13 September 2016

By email: **submissions@retailbankingremunerationreview.com.au**

Mr Stephen Sedgwick
Independent Reviewer
c/o - Australian Bankers' Association, Inc.
Level 3, 56 Pitt Street
Sydney NSW 2000

Dear Mr Sedgwick,

Independent review of product sales commissions and product based payments

The Consumer Action Law Centre (**Consumer Action**), Financial Rights Legal Centre (**Financial Rights**) and Good Shepherd Microfinance (**GSM**) are pleased to provide a joint submission in response to the Australian Bankers' Association Inc. (**ABA**) Terms of Reference paper *Independent review of product sales commissions and product based payments.*

We are not able to provide detailed comment on the operation of product sales commissions and product based payments, for the simple reason that these are generally not disclosed at the point of sale. Accordingly, we can only infer from the consumer impacts we observe that poorly constructed incentives have played a part, (and we suspect, have driven), inappropriate sales practices. Our work certainly exposes us to the impact such practices have on vulnerable consumers. Furthermore, significant research does exist to show that commission and product based payment systems do affect lending and sales practices, and we have drawn on some of that research to inform this submission.

We collectively take the view that product sales commissions and product based payments inevitably distort sales-staff behaviour, placing the imperative to make a sale above considerations of appropriateness for the consumer. Anecdotally, we are advised that banking staff are driven to meet targets in an atmosphere of relative job insecurity, with the prospect that failing to meet those targets may result in a loss of employment and the possibility of less lucrative employment outside of the banking sector. Independent media reports support the assertion that staff morale within the banking sector is poor, and pressure on staff to meet sales targets is a major cause of that discontent.[1] From a consumer perspective, these factors create a culture that is intimidating and where they are likely to be subjected to pressure sales tactics. In the United Kingdom, this dynamic has been recognised by major banks such as the Royal Bank of Scotland and Natwest—both of whom scrapped cash bonuses for branch staff offering credit cards, loans and mortgages to customers in early 2016.[2] Significantly, these measures were taken following persistent consumer advocacy against bonus and commissions, including the three year *"stop the hard sell*" campaign run by This Is Money.Co.Uk.[3]

In Australia's retail banking sector the consumer's genuine need and capacity to repay are currently not the primary factors driving sales—and this leads to significant consumer detriment. Until there is a major cultural shift in the retail banking sector, it is difficult to see how these negative outcomes can be avoided. Certainly, it would seem that minor adjustments to current payment systems are unlikely to have any significant effect. Indeed, an industry-wide wholesale overhaul of product sales commissions and product based payments is required—and the notion that commissions and product based payments are necessary at all should be fundamentally questioned.

Consumer Action and Financial Rights have done significant work in the area of consumer credit insurance (**CCI**), an area where product sales commissions are known to drive sales, and we draw on that work (in addition to recent work by the Consumer's Federation of Australia (**CFA**) in response to the Banking Code of Practice Review) for the purposes of this submission. Similarly, GSM has a strong focus on financial inclusion and has developed a range of initiatives informed by global best practice. This includes the development of an understanding of how genuine consumer need can be addressed through ethical banking practice. Of relevance to this submission, banking which genuinely promotes financial inclusion can only be carried out in an environment where bank staff are able to engage meaningfully with customers—and is difficult to pursue in an environment that is heavily focused on sales, driven by commission and product based payments. While we lack detailed data to provide a more thorough analysis, we are sufficiently convinced of the negative outcomes of commission driven sales to contest the value of retaining such incentives, and believe that a major cultural shift in banking practice is necessary for the public good.

Our further views are outlined below.

