Memorandum for Group Regulatory, Compliance and Operational Risk Committee

Damian Murphy
Chief Risk Officer, NAB Wealth

NAB WEALTH ADVICE REVIEW

1. Purpose

The Group Regulatory, Compliance Operational Risk Committee (GRCORC) is asked to NOTE the NAB Wealth Advice Review which is attached as Appendix 1 to this memorandum.

The NAB Wealth Advice Review was noted by the Group Risk Return Management Committee on 28 July 2014 and a more concise version was presented to the Principal Board on 6 August 2014.

2. Background

The attached memorandum provides an update on the processes and controls in place with regard to the provision of financial planning advice by NAB Wealth, particularly in the context of the recent Senate report references to CBA.

3. Recommendation

The GRCORC is asked to NOTE the NAB Wealth Advice Review

Proposed by:

Damian Murphy
Chief Risk Officer,
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August 2014

Andrew Hagger
Group Executive
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APPENDIX 1

NAB WEALTH ADVICE REVIEW

1. Purpose:

To provide further assurance to the Group Risk Return Management Committee (GRRMC) regarding the processes and controls in place with regard to the provision of financial planning advice by NAB Wealth, particularly in the context of the recent Senate report references to CBA.

2. Background:

The June 2014 Senate Economic Reference Committee Report (the Report), as it relates to the practices of the CBA Financial Planning business and associated actions by ASIC, has wide and deep implications for the financial services advice industry as a whole.

The Report found with regard to CBA significant concerns in relation to supervision, file review procedures, advice templates, breach reporting, record keeping and compliance, and significant and widespread problems with the quality of advice. “The committee believes that the CBA's characterisation of the misconduct at CFPL as 'inappropriate advice' provided by 'a small number' of CFPL advisers, deliberately and grossly understates the extent of the wrongdoing within CFPL. The committee believes the phrase 'inappropriate advice' comprehensively fails to capture the deceptive and misleading conduct of CFPL financial advisers. Indeed, the committee heard compelling evidence that client signatures were forged and/or misused by CFPL financial advisers, and while the committee reserves judgement on whether this activity would provide a basis for criminal action, it suggests that to characterise such activity as 'inappropriate' is, in itself, entirely inappropriate. Further, the phrase 'inappropriate advice' does not capture the systemic failures in the CFPL's business operations, including the ineffective compliance regime and toxic sales-based culture fostered by flawed remuneration arrangements.”

Management have taken this opportunity to verify our level of confidence in our current processes and controls, governance framework and people. The review being undertaken has commenced analysis on whether we remain in line with industry leading standards and will allow us to continue identifying key areas for improvement in a time of significant change in industry and community expectations.

The scope of the management review includes all NAB Wealth advice led businesses.[1] Management was supported by Deloitte who bring independent industry knowledge, experience and insight. This external lens serves to critically, question and assist us with identifying areas that we could strengthen or focus on over the medium term to improve our business.

Our management review is not yet complete. However, we are in a position to provide interim findings, pending deeper reviews in specific areas. These are set out in the

[1] This includes NAB Financial Planning employed advisers and the Private Wealth financial advice business that both operate under NAB's Australian Financial Services Licence (AFSL), the self-employed advisers that operate under the Apogee Financial Planning Limited; Godfrey Pembroke Limited, GWM Adviser Services Limited (Garvan and MLC Financial Planning, MLC Advice) and Meritum AFSL's and JBWere. This paper does not address any advice provided to wholesale investors by any part of NAB (for example the Products & Markets business).

Attachment 1 and summarised below.

3. Summary of Interim Findings from the management review:

1. The financial planning and advice industry has been on a journey since 2006 towards greater trust and transparency. NAB Wealth has been amongst the forefront of the industry throughout that journey, with strong governance, the development of a culture of quality advice, quality reactive issues management, an early move to fee-for-service on most products and rising self-imposed standards. The industry continues to be undergoing a rapid period of change, and our ability to stay at the forefront is by no means assured.

Dick Morath, as Chair of the Advice and Licences Board, believes the two most significant attributes that differentiate NAB Wealth are:

- A culture of delivering quality advice that is embedded throughout all layers of the organisation and among advisers themselves
- A governance framework that underpins the culture and ensures a higher degree of compliance

We have led the industry in placing customers' interests first. For example, introducing fee for service for advice on investment products, several years ahead of the legislative requirement, was driven by Godfrey Pembroke advisers themselves. In addition, the Adviser Compliance Group includes representatives from each of the NAB Group aligned licensees and contributes to the development of licensee standards. Engaging advisers in this way facilitates more effective compliance with policies and standards.

