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Strong banks – strong Australia

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Mr Steve Sedgwick AO
Independent Reviewer
Retail Banking Remuneration Review
By email: submissions@retailbankingremunerationreview.com.au

Dear Mr Sedgwick

Retail Banking Remuneration Review – Response to Issues Paper

The Australian Bankers' Association (ABA) welcomes the opportunity to provide this submission to the Retail Banking Remuneration Review (Independent Review), in response to the Retail Remuneration Review Issues Paper published 17 January 2017 (Issues Paper). This submission is in addition to our initial submission to the Independent Review dated 23 September 2016.

With the active participation of 25 member banks in Australia, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and the community, to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

The banking industry looks forward to receiving the findings of the final report. The findings will provide an important basis for the industry to identify responses and actions needed to remove or change product sales commissions and product based payments that could lead to poor customer outcomes and seek any regulatory approvals necessary for the banking industry to take action. The findings will also help banks to review current and develop new overarching principles on how they pay and incentivise all employees.

This submission provides high level responses to the themes raised in the Issues Paper and responds to the issues for further feedback at an industry level. Mindful of competition law issues, the ABA has not commented on the design of remuneration and incentive structures. The ABA notes that individual banks may engage directly with the Independent Review via written submissions and consultations, and may provide further information about the detail of their remuneration structures, operational risk and compliance arrangements, and agreements with third parties.

If you or your secretariat would like to discuss any of the matters raised in this submission, please contact either myself or Christine Cupitt, Policy Director – Retail Policy on (02) 8298 0416, ccupitt@bankers.asn.au.

Yours sincerely

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1. Executive summary

To help build trust and confidence in banks, the industry is working to deliver better products and services to customers, and create a better culture. A part of this is promoting ethical behaviour and increasing standards. To this end, the banking industry has agreed to remove or change product sales commissions and product based payments that could lead to poor customer outcomes.

This submission provides additional context and perspective on the impact of remuneration and incentive structures on decisions made by staff and on customer outcomes in the broader retail banking environment.

For staff, incentives form one part of their overall pay and conditions (staff value proposition). Staff have access to informal and formal channels to 'speak up' when they have concerns about the design and effect of incentive structures and in some banks may have the opportunity to provide input into the design of incentive plans. Remuneration and incentive structures must be approved through formal governance processes.

The way banks provide services and products is influenced by a range of factors, including the training provided to staff, the culture of the bank, compliance with legal and regulatory obligations and remuneration and incentive structures. Banks also make available how they design their remuneration arrangements for all levels of staff, and specific payments made to certain bank executives, through bank annual reports for example.

In addition to looking at how they pay staff, banks are also improving the way they handle customer complaints and strengthening their commitments to customers in the Code of Banking Practice.

The ABA believes that any changes to product sales commissions and product based payments should be made with the broader, evolving, retail banking environment in mind.

2. Introductory comments

Banks recognise that they play an important role in people's lives and in supporting Australia's economic growth. Banks have responsibilities to the community and must also meet their obligations to customers, employees, shareholders and under the law.

Over the past decade, there has been a fundamental shift in corporate culture where the traditional concept of shareholder value creation has been challenged by the concept of the social licence. The banking industry is working to deliver better products and services to customers, and create a better culture. A part of this is promoting ethical behaviour and increasing standards.

To support these objectives, the banking industry has committed to responding to the final recommendations of the Independent Review and to remove or change product sales commissions and product based payments that could lead to poor customer outcomes.

In recent years banks have made significant changes to remuneration practices to place more of an emphasis on behaviour over sales targets. This has been in response to the Future of Financial Advice (**FOFA**) obligations, ongoing review and improvement of remuneration and incentive arrangements, and evolving community expectations.

Some banks have already announced further enhancements to their remuneration and incentive structures to address concerns in relation to customer outcomes and the potential for mis-selling.

While the Issues Paper has not identified systemic issues warranting the outright banning of product based payments, we recognise there is more to do.

3. Improvements to bank culture

The Issues Paper highlights the link between remuneration structures and the importance of culture, good governance, performance management systems, compliance checking, and communications. In addition to the banking industry's commitments surrounding the Independent Review, the industry is taking other action to deliver better banking, including:

- Making it easier for customers when things go wrong: Appointing customer advocates to give retail and small business customers a greater voice and help resolve problems more efficiently.
- Reaffirming support for employees who 'blow the whistle' on inappropriate conduct: Ensuring banks have the highest standards of whistleblower protections with a robust and trusted framework for whistleblowing.
- Removing individuals from the industry for poor conduct: Implementing arrangements to identify poor conduct across all bank employees, including customer facing and non-customer facing roles, and promoting good conduct and ethical behaviour.
- Strengthening the commitment to customers in the Code of Banking Practice: Ensuring the Code of Banking Practice adequately covers expected standards for banks and their relationship with customers, and includes a focus on ethical behaviour.
- Supporting ASIC as a strong regulator: Demonstrating banks' commitment to a well-regulated banking and financial services industry.

