Australian Government

The Treasury

27 March 2019
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Mr Jason Lange
Executive Director
Office of Best Practice Regulation
Department of the Prime Minister and Cabinet
1 National Circuit
BARTON ACT 2600

Dear Mr Lange

GOVERNMENT RESPONSE TO ROYAL COMMISSION – REGULATION IMPACT STATEMENT REQUIREMENTS FOR FINAL DECISIONS

On 1 February 2019, the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services provided its Final Report to Government. On 4 February 2019, the Government released the Final Report and its response. The Government has committed to acting on all 76 recommendations of the Final Report.

I am writing to set out how the Regulation Impact Statement (RIS) requirements will be satisfied in relation to the final decision points for the measures that are part of the Government response. Implementation of the Government response is expected to take place over a number of years; however, in my view it is appropriate to address the RIS requirements for the package of measures at this point in time, in the earliest stage of implementation.

Certification of the Royal Commission Interim and Final Reports

During the course of the Royal Commission, Commissioner Hayne held seven rounds of public hearings (68 days in total), heard from 134 witnesses and received over 10,100 public submissions. In addition, the Office of the Royal Commission received many thousands of telephone calls and emails.

In my view, the Royal Commission's Interim and Final Reports have undertaken a process and analysis equivalent to a RIS and have adequately addressed all seven RIS questions for the matters covered by their recommendations. I am satisfied the process meets best practice consistent with the Australian Government Guide to Regulation.

As you may be aware, the Government's response covers matters beyond what was outlined in the Royal Commission's Interim and Final Reports. I have provided further analysis of these matters, including anticipated regulatory impacts, at Attachment A. Similarly, I certify that these additional analyses, when combined with the Royal Commission reports, adequately address all seven RIS questions for the matters in the Government's response.

Certification of independent reviews has previously been undertaken in respect of a number of matters that are part of the Government's response. These include matters related to:

- superannuation: a certification letter signed by Ms Vicki Wilkinson is at Attachment B;
- ASIC's enforcement powers: a certification letter signed by Ms Diane Brown is at Attachment C; and
- remediation and redress: a certification letter signed by Mr John Lonsdale is at Attachment D.

Regulatory costings, for all measures that give rise to regulatory costs under the Regulatory Burden Measurement Framework, are being agreed with the OBPR.

Yours sincerely

Paul Verschuer
Deputy Secretary
Markets Group
Treasury

Supplementary analysis: Government response to the Royal Commission

Ending grandfathering of conflicted financial advice remuneration

In its response to the Royal Commission Final Report, the Government announced it would end the payment of conflicted remuneration to financial advisers under arrangements entered into before the introduction of the ban on conflicted remuneration (commonly referred to as grandfathered conflicted remuneration), as recommended by the Royal Commission (recommendation 2.4), effective from 1 January 2021.

To ensure the benefits of ending grandfathering flow through to clients, the Government announced it would also require that any previously grandfathered conflicted remuneration that remained payable after 1 January 2021 could no longer be paid to financial advisers but must instead either be:

- paid as a cash rebate to clients, where the conflicted remuneration can be attributed to a particular client; or
- where the conflicted remuneration can only be attributed to a client group, be passed through in a just and equitable way to that particular client group . This could be by way of a cash rebate or a monetary benefit (for example, a reduction in fees).

The Government released exposure draft legislation that provided for the end of grandfathered conflicted remuneration from 1 January 2021. The draft legislation was released for public consultation from 22 February to 22 March 2019.

The Government also released draft regulations for public consultation on 28 March 2019. The draft regulations, amongst other things, provide details on how benefits must be passed through to the customer and the record keeping obligations that apply to persons required to pass through benefits.

The Government has also issued a direction to the Australian Securities and Investments Commission (ASIC) to undertake an investigation in the period leading up to the end of grandfathering (1 July 2019 to 1 January 2021) to monitor industry behaviour, including the pass through of the benefits of removing grandfathered conflicted remuneration to clients.