In all our advice channels, we have also extended FoFA's mandated flat dollar advice fees on geared investments beyond the legal minimum. We do still have significant grandfathered investment commissions and some elements of grandfathered volume based rebates (the latter inherited through the Aviva acquisition). Large upfront commissions remain in place across the industry for insurance products and while there is the opportunity to take the lead in this space, we would need a strong commercial case to do so which is not currently apparent. We also recognise the tension between the potential consumer detriment of commissions and the likely reluctance of consumers to seek insurance advice if they have to pay explicit fees for it, which was the primary reason these commissions were exempted from the FoFA ban on commissions.

This reflects a strong identity and self-belief which we are re-assessing in the context of the CBA issues and the new environment.

2. We have not found the sort of systemic breakdowns identified in the Report, particularly in relation to the culture within NAB Wealth that the Senate inquiry and ASIC have found in relation to CBA.

The Senate report found that CBA had a sales culture throughout the organisation that was focused on fee generation to the extent that pressure was placed on staff to overlook poor conduct by advisers who generated high sales. Further, CBA's compliance function "lacked teeth" and whistleblowers were ignored. When pressured to act, CBA's initial response to evidence of inappropriate conduct, which included forgery and falsifying documents, was to limit the scope of their review and where remediation was necessary, offering amounts that were significantly less than the clients' entire loss.

The differences between NAB Wealth's operations and CBA's as described in the Senate inquiry are significant. In contrast, NAB Wealth had and continues to have a strong culture and compliance framework with no bias toward higher revenue earners with regard to audits conducted and consequence management. We use experienced industry leading Non-Executive Directors to differentiate our governance processes. With their independence they assist in addressing any conflicts of interest that are escalated to their attention including compliance related issues, sales practices and approved products (including NAB Group products).

The entire industry is exposed to the risk of inappropriate advice. NAB Wealth's key differentiators of quality advice culture and governance ensures that when we become aware of an issue we face into it and deal with the outcomes required.

When signs of inappropriate conduct have been detected our reviews have been broadened beyond the initial issue identification and findings to identify related cases. Where compensation is considered appropriate it is based on a genuine assessment of liability in the client's best interest.

Having said that, some aspects that were evident at CBA were also characteristic of NAB Wealth and the broader industry at that time. This has led to the NAB Wealth cases noted below.

3. NAB Wealth has encountered, and continues to encounter, cases of inappropriate advice and occasionally, rogue advisers.

Our approach to dealing with these situations does not differentiate based upon whether the advisers concerned are high revenue earners. NAB Wealth has a long history, going back to the 1990s, of terminating high producing advisers who do not fit its culture. Some notable examples include:

- Emmanuel Cassimatis (MLC Agent, 1990s) – ignored relevant personal circumstances and applied a 'cookie-cutter' process that led to inappropriate gearing advice. (Cassimatis went on to establish Storm Financial.)
- Craig Stubbs (Apogee, 2004) – moved on due to poor compliance.
- Graeme Cowper (NABFP, 2010) – terminated for file reconstruction and compliance breaches
- Nick Sinclair (Garvan, 2012) – moved on due to conflicts of interest involving property development.
- Lawrie O'Neill (Godfrey Pembroke Limited, GPL, 2013) – President of the GPL Practice Development Group moved on due to sustained poor compliance.

We have highlighted a number of other major incidents from over the last five years (some completed and some ongoing) including those related to replacement insurance advice, gearing advice, and the adequacy of resources being devoted to client complaints handling. In four of these cases we found that the adviser had reconstructed file records, or even forged client signatures where they were required for internal purposes, so that the file would appear compliant. While three investigations are continuing, we have implemented changes to policies as a result of findings and have also undertaken broader reviews using risk factors identified in specific cases. Four of these cases did involve high revenue advisers and there were appropriate consequences for them. Of note, these instances were not self-detected and arose from client complaints or regulatory questions.

We have suspended, terminated or ensured resignations of 31 NAB FP and aligned advisers over the past two years due to conflicts of interest, inappropriate advice, inappropriate practices or serious or repeat compliance breaches. Many of these recorded annual sales well in excess of the average adviser. Meritum has had six terminations over the past two years related to compliance issues.

