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The thick edge of the wedge

The future for financial advice
and the client service dynamic

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In its wake-up call to the Australian financial services industry, Commissioner Hayne's Interim report encourages a broader consideration of community expectations for every business in the client services marketplace.

The Commissioner's approach of working through case studies of misconduct, has provided uncomfortable insights into the motivations, cultures and behaviours that have underpinned some of the misconduct of financial services businesses in Australia.

Through the confronting lens of victims, it draws conclusions about the standard of "community expectations" and cuts through years of cascading scandals to shine a light on the state of the industry and expose the very bones of capitalism, inviting a critical re-evaluation of the consequences of breakdown in competition and pursuit of "profit [as the] informing value".

In taking such a strong position the report speaks to a broader audience than financial services, and does not arrive in isolation. The Productivity Commission's report into competition in the sector, published just a month earlier, also reflects on the apparent disconnect between customers and business.

"While some of the major banks argued that they do not, individually, exercise market power, they have been able to insulate themselves from competition and sustain returns despite the massive system-wide shock of the global financial crisis. There is evidence that they have sustained prices above competitive levels, offered inferior quality products to some groups of customers (particularly those customers unlikely to change providers), subsumed much of the broker industry and taken action that would inhibit the expansion of smaller competitors in some markets. All are indicators of the use of market power to the detriment of consumers."

Key take outs on culture

- Commissioner Hayne was vocal about the culture of financial services and the larger questions about 'how profits are made'. In addition to questions about the nature of business, he emphasised the role of individuals within groups behaving poorly or not being able to understand their individual accountabilities clearly, and how that affects whole cultures.
- He spoke about the "siren song of finance" referencing the view that people in the finance industry broadly are, perhaps even despite their best intentions, motivated by remuneration and money and that this blinds them to their individual duty to act in the client's interest.
- One of the sharpest business shocks comes from the realisation that industry practice for long form projects and complex internal protocols obscure the community standard of doing the right thing. This is a culture challenge for the whole of corporate Australia.
- The Commission used the very powerful lens of "community expectation" by applying victim-based case study examples. This was not just a legal point to make, but a reminder that the community's expectations are different to the industry's when it comes to treating our most vulnerable – surely the very measure of culture?

While specific policy recommendations are likely to emerge with the final report, Commissioner Hayne's interim report is set out as an encouragement to change ahead of future government and regulatory intervention.

It sends a clear message that the tide of profiteering has to turn and that, one way or another, means must be found to ensure that existing laws – and the principles underpinning them – are adhered to and enforced.

Extract from the interim report

“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 general challenge to regulatory action rather than radical legislative reform, frames the debate as a challenge to rediscover the ‘fundamentals’ of doing the right thing by the client and society, and enlivening the accountability of individuals.

Echoing the sentiment of APRA's Prudential Inquiry report into CBA's governance and culture, Commissioner Hayne makes it clear that the North Star for financial entity conduct and compliance needs to be a default of ‘should we?’ rather than ‘can we?’. He raises six principles which cut to the core of how profits should be made:

1. *Do not mislead or deceive*
2. *Provide services that are fit for purpose*
3. *When acting for another, act in the interests of that other*
4. *Obey the law*
5. *Be fair*
6. *Deliver services with reasonable care and skill.*

Key take outs on regulatory practice and future legislation

- Commissioner Hayne flagged that his report is not an invitation for the laws to be radically changed, but about the need for them to be more radically enforced.
- He cautioned against over-legislating and invited discussion about the regulatory system, regulatory capabilities and regulatory appetite.
- Commissioner Hayne wants to enliven the sense of individual obligation and responsibility.
- He saw this as an issue of standards and education supported by regulatory attention on the individual in our view this will translate to individual licensing or registration.
- This flags an increasing future focused on individual accountability for every role in the sector, complete with potential individually focused rules and likely individually targeted sanctions.
- Other jurisdictions have something to teach us about future legislative change, but our markets are regulated differently. In practice, it is not a direct drag and drop in terms of regulatory models. One area of clear community appetite is in a regulatory model that increases the prosecutorial models of action.