The regulatory impacts for industry are expected to be associated with the following activities:

- Contract renegotiations: Financial advisers and product issuers are expected to renegotiate their contracts to remove grandfathered conflicted remuneration in the lead up to 1 January 2021. These will be one-off transitional costs.
- Calculations of appropriate rebates: For those contracts where there is grandfathered conflicted remuneration at 1 January 2021, the payer of the conflicted remuneration (generally a product issuer) will need to identify affected clients and determine the most appropriate way to calculate and pass through the benefits of the grandfathered conflicted remuneration payments. These will primarily be one-off transitional costs to establish rebating mechanisms. There will also be some ongoing costs relating to the making of the payments (where rebating is required) and to assess whether the adopted methods for passing through benefits remain appropriate.

- IT systems: Compliance with the new requirements will require firms to change their systems. These system changes are necessary to stop the payment of grandfathered conflicted remuneration to financial advisers and, in some cases, to rebate it to clients. These will be one-off transitional costs.
- Record keeping: There will be new record keeping requirements imposed on payers of conflicted remuneration to maintain records of how and when conflicted remuneration was rebated after 1 January 2021.

Consumers are expected to benefit from the Government's decision in the following ways:

- The provision of higher quality advice, due to the removal of conflicts of interest associated with grandfathered conflicted remuneration.
- Lower fees, either as product issuers no longer need to recover the costs of paying grandfathered conflicted remuneration to financial advisers or because product issuers will be required to rebate or otherwise pass through the benefits of grandfathered conflicted remuneration to clients.

Other factors relevant for consideration are:

- Cumulative impacts of reforms: There has already been a number of Government reforms legislated for the financial advice sector. These reforms will come into effect over the coming years and will have a substantial impact on the industry (including potentially leading to the exit of a large number of advisers).
- Access to advice: Ongoing reforms aimed at improving the quality of advice provided to consumers and eliminating conflicts of interest result in the direct cost of advice to consumers increasing, which may potentially impact on access to advice. The Government has committed to establishing a Financial Advice Review, as recommended by the Royal Commission (recommendation 2.3), which will examine the effectiveness of measures that have been implemented by the Government, regulators and financial services entities to improve the quality of financial advice. This review could also examine any impacts the reforms have had on access to advice.

Amending the duty to take reasonable care not to make a misrepresentation to an insurer

In its response to the Royal Commission Final Report, the Government announced it would amend the duty of disclosure in the *Insurance Contracts Act 1984*, as per recommendation 4.5 of the Royal Commission.

The duty of disclosure allows insurers to appropriately price the risks being underwritten through limiting the risk of fraud and misleading disclosures. However, the Royal Commission found that the current duty of disclosure fails to recognise the extent of the information asymmetry between a consumer and an insurer and, in particular, fails to recognise that insurers are always better placed than an insured to identify the categories of information that they consider to be relevant to their decision of whether to insure a risk. This can result in consumers having their claims declined where they may have inadvertently failed to disclose their past circumstances.

The proposed amendment may result in insurers repricing some insurance contracts, but will result in a greater number of consumers having effective insurance policies.

Restricting the grounds on which life insurance contracts can be avoided

In 2014, a number of amendments to the Insurance Contracts Act were made that sought to improve the operation of the law, including to section 29(3) which provides life insurers with the ability to avoid a contract if the consumer was misrepresenting or not disclosing information to the insurer.

The Royal Commission received submissions indicating that some insurers interpreted the change in section 29(3) as expanding the circumstances in which an insurer could avoid a contract of life insurer and resulted in an 'avoidance' regime that was unfairly weighted in favour of insurers.

The Royal Commission recommended, and the Government agreed, to amend section 29(3) so that an insurer may only avoid a contract of life insurance on the basis of non-disclosure or misrepresentation if it can show that it would not have entered into a contract on any terms (recommendation 4.6). This will, in effect, reinstate the previous intent of section 29(3) of the Insurance Contracts Act to the benefit of consumers.