In Phase 2 of our work we will conduct additional targeted reviews and/or enhance our adviser risk profiling matrix approach. This will include other dimensions such as higher revenue earners, unusual revenue activity and higher client loads.

While there is no regulatory supervision or review required, the existence of these cases means there is the risk, should they come under political or media attention, that links could be made to the CBA situation.

4. Our workshops, insight from Deloitte and interrogation of our advice processes and frameworks, when put in a modern consumer and changing regulatory context that takes into consideration recent investments by competitors, show some key areas which we must strengthen if we are to remain amongst the forefront of the industry.

We have analysed our systems applying the eight themes identified from the Senate inquiry findings – namely robust supervision and monitoring, governance and oversight, ethical conduct, client centric culture, fair client remediation, adviser professionalism, client care and demonstrable change.

In some areas we have made strong in-roads into best practice. We introduced Statement of Advice (SOA) vetting for new advisers classified as higher risk in 2011, enhanced adviser due diligence program in 2012 and introduced adviser risk profiling in 2013.

However, it is clear in the light of recent industry-wide investment that our monitoring and supervision systems are not market leading, and in particular our technological capability to identify poor advice issues proactively is less advanced than we would like. Moreover, our existing technological capability is not being utilised sufficiently across the adviser network to enable best interest advice to be appropriately evidenced in all cases. While, across the industry, there is no major player using sophisticated analytics to provide predictive compliance investigations, BT are making progress in this area and are probably leading the field. There remains a challenge in consistently applying a technology solution in aligned advice networks.

5. Our work has also identified five areas across our advisory activities which we believe are worthy of deeper dives before concluding on our confidence levels around our processes and controls.

Management have committed to deeper analysis the following areas: (i) Meritum and JBWere; (ii) product / investment strategy suitability including gearing; (iii) compliance audit process; (iv) adviser on-boarding, training and exiting; and (v) insurance substitution. These are the areas indicated during workshops and data interrogation as most worthy of deeper work that may uncover further aspects to be addressed.

4. Next Steps:

Management's immediate focus will be as follows:

- Complete the five deep dives identified for review, and create initial delivery plans to improve the control environment if required
- Provide a roadmap for the strengthening of our advice processes, particularly in the area of monitoring and supervision
- We have committed to accelerate the integration of Meritum's advice compliance framework within NAB Wealth ahead of the planned 1 October 2014
- We will refresh Whistleblower communications across NAB Wealth

5. Recommendation:

The GRRMC is asked to **NOTE** this paper.

Proposed and supported by:

Andrew Hagger
Group Executive, NAB Wealth
July 2014

Attachment 1: Interim Findings of Advice Review
Attachment 2: Statement from Chief Risk Officer, NAB Wealth is attached.
Attachment 3: Statement from Deloitte.

Please note the GRRMC version included Attachments 1 & 3, however, they have been removed from the GRCORC version and are available from Group Governance upon request.

Attachment 2 – A statement from the Chief Risk Officer, NAB Wealth

"I have reviewed this paper and support the next steps.

The risks associated with financial planning advice are largely managed through "defensible" verifiable processes assessed some time after that advice or investments have not met client expectations.

The last decade has seen the ongoing maturity of the financial planning and advice industry, as well as changing regulatory and community expectations around client focus and outcomes - leading to continuously higher standards being imposed to support a "defensible" position. NAB Wealth has responded by improving its compliance monitoring approach and systems.

In the above context, without further detailed reviews, I cannot provide assurance that there is not an exposure to inappropriate advice in the "back book". Risk will use the insights obtained through the reviews and Deloitte work to further interrogate the "back book".

The focus needs to be on ensuring current and emerging risk and compliance systems and controls with respect to dealings with customers; appropriate products; and sales practices,are fit for purpose. We also need early issue identification; escalation; and facing into challenges quickly with a mature customer remediation approach. The key enablers are a customer centric focus and an appropriate risk culture.

I support investigation into technology investment in data analytics and real time advice monitoring to further facilitate the provision of appropriate advice in the context of current industry best practice.

The next steps proposed in the paper will investigate known issues and help to ensure our processes are developing appropriately. Those enhancements will be monitored to ensure they are embedded and operating.

It may be appropriate, if further issues emerge that raise systemic concerns, that we commission independent assurance as to the operational adequacy of our compliance monitoring and oversight systems and controls."

Damian Murphy
Chief Risk Officer, NAB Wealth
July 2014