Extract from the interim report

“The findings of ASIC’s report 562 (into vertically integrated businesses showing a bias towards selling in-house products and a far greater instance of inappropriate, even harmful, advice) demonstrate the validity of a basic observation... that the choice between interest and duty is resolved, more often than not, in favour of self-interest. And they are results that, on their face, deny a fundamental premise for the legislative scheme of the FoFA reforms: that conflicts of interest can be ‘managed’ by saying to advisers, ‘prefer the client’s interests to your own’. Experience (too often, hard and bitter experience) shows that conflicts cannot be ‘managed’ by saying, ‘Be good. Do the right thing’.”

In addition to grandfathered commissions – Hayne raised the stakes on wholesale changes in a number of other key areas:

Remuneration

01. Removal of all forms of volume/ value based bonuses (or sales-based variable remuneration) looks like low-hanging fruit from Commissioner Hayne’s perspective, especially with one major bank already having taken this step. He does caution though that removal of frontline sales bonuses will fail to have substantive impact unless the incentives of managers and executives are aligned. This is a call out to a general conversation about ‘remuneration and recognition’ across the board.

- Indeed according to an analysis by the Centre for Law, Markets and Regulation (UNSW), the word ‘remuneration’ was the second most referenced term in the report (behind ‘regulation’).

- The issue of the biasing power of remuneration is one that substantially exercised Commissioner Hayne. His statement that the “siren song of finance” acted as a compulsion that overrides client interest, is a message for all participants. The confronting conclusion of the effect of skewed pay models, adds fuel to the debate about what level of pay, and in particular bonus and ‘at risk’ pay, is appropriate in a sector that is supposed to be motivated by client interest.
- This debate will continue to draw public attention. Already data from the Governance Institute of Australia’s Ethics Index survey shows that Australians correlate size of remuneration with assumptions about a lack of ethics. Parliamentary scrutiny has also focused on this issue at an executive level in the banking sector and it is possible that remuneration interventions and in particular interventions around biasing remuneration, could well be a legislative outworking.

Key take outs on incentives & remuneration

- Remuneration is an issue of biasing power for Commissioner Hayne
- Remove all forms of volume/value based bonuses or sales-based variable remuneration
- Removing frontline sales bonuses will fail to have any substantive impact unless the incentives (financial and non-financial, formal and informal) of managers and executives align
- Begin the debate about the levels of pay, bonuses and ‘at risk’ pay that are appropriate for a sector acting in clients’ interests
- Do so under public scrutiny.

Change to best interest

02. Building on the idea of 'client interest', a rearchitecting of the "best interests duty" seems almost inevitable in the final report and consequent legislation.

Extract from the interim report

- "As amplified in the legislation, and as implemented in practice, the best interests duty and associated obligations are more in the nature of obligations to 'do no harm' to the client than 'do what is best'. The legislative provisions emphasise process rather than outcome. Although the fundamental obligation is cast as a 'best interests duty'... the Corporations Act provides that the best interests obligation will be met if an adviser follows the steps described in Section 961B(2). In practice this requires the adviser to make little or no independent inquiry into or assessment of products. Instead, in most cases advisers and licensees act on the basis that the obligation to conduct a reasonable investigation is met by choosing a product from the licensee's 'approved products list'."
- Commissioner Hayne appears to take general issue with the industry's application of the best interest duty, suggesting the common practice of reliance on the 'safe harbour' provisions (i.e. focusing on process rather than outcome) are errors of law, and public expectation. Not only does this almost guarantee a rewrite of the duty, it may open the potential for substantial questioning and potential litigation of past practice.
- The Commissioner's discussion of best interest also drew on issues of 'best' products. He reserved particular concern for the fact that in practice the house product was frequently deemed to be the best product, in the absence of any review.

- This opens questions about the role of Approved Product Lists (APLs) that advisers are required by licensees to use. Notably, the Productivity Commission has also made recommendations about APLs, arguing that ASIC should publish annual data about the use of APLs and their influence on the investment of client funds. Commissioner Hayne appears to go further. When noting his concerns about the shortcomings of disclosure, it seems unlikely that increases in ASIC APL disclosures would be considered to address the underlying problem effectively enough.