About Consumer Action

Consumer Action Law Centre is an independent, not-for profit consumer organisation based in Melbourne. We work to advance fairness in consumer markets, particularly for disadvantaged and vulnerable consumers, through financial counselling, legal advice and representation, and policy

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[1] Ong, Thuy. *Banks' profit pursuit having 'devastating' impact on staff*, ABC Online News, 22 August 2016. Available at: http://www.abc.net.au/news/2016-08-22/union-warns-banks-pursuit-of-profits/7772232
[2] Boyce, Lee. *NatWest/RBS scrap bonus incentives for staff members pushing products in branch to help 'rebuild customer trust'*, This Is Money.Co.Uk, 20 November 2015. Available at: http://www.thisismoney.co.uk/money/saving/article-3326750/NatWest-RBS-scrap-bonus-incentives-staff-members-pushing-products-branch-help-rebuild-customer-trust.html
[3] Boyce, Lee. *Stop the hard sell: How This is Money has exposed bad bank advice and pushy sales tactics in branches across the country*, This Is Money.Co.Uk, 14 February 2013. Available at: http://www.thisismoney.co.uk/money/saving/article-2277997/How-This-Money-exposing-bad-bank-advice.html

work and campaigns. Delivering assistance services to Victorian consumers, we have a national reach through our deep expertise in consumer law and policy and direct knowledge of the consumer experience of modern markets.

About Financial Rights

The Financial Rights Legal Centre (Financial Rights) is a community legal centre that specialises in helping consumer's understand and enforce their financial rights, especially low income and otherwise marginalised or vulnerable consumers. We provide free and independent financial counselling, legal advice and representation to individuals about a broad range of financial issues. Financial Rights operates the Credit & Debt Hotline, which helps NSW consumers experiencing financial difficulties. We also operate the Insurance Law Service which provides advice nationally to consumers about insurance claims and debts to insurance companies.

About Good Shepherd Microfinance

Good Shepherd Microfinance offers a suite of people-centred, affordable financial programs to people who are financially excluded. These programs promote economic wellbeing for people with low incomes, especially women and girls, and move clients from financial crisis to resilience and inclusion.

We work collaboratively with the corporate, government and community sectors to create people-centred programs that enable clients to realise their own economic wellbeing, as they define it themselves. This approach leaves clients feeling valued and in control of their finances and lives.

Incentives, culture and behaviour

In the wake of the Global Financial Crisis (**GFC**) there has been significant academic interest in the culture of banking, and specifically in the role that commission based sales incentives played in generating such poor public outcomes.

Some research has indicated that the culture of banking has an adverse impact on the individuals within it—to the extent that the culture of the industry undermines the usual social norms of honesty and ethical conduct.

In a 2014 research letter to *Nature – International Weekly Journal of Science*, three economists from the University of Zurich (Alain Cohn, Ernst Fehr and Michel Andre Marechal) wrote:

> "*Here we show that employees of a large, international bank behave, on average, honestly in a control condition. However, when their professional identity as bank employees is rendered salient, a significant proportion become dishonest. This effect is specific to bank employees because control experiments with employees from other industries and with students show that they do not become more dishonest when their professional identity or bank-related items are rendered salient. Our results thus suggest that the prevailing*

business culture in the banking industry weakens and undermines the honesty norm, implying that measures to re-establish an honest culture are very important."[4]

While it is not explored by the paper, it is possible that this cultural outcome is partly the result of an environment strongly driven by incentives, often in conflict with the best interests of the consumer. Put another way—in an environment where staff are routinely incentivised to make sales which are not in the consumer's best interests, it would not be surprising if the prevailing culture "weakened the honesty norm", as found in the paper.

Certainly, in two separate pieces of research published by Harvard Business School and the Federal Reserve Bank of Chicago respectively, natural experiments have found that financial incentives have a clear impact on the behaviour and decision making of bank staff.

The Harvard Business School publication*, Incentivizing Calculated Risk-taking: Evidence from an Experiment with Commercial Bank Loan Officers,* found there was a:

> "…*strong and economically significant impact of monetary incentives on screening effort, risk-assessment, and the profitability of originated loans*."[5]

In a similar vein, the Federal Reserve Bank of Chicago paper, *Perverse Incentives at the Banks? Evidence from a Natural Experiment*, found:

> "*The effects of such incentive pay on approved loan characteristics are dramatic, and are largely consistent with economic theory*."[6]

While neither finding seems surprising (and largely concur with common sense), they do provide rigorously researched evidence that incentives have a strong impact on staff and are likely to skew judgement.

