whilst financial services entities can outsource activities, they cannot discharge the statutory obligations underpinning them and the Report highlighted this as a significant area where issues arise. Issues were split across the provision of advice and use of intermediaries, with themes such as sufficiency of oversight by the entities, conflicted relationships and the confusion of roles between them.

The Report focused on how the structure of remuneration has had a detrimental impact on good customer outcomes. The use of value-based incentives with upfront and trail commissions have driven poor behaviours and led to a situation whereby “the choice between interest and duty is resolved, more often than not, in favour of self-interest”. Aligned to this, both the extent and quality of review and challenge by entities’ own staff of these external agents has been found wanting, creating a perfect storm of inappropriate activities that are not identified and challenged by entities.

In light of the Commission’s findings, do your frameworks around intermediary or appointed representative activities allow you sufficient oversight and assurance that they are doing the right thing and acting in a manner that tips the scale of interest and duty towards the customer?

“Both entities and customers appear to be confused about the roles of intermediaries. Issues then arise about how entities can communicate with customers to create realistic expectations of products bought through intermediaries.

And questions of communication arise when considering what obligations an entity owes to clients of an employee or intermediary when the entity suspects that employee or intermediary of misconduct toward at least some of their clients.”

- Commission Hayne on Intermediaries

Question 4:

How reasonable are your lending inquiries?

The Report highlighted a number of instances where banks believed the cost of verifying evidence was too much for the benefit it brought. In outlining its findings, the Report set out its key factors in what it believes reasonable inquiry and verification should look like. These are:

- Requirements and objectives: Establishing the customer's purpose for the finance required.
- Financial situation: Balancing both sides of the equation - i.e. both income and expenditure.
- Verification: Assessing the realism, accuracy and completeness of both the customer's income and expenses.
- Scalability: A proportionate approach to verification based on a number of factors relating to the customer and lending – see Figure 1 below.

As New Zealand's banks digest the Commission's outputs, it remains worth asking the question of to what extent does your lending, across all types of facility, follow the principles outlined by the Report? If not, what framework and processes will allow you to fully seek to deliver lending that is suitable for the customer?

Scalability in lending inquiries



Question 5:

Are your customer systems and controls fit for purpose?

Throughout almost every section of the Report, from financial advice to agricultural lending, entities acknowledged issues in systems and controls that led to poor customer outcomes. The majority of them were system-driven, such as interest miscalculations caused by a variety of different technical challenges and failing to provide services that customers were automatically charged for. In the case of fees for no service, the issue was compounded by not having systems or processes to even determine whether what was promised had been delivered. The table below provides further examples of errors impacting customers.

The Report made a number of observations around this, observing that entities should not offer to sell what they cannot deliver nor should they sell a product until they have adequate systems in place.

To New Zealand entities the same challenge is posed. How do you gain comfort that the issues seen in Australia are not happening to your customers? Can every activity-linked fee be evidenced as having been delivered to the customer? Are you able to reconcile the interest charged to customers to the product and rate they signed up to?

Types of errors identified impacting customers

- Failure to link off-set accounts
- Failure to apply correct interest rates
- Inaccurate serviceability calculators
- Failure to apply fee waivers
- Failure to apply bonus features
- Fees charged for services not provided
- Failure to process account payments
- Failure to transfer interest only loan terms to principal and interest
- Failure to trigger hardship notices
- Incorrect mail out of debt collection/final notices



Question 6:

How do you identify and assist vulnerable customers?

Whilst much of Volume 1 of the Report focused on the actions of the entities, Volume 2 of the Report discussed a number of case studies which showed the human impact of the entities' actions. As the evidence in the hearings showed, the effects can be profound. The Report identified failures to identify and assist vulnerable customers throughout the customer lifecycle, from the initial point of lending all the way through to remediation of products mis-sold.

Vulnerability was a feature of all the four hearings in the Report. This included inappropriate lending in the Consumer Lending and SME Lending segments and poor quality of customer guidance provided in Financial Advice. Financial hardship across Agricultural Lending and both access to and fair pricing of products to customers with limited financial literacy in Rural Communities also featured.

In New Zealand, the same challenges exist. How do you, as a business:

- define vulnerability?
- provide staff with sufficient guidance on to how to identify a potentially vulnerable customer?
- manage acknowledged vulnerability throughout the various stages of the customer lifecycle
- ultimately ensure fair and equitable treatment of your vulnerable customers?

Examples of vulnerable customer case studies

- A 72-year-old pensioner sought and obtained a 30 year \$50,000 home loan in March 2017 which was subsequently sent overseas to fraudsters. Bank statements provided to the lender for decision making had numerous similar transactions that highlighted suspicious behaviour.
- A problem gambler who asked a bank not lend him money, only to receive letters offering him credit card limit increases.
- Funeral policies sold to financially vulnerable customers where the premiums cost far more than the actual cost of the funeral.





Question 7:

How quickly do you correct your errors impacting customers?

The theme of timely and appropriate remediation of customers was a constant throughout the Report. By the end of the first Consumer Lending hearing, 900,000 Australian customers had been identified as impacted by misconduct or conduct below community standards and expectations.

The Report itself was critical not just about the extent of the problems but, where it had been identified, the speed and fairness of the entities' response to remediating their own misconduct. Entities were slow to identify the scale of a problem and to determine a proportionate response to this. Problems that were identified years before in the business went unreported to senior management or, where these were known, were not acted on.