Ongoing service

03. Given the prominence of "fee for no service" in the case studies, ongoing service arrangements and the quality of client care will without doubt be another area in which Commissioner Hayne recommends reform. In particular, he highlights:

- "Licensees did nothing to prevent advisers having more customers on their books than they could monitor or advise annually."
- "The services to be provided under ongoing service arrangements were, and still are, often neither well-defined nor onerous."
- "As ASIC pointed out in its submissions, the promised services, even if provided, may not give the client a benefit commensurate with their cost."
 - He states that the content of ongoing services is a matter to be settled between a client and an adviser but, at the very least, is likely to recommend two specific regulatory reforms:
 - Switching to an annual (as opposed to two-yearly) re-negotiation of, and opt-in for, ongoing services.
 - A requirement that an entity (e.g. investment platform) asking for payment of fees for ongoing services obtain express authority from the client.

Structural change

Lastly, on the issue of structure, Commissioner Hayne made it clear that he has little tolerance for the inertia, opacity and complacency that have historically entrenched conflicted remuneration arrangements and delayed responses to client errors.

Even so, he is not so directive about the case for forced structural change, recognising that efficiency goals in all forms of business tend towards shared service models and integrated systems, suggesting it is more a matter of cultural commitment.

As it happens, Commissioner Hayne may have no need to make comment on the point of vertical integration, as the majority of the big four banks have already introduced structural changes to withdraw from all or some aspects of their financial advice businesses.

Similarly, there are inter-related trends already rolling across the industry that are set to have a significant impact on market dynamics and competition, which, before any intervention by Commissioner Hayne, could lead to the demise of vertical integration:

Current trend	Impact	Upcoming accelerant(s)
The narrowing of 'advice' in the value chain – being driven by changing consumer investment needs and shifts to Super and new platform services, and advisers leaving the large licensees	Surge of a new advice value proposition – fee for service based, self-funding, long-term relationship focused and increasingly distributed through self-licensed practices	The professionalisation of the industry and emergence of a new (and arguably) more select and premium service offering: The face and footprint of the industry will have changed within three years. Moreover, should Hayne go down the route of recommending individual licensing of advisers by ASIC, public perception of advice as a 'true' profession would also be considerably advanced.
Transformation of back-office cost base	Small adviser networks less encumbered by (lack of) scale and better able to compete	The launch and scaling of new third-party 'Regtechs' that can provide outsourced services to cater for the compliance and support needs of advisers: Such technologies could be critical to the viability of adviser networks which will be expected to make significant investments to improve their compliance and conduct oversight, particularly their monitoring and supervision capabilities.
A growing proportion (15-25%) of Australian adults willing to use digital advice channels	A new (more transactional) advice channel opening up competition in the industry and lowering prices – there is presently, according to the Productivity Commission, an estimated gap of \$1,700 between the cost of comprehensive advice and what customers are willing to pay	The ever-improving quality and sophistication of underlying technology and algorithms: This will be further propelled by the big data injection from Open Banking reforms being implemented from mid-2019. What's more, public trust would receive a further boost if, in keeping with the Productivity Commission's report, ASIC were to explore the introduction of a supplementary accreditation process for digital advice.
Product manufacturers rationalising and simplifying their product portfolios	Increased (true) product differentiation/competition coupled with more transparency/better comparison tools leading to improved consumer power	The introduction of the Design and Distribution Obligations together with ASIC's Product intervention power (most likely 2019): If effective, these new regulatory tools would propagate product simplification and tighten product targeting, marketing and distribution. Moreover, coinciding as they do with the introduction of Open banking, the hope is that they would engender a real wave of product innovation and tailoring to individual consumer needs.

“Commissioner Hayne appears to take general issue with the industry’s application of the best interest duty, suggesting the common practice of reliance on the ‘safe harbour’ provisions (i.e. focusing on process rather than outcome) are errors of law, and public expectation. Not only does this almost guarantee a rewrite of the duty, it may open the potential for substantial questioning and potential litigation of past practice.”

The march of professionalism

In 2019 financial advisers will face stringent new requirements to lift education, training and ethical standards.

An exam will be introduced for all new advisers (in addition to a degree requirement) and existing advisers will likely have less than two years to pass it, or exit the industry. The foundations for the code of ethics will also be put in place with statutory effect and potential regulatory weight. Although the role of effective code monitoring by private bodies drew scepticism from Commissioner Hayne.

Increased professionalism is undoubtedly essential but the process of transition will have mixed side effects. In the next five years, the face and composition of the adviser population will change, as will its absolute numbers. While exact figures are difficult to predict, Adviser Ratings reported in May 2018 that:

- There could be a greater than 50% reduction in the number of advisers (or at the very least the same as the UK experience which was a 25% reduction post RDR).
- With advisers leaving the industry or selling their practices, in excess of \$200 billion in client money is expected to transition in the next 12 months, with \$900 billion potentially moving into the unadvised pool in the next five years.