Implemented together, we believe this package of initiatives will contribute, across the industry as a whole, to improved culture in banks, and will enable the introduction of enhanced remuneration and incentives structures that take a balanced view of service and sales, and support good customer outcomes and sound banking practices.

4. Working with staff on remuneration and incentives

4.1 Staff value proposition

Incentive structures form only one part of the value proposition for bank staff. Banks develop broad propositions to attract and retain staff, covering career and development opportunities, training and education, flexible working options, parental leave and childcare arrangements and in some cases additional leave and superannuation entitlements.

In most cases, incentives only account for a small proportion of the overall remuneration.

Banks differentiate themselves through their staff value proposition and prospective staff are able to assess a bank's staff value proposition as part of a competitive labour market. Incentive structures, and their influence on staff choosing to join a bank should be considered in context of the broader staff value proposition.

4.2 Staff feedback and consultation

Banks work with staff and employee representatives in a number of ways to develop remuneration and incentive structures.

In addition to the process to agree enterprise agreements with employee representatives, some banks choose to work directly with their staff to develop incentive structures, which do not generally sit within the enterprise agreement.

The nature of the consultation will vary based on the significance of the incentive structure and the number of staff it will cover. The consultation process may include the outcomes of staff engagement and feedback surveys, staff representative working groups and communication and change programs.

Staff also have a variety of ways to directly and anonymously escalate feedback on concerns about remuneration and incentive structures, including conversations with management, participation in consultation processes, employee engagement surveys, reports to internal risk management or human resources staff or designated committees, and breach and incident reporting arrangements.

The ABA notes the illustrative examples of staff feedback set out in the Issues Paper, which were obtained through a limited sample of staff interviews. We suggest that these examples be taken together with the results of staff engagement surveys, which are taken across the hundreds of thousands of staff that are employed by Australia's banks. Individual banks may provide further information on employee engagement survey results through the consultations.

4.3 Approvals and governance

Remuneration and incentive structures are subject to rigorous governance and approval processes.

These structures are designed in accordance with the bank's remuneration, governance and risk management policies, regulatory requirements[1] and sound banking practices. These policies are approved through board delegated committees.

The structures are then approved through senior remuneration committees, which are bound by the requirements of the bank's remuneration policies, and monitor the performance of remuneration and incentive structures over time.

Compliance with remuneration governance and approvals processes is monitored by bank risk and compliance and internal / external audit teams.

5. Disclosure of remuneration arrangements

Banks are subject to existing disclosure obligations in relation to remuneration and incentives.[2] Regulatory obligations require the disclosure of information about the design of remuneration and incentives structures, how they are overseen, and how they are adjusted to reflect risk, and longer term performance.

Information about the way staff are paid is also included in the Financial Services Guide and Credit Guide, which banks must provide to customers in most circumstances.

Banks also disclose the detail of executive remuneration, including the amounts paid to certain executives, in reports to shareholders and the market.

The ABA notes discussion of other remuneration disclosure models, such as those implemented by a small number of banks in the UK. At this time, we suggest that the industry be given time to respond to the remuneration outcomes of this review and current regulator reviews, such as the ASIC Review of Mortgage Broking, and a post implementation review of the UK arrangements be conducted, before any firm recommendations are made on changing bank disclosure requirements.

6. Good customer outcomes

The ABA believes that a good customer outcome is an outcome that meets the identified objectives and needs of the customer and is appropriate to their circumstances. The outcome may involve the provision of a service or advice, or the sale of a product. It may also involve doing nothing. Importantly, the bank, or other financial services provider should take steps to identify the objectives, needs, and circumstances of the customer and must have staff training, processes and controls in place to support the provision of the right solution for the customer.

Our view is based on the principles that underpin the modified best interest duty for personal advice on basic banking products, implemented as part of the FOFA reforms[3], and we suggest this is a much clearer, more readily understood concept than that used by the FSA in the UK.

[1] For example, An APRA-regulated institution must establish and maintain a documented Remuneration Policy.
[2] Prudential Standard APS 330 Public Disclosure.
[3] The modified best interest duty is explained in the table in appendix 1.