The Government decision is unlikely to result in material regulatory costs because the proposed amendment to section 29(3) is largely closing a loophole in the law that few insurers have exploited.

Removing of the exemption for claims handling from the definition of financial advice

The Royal Commission recommended that the handling and settlement of insurance claims, or potential insurance claims, should no longer be excluded from the definition of 'financial service' (recommendation 4.8). The recommendation related to both life and general insurance products. In its response to the Royal Commission Final Report, the Government accepted the recommendation.

Claims handling is currently excluded from the definition of a financial service. This means that insurers are not under a statutory obligation to handle claims efficiently, fairly and honestly, and ASIC is limited in the regulatory interventions it can make.

The need for the reform was demonstrated through a number of case studies examined in the Royal Commission's sixth round of hearings that concerned insurance.

In particular, in the case of general insurers, the Royal Commission's case studies highlighted instances of some insurers failing to handle claims in a fair and transparent matter, failing to act in an efficient, professional and practical manner, and breaching the insurer's duty of utmost good faith. The Royal Commission also found evidence of delays in claims that resulted in consumer detriment.

In the life insurance context, the Royal Commission's case studies identified numerous occasions where some insurers breached their duty of utmost good faith. Additionally, the Royal Commission highlighted several instances where insurers' conduct fell below community standards and expectations.

Removing the exemption will benefit consumers by ensuring they can expect the same standard from insurance claims handling as they can from all financial service providers. ASIC will also be provided with a clear mandate in relation to the oversight of claims handling. Removing the exemption may, however, have potentially unintended consequences if done in a way that, for example, inappropriately and inadvertently extends all licensing and financial advice rules to claims handling.

On 1 March 2019, the Government released a consultation paper on removing the exemption for insurance claims handling from the definition of 'financial service' in the *Corporations Act 2001*. The consultation was undertaken to identify the most appropriate way to implement the Royal

Commission recommendation to maximise consumer protection and minimise any unintended consequences of the reform.

Imposing a new statutory obligation to co-operate with AFCA

In its response to the Royal Commission Final Report, the Government announced it would introduce a new statutory obligation to require all compulsory AFCA members, including Australian Financial Services Licence holders (AFSL), Australian Credit Licence (ACL) holders and superannuation Registrable Superannuation Entities (RSEs), to cooperate with AFCA in the resolution of disputes.

The Government's action will address a problem identified by the Royal Commission that the lack of a statutory obligation to cooperate with AFCA is an 'important omission' in the dispute resolution framework, stating that 'there is little benefit in mandating the existence of [dispute resolution] systems if there is no obligation to comply with those systems.' The focus of the Royal Commission's recommendation was to require AFSL holders to take reasonable steps to co-operate with AFCA including, in particular, by identifying, locating and providing to AFCA any documents and information that AFCA reasonably requires for the purposes of resolving the complaint.

The AFCA Rules currently provide that AFCA members are required to provide information to AFCA within the timeframes specified by AFCA unless specific circumstances apply (for example, where provision of the information would be a breach of confidentiality or where the information no longer exists or cannot reasonably be obtained)[1]. The Royal Commission found that the 'proposal [for a new statutory obligation to co-operate] will serve to give statutory force to the promises that AFSL holders have made to the EDR body, and will allow ASIC to take action if those promises are not kept'[2].

On 20 February 2019, the Government announced that the Royal Commission Taskforce is 'preparing a Regulation to be finalised in March that will ensure all consumers that are subject to dispute resolution by AFCA benefit from this recommendation.'[3]

The Government's announcement broadens the coverage of the new statutory obligation to all financial firms required by law to be a member of AFCA, including ACL holders and superannuation RSEs. This will ensure that the omission identified by the Royal Commission is addressed for all compulsory members of AFCA, and ensure that any consumer that brings forward a dispute against a firm required by law to be a member of AFCA will benefit. Treasury has consulted with AFCA, ASIC, the Australian Prudential Regulation Authority and the Superannuation Complaints Tribunal in the development of the Regulation.