As well as a market 'shape' effect, there will be a substantial market 'content' effect with changed behaviours and new ethical requirements affecting the entire practice of financial advice.

This may also be echoed in regulatory structures, not just through ASIC's oversight of a statutory ethical code but through its, "Close and Continuous Monitoring" program, which embeds ASIC officers in business.

In similar fashion, the Productivity Commission also recommended the simultaneous appointment of a new 'Principal Integrity Officer' (PIO) in the increasingly overlapping credit licensee environment.

Key take outs on conduct, accountability, truth and professionalism

- Commissioner Hayne's proposes that the industry and all participants need to be more truthful and accountable for the promises they make to the public and individual clients.
- This extends from fees that are charged to promises attached to those fees – for instance, promise of investment return or even just promises about whether the advice is bespoke or off-the-shelf.
- These issues appear to require more or new professional standards. While Commissioner Hayne indicated his support for Industry Codes, he challenged the lack of truthfulness from those bodies in the promises they were making to the public and their members about in whose interests they operate.
- His summary was that Codes of Ethics need the weight of a regulatory authority. Association and Industry bodies should not be relied on as proxy regulatory authorities.
- This may mean that ASIC (or a future-version conduct regulator) will gain greater responsibility for standards and conduct and/or that code monitoring as currently envisaged in Corporations Act is a flawed premise.

In our view, we are looking at the thick edge of the wedge of wholesale financial services industry change.

The Productivity Commission argued that commission-based remuneration structures both limit competition and create conflicts for management and leadership. Therefore they require the appointment of a dedicated role, employed by ADIs and accountable for overseeing remuneration practices to ensure they do not lead to negative customer outcomes (by undermining the best interests duty).

Whilst proposed in the context of mortgages, the Productivity Commission envisages that the remit of a PIO would extend to other conflicted remuneration with the potential to impinge on consumers' best interests including financial advice and wealth management.

The concept is significant as it specifically empowers the idea of ethics and integrity in corporate structures and it encourages active engagement across the entire organisation. The Customer Advocate model in the banking sector is already in place, and as the post implementation review of their introduction gets underway, they do represent a powerful industry-driven initiative that reflects the recognition of customer centricity.

They may provide a framework that could be extended to encompass the top-to-bottom scrutiny, and independent oversight, of remuneration envisaged by the Productivity Commission. Either way, the call out for a 'Principal Integrity Officer' is seminal and, if robustly adopted by the industry may represent a 'last hope' for a self-regulatory role for industry around Conduct and standards.

These issues, even despite the potential revelations in the final report and consequential legislative reform, will have profound effects on the shape and future of the client-facing front-end of financial advice.

In our view, we are looking at the thick edge of the wedge of wholesale financial services industry change.

Commissioner Hayne's interim report landed with such a bang because its core narrative is coherent and built around six simple Conduct principles:

- Obey the law
- Do not mislead or deceive
- Be fair
- Provide services that are fit for purpose
- Deliver services with reasonable care and skill
- When acting for another, act in the best interests of that other.

Deceptively simple, these principles will have seismic consequence for the industry, because so many of the historical structures, policies, systems and practices (and resultant culture) seem to have acted against their application.

The final report will be even more compelling, followed as is likely by action from Government. The Royal Commission into Misconduct in Banking, Superannuation and Financial Services' prosecution of failure of these principles, presents both an opportunity and clear expectations for the industry to craft the future value proposition for financial services.

The report has been harsh on the industry, but we have no doubt about the industry's capacity and determination to respond to the issues and transform.

Either way, the call out for a 'Principal Integrity Officer' is seminal and, if robustly adopted by the industry may represent a 'last hope' for a self-regulatory role for industry around Conduct and standards.

Predictions about the future

What this means for financial services generally

Every person employed within the Financial Services system is likely to be affected by increasing expectations of individual accountability.

This may range from the introduction of internal standards of conduct for all roles, through to direct regulatory obligation for senior roles and client-facing functions. Early examples of this have been introduced through the FASEA and BEAR regimes already and were referenced by Commissioner Hayne for potential expansion.