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6.1 Impact of mis-selling

We believe a product is mis-sold if the sale is not part of a solution that meets the identified objectives and needs of the customer and is appropriate to their circumstances.

The impact of mis-selling will vary based on the customer's circumstances, and more significantly, the risk profile of the banking product. For example, the impact of mis-selling a basic deposit product will be substantially less than the impact of mis-selling a high value interest only loan, which is why heightened compliance and approval processes sit around higher risk products.

6.2 Cross selling

Many customers take advantage of simplifying their financial arrangements and reducing their costs by having their products with one bank or financial institution. Meeting all or many of a customer's banking needs has a clear service imperative and may well be aligned with the identified needs and objectives of the customer. What's important is that bank staff are paid to provide good service, suitable products, quality advice to their customers.

6.3 Service and sales

As discussed above, the ABA believes that a good customer outcome involves a solution that meets the identified needs and objectives of the customer and is appropriate to their circumstances. Exploring and understanding a customer's needs and objectives and providing the customer with the right solution sits at the heart of customer service.

The ABA supports remuneration and incentive arrangements that promote a balanced sales and service outcome.

7. Risk management – for customers and banks

7.1 Risk management and compliance programs

Banks maintain broad risk management and compliance programs to ensure compliance with the law and adherence to bank standards, policies and processes. The programs address conduct requirements such as the proper segregation of duties, the general obligation to manage conflicts of interest,[4] responsible lending obligations,[5] the modified best interest duty,[6] disclosure requirements, and training and accreditation requirements for front line staff. An overview of these requirements is set out in Appendix 1.

Bank risk management and compliance programs are intended to promote transparency and provide clear information to customers about products and services, ensure staff are appropriately trained, and manage mis-selling risks that may impact on customers.

Some aspects of bank risk management and compliance programs are universal, including conflicts management, core training requirements and standardised disclosures, terms and conditions. Other aspects are designed to specifically address the risks specific to certain types of financial and credit products. Banks have robust frameworks for products that require more detailed conduct and process requirements before provision (for instance, credit products), as opposed to other non-credit retail products, such as transaction accounts which have fewer conditions to satisfy due to the lower level of risk associated with the mis--selling of such products.

[4] s912A, *Corporations Act* 2001.
[5] Responsible lending obligations apply to decision to provide consumer credit, under Schedule 1 of the *National Consumer Credit Protection Act.*
[6] Modified best interests duty applies to personal advice on basic banking products s961(b)(3), *Corporations Act* 2001.

7.2 Credit

Credit products are subject to specific conduct regulation, including the Responsible Lending Obligations (RLOs).

In addition to the RLOs, banks establish specific eligibility criteria to assess and determine whether a credit product should be sold to a customer. The effect of the eligibility criteria is twofold. First, these criteria establish centralised decision making, and removes the decision to sell the product from the 'seller' or customer facing staff in most cases.[7] Second, these criteria apply an additional process and assessment to ensure that banks operate with sound practice and protect against over stressing customer credit responsibilities when purchasing credit products.

7.3 Risk management – third parties

Similar regulatory obligations and risk management programs apply to third parties, including mortgage brokers. These obligations and risk management programs also promote transparency, provide clear information to customers about products and services, ensure representatives are appropriately trained, and manage mis-selling risks that may impact on customers.

We note that ASIC is currently undertaking a review of mortgage broker remuneration structures, which is considering both remuneration and consumer outcomes and we await the findings and proposals of that report.

8. Information requests

The ABA notes that banks will provide responses to the specific questions on targets and remuneration structures. Mindful of competition law issues, the ABA has not commented specifically on changes to these structures. However we have provided responses to information requests related to conduct (including disclosure), regulation, compliance, and remuneration principles.

8.1 Strengthening the regulatory framework

The banking industry is committed to improving its self-regulatory framework and is working on improved self-regulatory and co-regulatory arrangements, such as:

- Changing remuneration practices based on the final recommendations of this Independent Review. The industry will need the support of ACCC to effect any industry level commitments to change remuneration practices.
- Enhancements to the Code of Banking Practice, based on final recommendations of the Khoury Review.
- Adoption of improved internal dispute resolution (IDR) arrangements, including the appointment of customer advocates.
- Arrangements to improve the identification of people with a poor conduct history so banks can make more informed employment decisions.

The banking industry also supports regulatory enhancements, such as enhancements to breach reporting and enhancements which may apply changes to supported remuneration arrangements across all participants involved in the market for retail products.