The proposal has been assessed as not imposing regulatory costs for industry. While there may be enforcement costs arising from the failure to comply with the new statutory obligation to cooperate for on-compliant financial services providers, enforcement costs are excluded from the Regulatory Burden Measurement framework.[4]

Increasing public reporting and oversight of firms' remediation activities

In its response to the Royal Commission Final Report, the Government announced it would strengthen the oversight and transparency of remediation activities through increasing AFCA's role in the establishment and public reporting of these activities.

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[1] AFCA Rules, clause 9.1.

[2] Royal Commission Final Report, p317.

[3] Treasurer's Media Release, 'Government action on Banking Royal Commission Recommendations 1.7, 2.4, 4.2, 4.8 ,4.11'

[4] Department of the Prime Minister and Cabinet, Office of Best Practice Regulation, *Regulatory Burden Measurement Framework: Guidance Note*, p4

The Royal Commission has heard evidence that firms' remediation activities are often slow and ineffective. Increased transparency and accountability for these activities would place increased pressure on firms to ensure their remediation activities are undertaken appropriately, which would benefit consumers.

The Government's proposal will not impose regulatory costs on the broader industry, but will impose insignificant administrative costs on AFCA. .

Establishing a national farm debt mediation scheme

In its response to the Royal Commission Final Report, the Government announced it would establish a nationally consistent farm debt mediation scheme that would require lenders to offer farm debt mediation as soon as practicable after a loan becomes impaired and well before foreclosure to assist borrowers to get loans back on track.

Existing State and Territory farm debt mediation schemes cover 87 per cent of farm businesses (according to ABARES data) and offers of mediation are compulsory prior to foreclosure in New South Wales, Victoria, South Australia and Queensland. Farm debt mediation is provided under a voluntary scheme in Western Australia. The existing schemes are broadly similar, and work is underway to harmonise these into a nationally consistent system. Tasmania, the Northern Territory and the Australian Capital Territory do not currently have formal mediation schemes.

A national scheme would require all lenders to adhere to the scheme and for both parties to engage in external mediation as soon as practicable after a loan becomes impaired and well before foreclosure.

This proposal would involve some regulatory impacts and costs. Lenders would likely experience additional costs due to the introduction of a scheme in states and territories where schemes are not in place. Greater national coverage and bringing forward mediation in the process of resolving impaired loans may increase the number of mediations, implying greater administrative costs and potentially delay costs if mediation schemes cannot meet demand. Some costs would be offset for national lenders if existing schemes moved to be nationally consistent as lenders' internal processes could be streamlined.

The impact on farm borrowers is that they would likely benefit from mediation at a time that allows for positive resolution of impaired loans. It may raise their administrative costs preparing for mediation, but it is expected that mediation would replace an internal process in many instances so that administrative costs may not rise by much.

Extending Design and Distribution Obligations to Credit Act and ASIC Act products and the Product Intervention Power to ASIC Act products

In its response to the Royal Commission Final Report, the Government announced it would extend the Design and Distribution Obligations (DDO) to credit and ASIC Act products and the Product Intervention Power (PIP) to ASIC Act products.

- Legislation[5] currently before Parliament, to implement DDO for financial products regulated under the Corporations Act and to apply the PIP to Corporations Act and credit products, has been amended to make the extension.

The Royal Commission found that it was unclear why all products within ASIC's regulatory remit were not covered by DDO and PIP. The proposed extension will achieve this.

[5] Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018

The extension of DDO and PIP in this manner will provide additional protections to consumers of financial products by ensuring that issuers of all financial products offered to consumers will need to determine a target market for the products and distributors will be required to take steps to ensure products are only offered to consumers within that target market. In addition, ASIC will be able to intervene to protect consumers from significant detriment caused by all products offered.

The proposal will impose regulatory costs for issuers and distributors of credit products and ASIC Act products in developing systems and training to implement DDO and in ongoing compliance monitoring. The regulatory impact of the application of PIP has previously been assessed at zero, given that ASIC will undertake a RIS process for each intervention made using the power.