Recent comments by both the Chair of ASIC and APRA⁴ have specifically framed this as a 'professionalism' challenge and the need for formal engagement with the personal aspiration of becoming a professional.

The long term outworking of such a dynamic could be wide ranging. Not only the articulation of professional standards systems and arrangements for the many different roles and levels in an organisation but also considerations of specific expertise and formal authorisations for different roles. It could even go as far as affecting concepts of remuneration, especially noting the arguments that participants in financial services have enjoyed a level of salary and remuneration that is generally seen to either lead to, or stem from unethical behaviour.

Professionalism and expectations of not just 'acceptable' conduct but 'ethical' conduct by all individual participants can only work if they are underpinned by structured systems of organisational support and the establishment of shared organisational values.

Ethics and integrity in the system need to be underpinned by ethically-directed compliance and reward systems across the entire business.

- Ethical Leadership will need to be negotiated and staked out by every organisation. Asking directly: What does good behaviour look like here? In the language of the Deloitte Conduct Practice, we identify this as 'Visibly Leading'.
- The ethical requirements established in the FASEA Statutory Ethics Code may well be a template for all practice across the financial services sector and roles. This is because they represent a general, statutory proposition for conduct, and because the expected Standards challenge organisations to ask: What does ethical behaviour (in response to a stated Code) look like at this firm? And how do we know it is happening?

In the language of the Deloitte Conduct Practice, we identify this as 'Choosing to Know'.

This translates beyond personal promises to the domain of organisational promises. Financial Services as an industry understands that it is in the business of making promises to clients every day. Promises include:

- The sorts of returns clients should get for their deposits
- The security they take from a home loan and mortgage
- The access they have to their own accounts
- The investment opportunities they have to manage their financial future
- The myriad detailed promises captured in daily transactions, documents and policies
- The grand promises made through brand and stated public commitments.

Living up to their promises is the positive commitment of all institutions. Making bolder, specific promises about future client relationships and ethical conduct, reflects a potentially exciting new pathway for financial services.

What does it mean for financial advice specifically?

In light of arguments around knowing and keeping your promises, the future of financial advice is set for radical change.

On a practical level, the recent model of advice, responds more to a finely nuanced compliance with the law, than to a simple focus on genuine client interest. It is not just potentially incorrect, it is also too costly to continue. The current practice relies on organisational scale and large or dedicated compliance staff, para planners and business teams. At a corporate level, this model has historically been heavily reliant on subsidisation of the costs from parent entities and other income streams. It cannot survive without a substantial change in either pricing to the client or cost efficiencies in the business.

However, the change to financial advice models will have to be more than an economic outworking of the current cost pressures, it will have to address (to its core) a new expectation for truthful, authentic service models and client relationships.

In our view, we expect to see rapid evolution in the following key areas:

01. The nature and channels for financial advice
02. The Products and Services that make up the financial advice offering
03. Business models and licensing arrangements.

Nature and channels for financial advice

We see that Financial Advice is likely to evolve into three distinct channels in the future:

01. Product and brand aligned services

The central value is for the client to be authentically aware of the products being offered (in light of true and clear branding) and for alignment to their best interests in terms of fair and suitable outcomes. This could even be a simple over-the-counter sales option.

The current blurring of 'advice' and 'sales' has proven impossible for consumers, and for some advisers, to distinguish between them. The capacity to project advice as tailored or even negotiated, when in truth it is only a standard service or a house product, will be removed. In many ways, this may look like a return to the tied sales agent models of the past, where the client chose an advice channel based on their brand preference for branded product.

02. Technology supported advice

Robo advice (fintech) is likely to be a strong delivery channel for transactional product offerings, and may make up the majority of simple or singular financial product decisions. The expansion of simplified products and fintech solutions will mean this channel will be available to financial advice practitioners acting on behalf of clients, as well as the increasing population of self-directed clients who may no longer choose to use an adviser, or at least not for the bulk of their simpler financial product needs.

03. The professional financial adviser

While likely to be a changed business environment, with a potentially smaller market of both participants and clients for a period of time, the future is optimistic for the adviser who is able to meet the professional and educational requirements to participate in that future. The importance of financial well-being, self-sufficiency in retirement, and complex financial opportunities, will continue to drive high net worth, pre-retirement and aspirational income Australians to an increasingly professional adviser community over time.