The Chicago paper in particular found:

> "*Depending on the loan officer's career concern and the size of the monetary bonus, which is tied to the amount of the loan requested, it may be in the loan officer's interest to not only book the good loans but also the questionable ones. In other words, monetary bonus may induce her to take more risks for these loans*."[7]

While we have not identified more local research, we believe the culture of banking is sufficiently international for the above papers to inform the current inquiry. In our view it is not unreasonable to suggest that if incentives affect the judgement of bank staff elsewhere, it would be surprising if

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[4] Cohn, Alain; Fehr, Ernst & Andre Marechal, Michel. *Business culture and dishonesty in the banking industry*, Nature – International Weekly Journal of Science, 19 November 2014. Available at: http://www.nature.com/nature/journal/vaop/ncurrent/full/nature13977.html

[5] Cole, Shawn; Kanz, Martin & Klapper, Leora. *Incentivizing Calculated Risk-Taking: Evidence from an Experiment with Commercial Bank Loan Officers*, Harvard Business School Working Paper 13-002, July 5 2012, p. 32.

[6] Argawal, Sumit & H. Wang, Faye. *Perverse Incentives at the Banks? Evidence from a Natural Experiment*, Federal Reserve Bank of Chicago, WP 2009-08, August 20 2009, p. 3.

[7] Argawal, Sumit & H. Wang, Faye. *Perverse Incentives at the Banks? Evidence from a Natural Experiment*, Federal Reserve Bank of Chicago, WP 2009-08, August 20 2009, p. 10.

they were not doing so in Australia, too. Although we are not privy to the sales commission and product based payment systems that banks employ, we do see very poor banking practice and the impact it has on consumers—we can only infer that much of that practice is driven by incentive structures.

Consumer Credit Insurance (CCI)

In 2011 and 2013 the Australian Securities and Investments Commission (**ASIC**) published reports identifying serious problems with CCI sales practices of Australian banks, and other financial service providers. In October 2015 these concerns came to a head, when Westpac was required to repay more than 10,600 consumers for mis-sold CCI associated with its home lending business.[8]

In its 2011 report *Consumer Credit* ASIC identified a series of systemic issues, including:

- *consumers being sold CCI products without their knowledge or consent;*
- *pressure tactics and harassment being used to induce consumers to purchase CCI products;*
- *misleading representations being made during the sale of CCI products; and*
- *serious deficiencies in the scripts used for the sale of CCI products.*[9]

In response to the issues identified by ASIC in CCI, Consumer Action has made the area a policy priority—publishing a major research report, *Junk Merchants*, in December 2015.[10] *Junk Merchants* details the serious problems of add-on products which include poor value, low claim rates, high decline rates and the fact that they are regularly mis-sold. In addition, *Junk Merchants* provides twelve case studies on the issue.

While not privy to the specific commission structures used by banks, our strong belief is that much of the poor selling practice around CCI is probably driven by incentive structures—to the point that bank staff are induced to engage in 'sale by stealth'.

The case studies below, which are drawn from the CFA's submission to the Banking Code of Practice Review, outline the ongoing problems that consumers experience with CCI, and the poor selling practices that beset the industry—probably driven by commissions and other incentives.

Case study 1

Theresa has held a credit card account with her Bank since 2001. She only just found out that she was paying $26-27 per month for insurance to cover her if she was retrenched or

[8] Staff writer, *Westpac offers refunds on insurance*, news.com.au, 29 October 2015. Available at: http://www.news.com.au/finance/business/banking/westpac-offers-refunds-on-insurance/news-story/cce6e15fa6ae1bfdcd609c765bb4b164

[9] ASIC (October 2011) Report 256: *Consumer Credit Insurance: A review of sales practices by authorised deposit-taking institutions*, paragraph 8. Available at: http://download.asic.gov.au/media/1343720/rep256-issued-19-October-2011.pdf

[10] Consumer Action Law Centre, *Junk Merchants*, December 2015. Available at: http://consumeraction.org.au/Junk%20Merchants%20-%20Consumer%20Action%20Law%20Centre%20December%202015.pdf

to cover medical expenses. At the time she signed up to the card she was a student, not working and receiving Centrelink income. The product was totally unsuitable for her since she could not make a claim. Theresa worked casually in 2003 in a bar for a couple of years. She did not commence full time work until 2006. She stopped working in 2012 when she became pregnant. Since then she has been caring for her child. She intends on studying her masters before returning to work. In 2007 she replaced the credit card with two new credit cards. At the time she was not advised that she had the insurance product that she was paying for. Because she was overdrawn one month ago she was advised that one of the charges was for insurance $27 per month. It was only then that Theresa realised she had the insurance and had paid a total of $5000 in premiums since 2001.

