Australian Impact Investments

Hayne Royal Commission: Implications for Investors

"*It is not that [the banks] have something to hide or that they are fearful of scrutiny. What they are deeply concerned about is that, in the absence of any real substance or evidence that would indicate the need for the extraordinary powers of a royal commission, then to rush down that path will seriously damage our reputation in global markets.*" Anna Bligh – Australian Banking Association, 26th July 2017

"*…this Final Report lays bare how banks have failed their customers and let down the Australian public.*"
Anna Bligh – Australian Banking Association, 4th February 2019

The Hayne Royal Commission revealed the extent to which major financial institutions in Australia have put their interests and profits ahead of the best interests of their customers. As a result, we have downgraded all major financial institutions to a RED rating (Creates Harm) – as outlined in the table at the end of this report. We have also recommended a strategy for ethical investors to adopt in relation to bank investments, to ensure the good work of the Royal Commission leads to sustained change.

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Report (*Report*) was released in February 2019 and we have worked through it in detail to form an independent opinion on its findings and recommendations. Our primary aim was to assess whether the misconduct highlighted by the Report was cultural or systemic, since systemic issues are usually easier to fix than cultural issues and don't necessarily indicate devious intent. Commissioner Hayne's assessment highlighted:

- Core banking services contained various instances of cultural problems, particularly around mortgage broking and agricultural lending, but were predominantly systemic issues.
- Services related to wealth management, insurance and peripheral activities, such as the use of bank tellers to cross-sell wealth management products, displayed significant evidence of misconduct driven by cultural issues that permeated entire organisations through a sales culture rewarding greed.
- Regulators (APRA and particularly ASIC) failed to create an environment of compliant (and ethical) activity through a lack of regulation enforcement and over-reliance on negotiation rather than penalties available under law. Essentially the regulators were captive to the entities under regulation.

It is interesting to note that wealth management and insurance activities contributed relatively small levels of profit for each of the major banks yet had a disproportionate impact on bank culture. As just one example, Commissioner Hayne concluded on the fee-for-no-service issue: "*There is no doubt that money was taken from clients. Nor is there any basis for doubting that, when taken, the taker did not intend to return it to the client. Senior executives and boards were aware of the issues yet did nothing to fix them, and in some instances continued to encourage misconduct through design of staff remuneration*." It is, therefore, disappointing that there was no explicit recommendation against vertical integration, particularly as vertical integration becomes an impossibly conflicted position for a financial institution that genuinely seeks change.

Where to from here?

One criticism of Commissioner Hayne is that the Report fell short of recommending prosecution of key individuals. We do not agree with this criticism. It is not the role of the Royal Commission to prosecute, instead the Report referred 24 cases to the appropriate authorities for potential prosecution.

The full list is currently undisclosed, but we know that it includes the big four banks and AMP. As those cases are prosecuted, we will receive further insight into the sector and be in an even better position to judge if any are better or worse than their peers from an ethical investment perspective.

Divestment

For many, the Report confirms deep suspicions about the ethics of the banking sector, and divestment is the logical response. Ethinvest advisers will be able to work through the tax and income implications of divestment with clients on a case by case basis.

Engagement

Divestment sends a clear message, but an alternative is for investors to retain existing holdings and use their voice as shareholders to ensure that changes promised by the banks are delivered. Ex-NAB Chair, Ken Henry, though rightly chastised in the Report, was correct in stating that it could take ten years to completely change the culture of an organisation the size of a major bank. We agree, and long-term change is even more unlikely if pressure is taken off these organisations. MLC, a subsidiary of NAB, has already indicated it will challenge penalties on "fee for no service" by arguing that offering to provide financial advice to customers, even if such advice was not provided, creates a fee entitlement.

Given what the Report unearthed, the sacking of the Chair and CEO and the bleak assessment of the testimony of NAB's most senior legal counsel, it is alarming that NAB so quickly wants to justify poor behaviour. This is potentially the first in a line of resistance actions taken by the banks to diminish the impact of the Commission, in the hope that as the news cycle moves on to elections, Brexit, the next Trump Twitterstorm etc. that things can "go back to normal".

Royal Commissions report to the Governor General, not the Treasurer. While Josh Frydenberg wanted a photo opportunity for political benefit, Commissioner Hayne's refusal to shake his hand, and the expression on his face, say it all…

By liaising with shareholder activism organisations, Australian Impact Investments is willing to help draft a long-term campaign designed to keep pressure on the senior management and boards of these organisations and ensure that the 76 findings of the Report do not simply fade away as politicians bow to lobbying pressure for diluted legislative changes. ASIC has already highlighted post-Hayne resistance to change.

What about "hybrids"?

Shareholder activism works for ordinary shares, but "hybrids" do not have voting rights attached and, in a world of low interest rates, finding alternative investments that offer the same risk: return relationship is extremely difficult. This leaves investors in the invidious position of either having to increase the level of financial and market risk in the portfolio to get the same amount of income – increasing the risk of capital loss in the process – or accepting significantly lower levels of income from the portfolio.

We recommend a pragmatic approach to "hybrids", namely retaining existing investments until they mature but not investing in new "hybrid" issues until the cultural issues are resolved (noting that this may take some years). Selling existing "hybrids" will not achieve any impact on the bank since it has already received the funds, and all selling will do is temporarily deflate the market price, reducing the seller's capital in the process. Boycotting new issues – particularly if accompanied by a public advocacy campaign in the press – provides regular points of engagement to retain pressure on the sector to deliver real reforms.

Appendix: ESG Rating of Financial Institutions post-Royal Commission

	Environment	Social	Governance
Australia New Zealand Banking Group Limited (ANZ)			
Commonwealth Bank of Australia (CBA)			
National Australia Bank Limited (NAB)			
Westpac Banking Corporation (WBC)			
AMP Limited			
Bank of Queensland			
Bendigo & Adelaide Bank			
Insurance Group Australia (IAG)			
IOOF Limited			
Macquarie Group (MQG)			
Suncorp Ltd			