Value proposition differentiators



Transactional
Financial Products
RoboAdvice



Branded Product
Channels



Professional
Financial Advice

Accessibility/
affordability



Price transparency



Relationship
centricity



Technology



Advice status



Strong

Weak

Not in place today but
conceivable in the future

Products and services

Advice channels will stratify along with changes to financial products. The Commission implied that products are generally too complex for most clients, and the current model of disclosure-based solutions to information asymmetry offers insufficient protection for clients. Complexity and choice appeared to the Commissioner to deliver more benefit for the industry than the client. Product simplification and much greater regulatory intervention in product design and distribution are likely to be natural consequences of both DaDO (Legislative Design and Distribution Obligations) and the Royal Commission. It is not too a big a stretch to imagine a therapeutic goods administration (TGA) model being adopted that identifies financial products and consumer access options e.g. over-the-counter or fully advised, based on consumer risk.

Business models and licensing arrangements

From business models and value propositions through to shared services and compliance systems, everything needs to be imagined differently. With the cost of traditional financial advice becoming inaccessible to many, and wholesale changes to meet expectations for truthful and trustworthy business engagement, the question is how do financial advice licensees restructure to ensure their processes are fit for the new era?

The possibility of individual licensing or establishing quasi-licensing through increased registration obligations will increase self-determination and accountability for the individual adviser. They could also lead to a shift in both business practice and the support systems of industry. There is likely to be a wide range of competitive service offerings and segmented business models (for instance the rise of advice collectives and shared service options) to support the varied shape and needs of corporate and individual participants.

The successful financial advice businesses of the future will have solved each of the elements on page 13, opposite.

Regulatory environment

Change in the structure of agencies

It seems clear from the commentary of Commissioner Hayne that regulatory responsiveness and industry's negotiation approach to legislative compliance have been contributors to the current macro challenges and that, in forming solutions, the structure, role and responsibilities of regulators should also be up for grabs. For instance, he makes the point that ASIC's mandate is both impossibly broad from a scope perspective and impossibly large from a community expectations perspective. Whilst not offering these as excuses for either ASIC or APRA's approach to prosecutions, it does invite a discussion about what should the future regulatory environment look like.

Design of regulatory systems is a particularly complex issue in Australia, with multiple layers of sovereignty and Constitutional arrangements that complicate efficiencies in the regulation (for instance 'licensing') of different participants and market arrangements.

Designing a system of regulation requires consideration of whether regulators should be:

- functionally modelled (on a scope of activity or issues perspective – conduct vs.. prudential etc.)
- modelled on a sector or specialist basis (for instance one each for insurance, superannuation, wealth, banking etc.)
- regulatory participant and market based (for instance large cross sectoral entities vs. smaller single sector, individual licensing vs. entity licensing etc.)
- risk modelled (according to consumer, institutional or markets risk perspective etc.)

The invitation is to think about what is the best regulatory structure for the needs of the community (balancing economic productivity and national benefit). The problem though is not insoluble and a fresh consideration of regulatory models, agencies and systems could well provide the foundation for a new model of success in business.

Change in the regulatory data expectations

One thing for certain is that, into the future, regulators will require completely new tool kits and operating models to be able to engage in and respond to the dynamic expectations of community on the one hand, and the increasing agility of business (and data-fuelled) capacity to pivot to new customer and product opportunities on the other. Even in the context of present regulatory initiatives (just think of the supervisory demands that the 'spirit of' DaDO will engender), the expectations on industry for greater data transparency and predictive risk management will drive a rapid shift to new forms of real-time engagement enabled by Reg/Super Tech.

The successful financial services and business entity of the future is not just the one that can maximise the value of its data for internal insight and commercial benefit but also the one that understands data as a powerful source of transparency and authenticity. Building a holistic data strategy and sharing client, business and community insights could improve regulatory engagement, community engagement and social licence.



Every aspect of the value chain will need to re-designed to succeed for a narrower, more heavily scrutinised and competitive environment.

What does it mean for doing business in Australia in the future?

It would be misreading the Royal Commission into misconduct in banking, superannuation and financial services to see it as only informing the debate about financial services.

It contains clear messages for all industries and for every business about the way they are purposed, and how their obligations to clients sit at the centre of good business practice.

