

January 2019

Why the Royal Commission's final report matters to property funds

The Royal Commission into Misconduct in the Banking, Insurance and Financial Services Industries final report is likely to recommend changes to financial services and wealth management, and property funds will have to navigate a more demanding compliance regime, a more proactive and assertive regulator, and a tighter lending environment.

Commissioner Hayne will hand down the final report on 1 February, following 10,140 online submissions from the public, 68 days of public hearings, 134 witnesses and more than 6,500 exhibits tendered.

Some main issues for property fund managers to address include vertical integration, governance, and increased ASIC surveillance. Compliance will need to be up to scratch. The Commission has amply demonstrated that any organisation can have weaknesses around compliance, and fund managers will need to ensure their houses are in order.

The regulators may assume a more aggressive approach which could make organisations nervous over the next few years. The Commission's interim report delivered some criticism toward APRA and its unwillingness to take misconduct cases to court. Will this sting APRA into action? A more assertive regulator was flagged by ASIC Chairman James Shipton, who said to the Royal Commission: "I want to make it crystal clear we will be undertaking more court-based actions."

Legislation is already underway to give the regulators stronger powers and increase the compliance demands on fund managers. The Commission has made it more palatable for increased compliance proposals to pass with little 'watering down' – significant changes which have either passed or are on the way include a tighter breach reporting regime, stronger penalties, Treasury's product design and distribution obligations, and the new Corporate Collective Investment Vehicle (CCIV), which also involves extra compliance for retail funds.

How much change can we expect?

The Final Report will most likely seek to make a bold statement given some shocking misconduct exposed, including: banks charging ongoing fees to deceased customers; insurers inappropriately pushing life insurance on vulnerable people; undermining legitimate mental health claims; inappropriate availability of credit, including offering increased credit limits to people suffering gambling addiction.

The interim report focussed on the questions: "Why did it happen?"; and "How can we avoid it happening again?".

Hayne has acknowledged the misconduct analysed at the Commission is already outside the law, and voiced caution about imposing additional laws.

But there is clearly an appetite for change to make the existing laws more effective. The interim report suggests the main issue is ensuring the existing laws are properly enforced, and has pondered whether existing laws should be applied or enforced differently, and whether it should be simplified.

How the Royal Commission will impact property funds:

Governance:

Governance failures emerged as a key issue, and the onus is on property funds to put their governance to the test and identify any potential weaknesses.

Board accountability has been highlighted in the media, and its possible boards will face more scrutiny around whether they have the right mix to meet heightened community expectations. Directors may face greater demands regarding operational issues, compliance and risk.

Key governance issues raised by the Commission include vertical integration, conflicts of interest, and breach reporting – tighter breach reporting rules are on the way, which could put some governance structures to the test. Breaches may occur but the true impact depends heavily on how quickly organisations can identify, respond and remedy breaches. Organisations which are slow to act will be punished and risk negative press and damage to their reputation.

Greater compliance:

Greater compliance demands were already in progress, courtesy of the ASIC Enforcement Review and other measures including Treasury's impending "product design and distribution" obligations, the CCIV, and new breach reporting rules. The Commission has only ensured a smoother path for these proposals.

Retail property funds will find the increased compliance demands particularly challenging, and it's possible boutique funds will find certain obligations within the product design and distribution guidelines difficult for releasing new funds to the retail market. In practice, these additional compliance measures will require funds to invest more in their compliance teams, and to invest more in legal advice. The additional costs involved will make some products marginal and could see boutique managers lean more toward wholesale products, which are not bound by these compliance measures.

Tougher breach reporting rules aim to give the regulator more bite with a more enforceable regime. The breach reporting reforms include extending the definition of a "serious breach" to catch a wider set of behaviours, and there will be higher penalties for failures to report.

The Commission focussed on some lengthy delays in reporting breaches, and it seems likely such delays will not be tolerated in future. While the banks were the major subjects at the Commission, all license holders need to analyse their breach reporting and ensure they have the processes to investigate, report breaches, and process any remediation quickly.

Property funds will need to be more proactive and consider working closer with the regulator where appropriate – ASIC has already shown a willingness to collaborate and be more proactive than previously. Property Funds may consider liaison with the regulator to identify weak points, to cover

off responsibilities and requirements in compliance and breach reporting. Property Funds should also remember ASIC expects to be continuously informed.

Tighter lending environment:

Tighter lending restrictions may have emerged independently, but have been validated and possibly accelerated by the Commission.

For example, the Commission asked serious questions of the benchmark used to assess customer debts and liabilities, including the Household Expenditure Measure (HEM) used by the banks. This prompted analysts to claim there are approximately \$500 billion of “liar loans” in the banking system.

The consequent lending tightening has seen falls in residential property around Australia, the largest falls since the 1980s, which has had knock-on effects including a drop in building activity – further falls could impact some unlisted property funds and may cast doubt on some building projects.

Non-bank lending has emerged to fill a void and is likely to get bigger. But how lending restrictions may impact end buyers is still playing out and will be watched with interest.

Finally

Moves toward greater compliance and regulation for financial services license holders were already well underway before the Royal Commission commenced proceedings one year ago. But the Commission has validated these proposals and property funds must adjust to a more demanding regulatory regime. The final report will impact property funds, the question is by how much.