8.2 General advice, personal advice, factual information

Consumers generally interpret 'advice' as advice that takes into account their individual needs and circumstances and do not generally appreciate the significant legal and technical differences between

[7] Individual decision making authority may be held by some specialised roles.

‘general’ and ‘personal’ advice. The ABA believes that the existing terminology for general advice may not always be clear and meaningful for consumers.

The ABA believes that a comprehensive review of the definition of financial product advice and the needs and expectations of consumers receiving general advice is required. Changes to the regulatory framework for the provision of financial advice must enable better and more informed consumer decision making, maintain appropriate consumer protections and encourage innovation in the delivery of financial advice.

8.3 Addressing information asymmetry

The ABA supports clear and effective product disclosure and communication with consumers. Effective disclosure is dependent on consumers being able to understand and apply disclosures to their financial needs and situations. Interactive disclosures, such as assessment tools and calculators, and better use of online communications, offer significant opportunities to raise levels of awareness and assist informed decision making by investors.

Importantly, removal of regulatory impediments for the industry to provide disclosures per customers’ preferred communication channels, for example, electronic, online or digital technologies, will complement the disclosure mechanism. Legislative changes should be made so that customers can opt-in to receive disclosures and communications in writing, but that the default is via electronic or digital channels.

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Appendix 1 – Overview of compliance requirements related to remuneration

Regulatory requirement	Overview
APRA governance requirements	All APRA regulated deposit taking institutions, including banks, are required to have in place a sound governance framework to ensure the institution is managed soundly and prudently. Prudential Standard CPS 510 Governance, requires banks to have a documented Remuneration Policy that outlines the remuneration objectives and the structure of the remuneration arrangements, including, the performance-based remuneration components of the bank. The Remuneration Policy must be approved by the Board. Importantly, remuneration arrangements must be designed to encourage behaviour that both supports the banks long-term financial soundness and the banks' risk management framework. Prudential Standard APS 330 Public Disclosure requires the disclosure of the following information for certain roles: • Information relating to the bodies that oversee remuneration, such as senior remuneration committees • Information relating to the design and structure of remuneration processes • The ways in which current and future risks are considered in the remuneration processes • The ways in which the bank seeks to links performance with remuneration • The different forms of variable remuneration (incentives) the banks uses and the rationale for using them • The ways remuneration is adjusted to take account of longer-term performance, and • The amounts of incentives paid across the bank. Prudential Standard CPS 220 Risk Management requires banks to have systems for managing material risks that may affect their ability to meet their obligations to their customers.
Disclosure requirements	Information about the way staff are paid is included in the Financial Services Guide[8] and Credit Guide[9], which banks must provide to customers in most circumstances.

[8] s941A, *Corporations Act*.
[9] s113, *National Consumer Credit Act*.

	Banks must also disclose the detail of executive remuneration, including the amounts paid to certain executives, in reports to shareholders and the market.[10]
Obligations to manage conflicts of interest	Under their financial services and credit licences, banks have general obligations to manage conflicts of interest.[11] This includes having processes to identify conflicts of interest and manage them to the relevant legal standard.
Responsible Lending Obligations[12]	Banks, and other credit licensees, must comply with the Responsible Lending Obligations (RLOs) when providing credit to customers, The RLOs require banks to: • Make reasonable inquiries about the customer's financial situation, and their requirements and objectives • Take reasonable steps to verify the customer's financial situation, and • Make an assessment about whether the credit contract is 'not unsuitable' for the customer (based on the inquiries and information obtained in the first two steps). A bank must not enter a credit contract with a customer, suggest a credit contract to a customer or assist a customer to apply for a credit contract if the credit contract is unsuitable for the customer.
Modified Best Interests Duty[13]	Banks, and other financial services licensees, must act in the best interests of customers when providing personal advice on basic banking products. To meet this obligation, banks must: • Identify the objectives, financial situation and needs of the customer • Identify the subject matter of the advice that has been sought by the customer and the objectives, financial situation, and needs relevant to the advice, and • Make reasonable inquires to ensure the information is complete and accurate.
Competency requirements	Under their financial services and credit licences, banks must maintain the competence to provide the services under their licences, and must ensure that their representatives are adequately trained and competent.[14]

[10] ss300, 300A, *Corporations Act*.
[11] s912A(1)(aa), *Corporations Act*, s47(1)(b), *National Consumer Credit Act*.
[12] Schedule 1, *National Consumer Credit Act*.
[13] s961(b)(3), *Corporations Act.*
[14] ss912A(1)(e)-(f), *Corporations Act*, ss47(1)(f)-(g), *National Consumer Credit Act*.