The mountainous body of evidence from a raft of regulatory commentary is universally aligned. Between the APRA report (Prudential Inquiry into the Commonwealth Bank of Australia), the Productivity Commission's recommendations (Productivity Commission report into competition in the Australian Financial System), commentary from ACCC's Chair Rod Sims (Companies behaving badly), and now Commissioner Hayne's interim findings, there is crushing evidence of a corporate business model that, in its pursuit of profits, is not 'putting customers first'.

The profitability lens adopted has been a short-term one. Sims makes the point that the competitive environment (or lack of it) has meant that 'being the best at meeting customer needs' has not been (or needed to be) the driving purpose.

Instead, a lack of effective competition coupled with sustained efforts to maintain that position, have been a breeding ground for poor behaviour and led to 'a race to the bottom'.

For business and government, there will be rich and challenging areas of policy debate in the years ahead, fuelled in the immediate term by an upcoming Federal election. The questions about whether the modern corporation and shareholder primacy model remains fit for purpose and whether our legal framework for monitoring and supervision is appropriate for societal expectations will be debated. Despite the Commissioner's entreaties, changes to legislation and further empowerment of regulators is inevitable.

Corporate Australia is already focused on rapid change. It accepts the need for a new compact. This is a demonstration of why politically driven change may not be necessary. However, even with Corporate Australia's best intentions, showdowns and an inevitable escalation in reputational, legally and economically, costly 'naming and shaming' are on the horizon.

This will also be motivated by the need for regulators to evidence their strengths to the community and legislators after having been challenged by Commissioner Hayne of being missing in action.

Success will require immediate and substantive consideration of corporate business purpose and social licence.

All organisations, including regulatory ones, will need to ask themselves:

What promises are we making to our customers in all of our communications, product offerings and interactions, and what culture (as defined by systems, policies, structures and individual accountabilities) do we want to have in our business?

Some practical ways to approach this might be:

01. Agree what is meant by acting 'ethically'

02. Ask what ethical behaviour looks like in each interaction with customers, and how it translates to our systems, policies and structures? Importantly, it also means establishing mechanisms for oversight of what good behaviour looks like in this business, and thinking through new models of compliance to support and encourage ethical behaviour.

03. Consider introducing a measure of 'customer value' that can sit alongside shareholder return and profit as an equal 'informing value' of the firm. For example:

- A. Savings or efficiencies generated that are shared directly with customers
- B. Customer savings from facilitated switching to better deals or 'nudging' of better behaviours
- C. Customer refunds from proactive remediations (i.e. before customer or regulator action)
- D. Customer value from the perspective of the customer.

04. Examine the organisation's business model and how its systems of reward, policies and structures support positive expectations. Ensure that complacency and distraction do not allow best intentions to be eroded in practice.

The underlying issues are seismic and so the solutions can and should be no less so. The competitive value proposition is an invitation to imagine broadly.

Of course, firms in concentrated markets can continue to make profits in the current fashion in the short term, but in the medium term there is an opportunity for a new business customer compact that could give rise to sustained thriving and corporate longevity. This is consistent with research showing that one of the key reasons why many large corporations fail to achieve an average life expectancy of greater than 50 years versus a potential of 200+ years (see our Centre for the Edge Shift Index) is because of a misreading of the short-term measurements for shareholder primacy.

In contrast, through the centuries, the longest-surviving companies have been those with a few core traits including a strong sense of identity, community and stewardship. Those more concerned with their effect on “real people” than exclusively on accumulation of capital and production of goods and services.

“Managers must decide how to position the human element in their companies. They can choose to produce wealth for an inner circle of managers and investors, or they can develop an organisation that is a community. The choice they make plays a large role in determining whether a company will outlive its founders.”

(HBR, “The living company”, 1997).

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Dr Deen Sanders OAM is a partner and Professionalism leader in our Governance, Regulation and Conduct team. Deen has more than 20 years of experience in financial services and is a recognised thought leader on regulation, ethics and standards. He was CEO of Australia’s Professional Standards Authority and the inaugural CEO of the Financial Adviser Standards and Ethics Authority.



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Johanna is a director in our Governance, Regulator and Conduct team. Johanna has fifteen years of financial services’ industry experience both in the UK and Australia, and has led significant change initiatives relating to Conduct and organisational behaviours.

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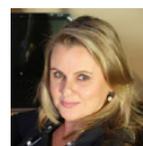
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