Source: Financial Rights Legal Centre CLSIS 127655

Case study 2

Maricor owns her own property secured by mortgage with her Bank. A friend of hers, Jean, approached Maricor to assist her with a car loan she needed for Jean's husband. Maricor introduced Jean's husband to her Bank. Maricor explained everything to the teller that the loan was for her friend Jean's husband and he would need to repay the loan. Maricor says it was not her intention to be a co-borrower for the loan. Maricor says that she sat with Jean's husband whilst he applied for the loan and believed the loan would be in Jean's partners name alone. A loan for $53,000 was applied for and granted with a $9000 premium for Loan Protection Insurance. Jean and her husband are now considering going bankrupt and Maricor is now left with a large debt and a huge add-on insurance debt.

Source: Financial Rights Legal Centre CLSIS 126535

Case study 3

Julio is an elderly pensioner and speaks limited English. He's been referred to the Insurance Law Service as he has discovered that there are debits on his bank account statements for contents insurance he never agreed to. He says he never signed up to contents insurance. He tells us that he went into a branch to do his banking, he remembers the girl giving him a brochure about contents insurance but he says he told her didn't want it. He says he got something in the post, but he ignored it and thought it was just marketing materials. He never wanted the insurance and told her so. He didn't know he had been signed up and had to contact the insurer to stop it. He wants his money back, as because they debited the premiums he cannot afford his electricity bill.

Source: Financial Right Legal Centre

Case study 4

Maria called her Bank to transfer funds between her two accounts. During the course of the same conversation she was offered an increase to her credit card limit (which she accepted) without the Bank making reasonable enquiries as to whether she could afford the increase. She was also sold credit card insurance which she did not know she had agreed to.

Two years later she contacted Care as she was in financial hardship and a financial counsellor informed her she had been sold insurance and to date had spent over $3000 in credit card insurance. Maria would not have taken it out if she knew what it was at the time.

Source: Care inc.

One form of poor sales behaviour that we have increasingly seen in our case work relates to the issue of disclosure and insurance. A key part to the sale of any insurance product is to ensure that the consumer discloses all information relevant to the policy. Every consumer has a duty to disclose every matter that they know or could reasonably be expected to know to the insurer to inform their decision whether to accept the risk or not. We are however concerned that there is a culture in the add-on sales space to rush through this disclosure process or ignore it altogether in order to close a sale.

We have worked with a number of consumers who have told the bank officer/sales representative that they, for example, have a criminal history and the sales person has responded that the consumer does not need to worry about that. The disclosure process is therefore manifestly inadequate resulting in policies that are worthless.

Case study 5

Cathy is a young Indigenous woman living on the north coast. She was applying for a car loan to buy a new car, as her last car was written off in an accident. She was at fault in the accident. She applied for an unsecured car loan through the local branch she normally did her banking with. She remembers talking to the teller about how she needed to get a new car because of the accident. The teller offered to arrange insurance at the same time. Her last car wasn't insured and that is why she now needs a loan. She arranged the insurance and Cathy does not remember being asked any questions about her driving history, she remembers they just had a bit of a chat and Cathy signed where the teller pointed to.

A few months later, Cathy's mum reverses the car into a neighbours fence by accident. Cathy's neighbour is after the repair costs, and Cathy also wants to repair the rear bumper damage. Cathy contacts the insurer. The insurer asks Cathy about whether she has ever had any accidents and Cathy says she had including the car being written off the previous year. The insurer indicates they won't pay the claim as she had failed to disclose the previous accident. Cathy is sure she told the teller at the time, as they had discussed it at length.