Where New Zealand entities have identified or do identify a problem, how confident are you in having a framework in place? Does this allow you to quickly cut to the breadth and depth of the issue and agree an appropriate, fair response through senior management for your customers? Do you already have a remediation policy and, if not, should you?

Extent of Australian customers impacted

Between 1 June 2010 and 28 February 2018, nearly 900,000 customers were identified as having been affected. That number comprised of:

- Home loans: 540,000
- Car loans: 17,000
- Credit cards: 34,000
- Add-on insurance – home loan: 10,500
- Add-on insurance – motor vehicle: 212,000
- Add-on insurance – credit card: 65,000.

Question 8:

How do you ensure your own staff behave appropriately?

Poor staff behaviour was a constant throughout all of the hearings outlined in the Report, which focused its attention on how this could happen. The Report identified three key drivers:

1. Financial benefit – One simple, but telling, observation informs Hayne’s inquiries. All the conduct identified and criticised in the Report was conduct that provided a financial benefit to the individuals and entities concerned. If there are exceptions, they are immaterial. For individuals, the conduct resulted in being paid more. For entities, the conduct resulted in greater profit.
2. Governance and culture – The governance and risk management practices of the entities did not prevent the conduct occurring. Compliance was light touch or too focused on legalistic interpretations of black letter law, rather than moral questions of ‘should we?’.
3. Insufficient independence of oversight – Too often the oversight of staff was provided by individuals with conflicted interests, with their own remuneration often linked to the performance of those they were meant to be managing.

For New Zealand entities, in relation to these drivers, how have you structured and resourced your remuneration, governance and three Lines of Defence to prevent them occurring?

Poor staff behaviours identified by the Commission

- Misappropriation of client and customer funds
- Forging of customer signatures
- Backdating of customer documentation
- Customer impersonation
- Collusion
- Aggressive and inappropriate sales techniques
- Lack of care and empathy towards vulnerable customers
- Weak performance management by team leaders
- Failure to report or escalate issues and concerns
- Failure to deliver agreed actions to customers in a timely fashion.

Future developments

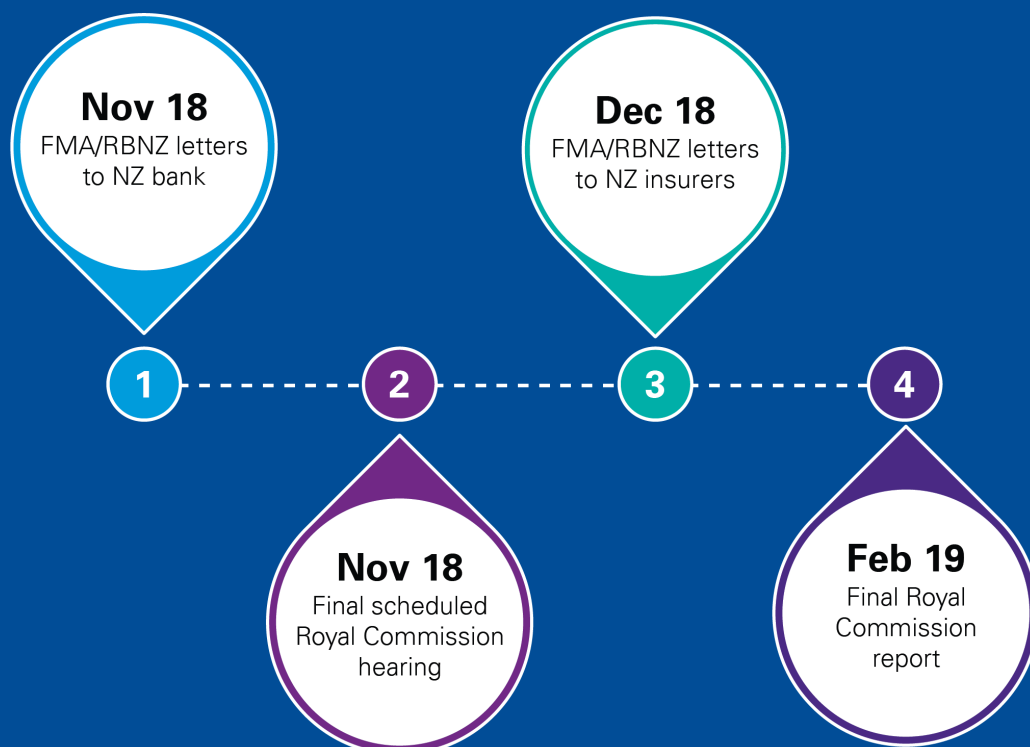
The Commission's Final Report is due in February 2019, with one final scheduled hearing due to take place in November 2018 covering design and application of financial services policy.

For New Zealand entities, the next few months bring on-shore culture and conduct updates from the Financial Markets Authority (FMA) and the Reserve Bank of New Zealand (RBNZ) with the public publication of the themed findings of their recent reviews into the banking and insurance sectors in early November 2018 and December 2018 respectively.

In addition, the banks and insurers themselves will receive their own entity-specific feedback during Q4 2018, which will set out work plans that the regulators expect to see completed during 2019.

Our message is that, like other territories where similar conduct and culture issues have been identified, close scrutiny of financial services entities' culture and conduct is here to stay.

Ongoing culture and conduct timeline



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