Source: Financial Rights Legal Centre

Case study 6

Matthew, who had suffered a mental illness in the past, purchased a car in late 2011 with finance from the car dealer, along with a CCI policy. When Matthew bought the CCI he expected that it would cover him in a number of circumstances, including if he suffered another episode of the same mental illness.

Matthew disclosed that he had suffered the mental illness at the time of applying for the insurance and the finance company representative said that, considering he had not suffered an episode of the mental illness for a number of years, he was 'fine' to take up a policy. Matthew bought the cover in relying on what the finance company representative said.

Matthew's illness did recur, which required him to spend time in hospital without income. His claim on the CCI was rejected on the basis that his mental illness was a pre-existing condition. Matthew could not continue payments on the loan, the vehicle was repossessed and sold and he was pursued for a residual amount by his lender.

Source: Junk Merchants Report, Consumer Action Law Centre

Further we have heard of sales staff who have simply provided poor advice, again in the service of a quick sale. We have clients who when asking about comparative products, sales staff state things like “yes, this is the same as your product” when they are in fact different.

Case study 7

Jenny had Landlords Insurance, and was in the process of refinancing her investment property. In the course of the refinance, the bank officer mentioned the banks branded insurance and asked Jenny if she wanted to switch. Jenny asked the bank officer if it covered the same stuff as her current insurer. The bank officer said words to the effect “oh, yeah it’s all pretty standard stuff.” Jenny was asked a few questions about the house and she switched. At the time, Jenny’s tenant has been late a few times with the rent but always made it up. Jenny proceeds to switch her cover, the schedule looked standard and it said covered lost rental.

A few months later, Jenny’s tenant moved out and left with unpaid rent and had also damaged the property. Jenny made a claim on her insurance, and the insurer declined her rental claim and didn’t cover all of the damage. Jenny was angry that the bank officer had said it would be the same and in the end it wasn’t. Jenny checks her old policy and finds that she would have been covered for everything.

Source: Financial Rights Legal Centre

Financial Inclusion

This review highlights the commitment of banks to improving their practices and meeting the individual needs of customers. We consider that it is possible for this commitment to inform a banking culture that is genuinely customer-focused. To achieve this, it is important to ensure remuneration structures support a culture that seeks to secure the financial wellbeing of all customers.

To deliver appropriate financial products and advice to customers, from the outset it is important to understand the needs and aspirations of customers. This means that banking staff must be given the opportunity and be empowered to build open and respectful relationships with customers through meaningful conversations. In practice, this means that staff need to spend enough time with customers to understand their unique circumstances, to ask questions that they may not have time to currently ask, and to respond to the individual needs of the customer. Furthermore, that banking remuneration structures encourage and reward good performance in these practices.

One avenue that can inform customer-focused banking practices is through a focus on financial inclusion. Good Shepherd Microfinance has been appointed by the Australian Government to develop a Financial Inclusion Action Plan (FIAP) program. The FIAP program provides an opportunity for organisations—including financial institutions—to prioritise financial inclusion, and tailor policies and practices accordingly - to enable economic mobility and resilience.

Through our work on this program, we have gathered best practice lessons about how financially inclusive practices can focus on the needs of each individual customer. We understand financial inclusion to be a combination of access, affordability, convenience, dignity and consumer protection.

In the context of this review of product based payments, we consider that the design of banking remuneration policy would result in better customer outcomes if it valued:

- Meeting customer needs and offering products and services are appropriate to the situation of the customer.
- Ensuring that ongoing use of products and services is affordable.
- Offering products and services that are accessible.
- Building awareness of the products, as well as the most effective way to use them.
- Ensuring that channels of communication are open, so that customers are given correct information and can speak to someone if needed.

Other elements of financial inclusion that could be incorporated into remuneration structures could include:

- Ensuring consumers understand their obligations, rights and ability to choose.
- Proactively providing financial information, (for example with regard the implications of comprehensive credit reporting).
- Proactively support people in financial hardship.

If you have any queries regarding this submission please contact:

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- Drew MacRae, Policy Officer, Financial Rights on 02 8204 1386 or at drew.macrae@financialrights.org.au, or
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Yours sincerely

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