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To the Manager

RE: **Consultation on remuneration requirements for all APRA-regulated entities**

The financial services industry plays an essential role in the lives of Australians, from providing for day-to-day transactions to providing for a comfortable retirement.

Markets were opened because with increased competition can come benefits for consumers. At the heart of these open markets is a profit motive that, when properly aligned, drives companies and their staff to innovate, improve quality and place downward pressure on costs. The payoff is meant to be mutually beneficial to businesses and consumers. In return businesses gain new customers and increase their profits, while consumers get better quality products at lower prices.

However, the Royal Commission highlighted that there is a deep problem in how financial institutions are operating. For too many financial firms it has been easier to increase profit by misleading, confusing or selling products to people that are simply inappropriate or are harmful.

This has resulted in widespread consumer harm, including:

- financial firms selling people junk insurance products that they can never claim on;
- advice firms stealing billions from people in the fees-for-no-service scandal;
- banks irresponsibly extending credit through credit cards, leaving just under a million Australians trapped in a cycle of persistent credit card debt[1]

As a consumer movement, we welcome APRA's proposed changes to remuneration requirements. These reforms are an important step forward. It is time to make markets work properly and restore the missing link between the pursuit of profit and good consumer outcomes. As a start, APRA should be looking to set direction on remuneration which will ensure staff are properly focused on the drivers of mutually beneficial profit. APRA must calibrate remuneration to ensure that the products and services firms are well-designed, suitable and fit for purpose.

[1] ASIC 2018, REP 580, Credit card lending in Australia

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Financial firms have failed to construct remuneration systems that can reward good consumer outcomes. Existing non-financial metrics used by financial institutions that attempt to measure this, such as Net Promoter Score (NPS) and Balanced Scorecards are ineffective at best and deceptive at worst. Many of these metrics are thinly-veiled proxies for encouraging a sales culture.

APRA must provide financial services firms greater guidance around non-financial metrics that accurately capture when staff members provide safe and well-designed products. They should use the new Design and Distribution Obligations as a guide to ensure firms are selling products that are suitable and well-designed. APRA must also mandate that all proposed remuneration system must be independently tested to ensure they are designed to foster good consumer outcomes. APRA should also periodically review and approve remuneration systems with a focus on major institutions most at risk of embedding harmful incentives in their systems.

The Design and Distribution Obligations must guide remuneration decisions

Corporations have an obligation to sell products and services to people that are safe, well-designed and are suitable to their needs. The Federal Government recently codified this principle through the Design and Distribution Obligations (DADO's). This new law places an obligation on firms to ensure they have financial products and services that are suitably designed and marketed to an appropriate cohort of the market. Firms are required to publicly identify the "target market" for the products they sell, ensuring that they market fairly to consumers who will benefit from the products. The DADO's will help achieve a cultural shift within financial firms away from simply selling financial products towards designing and distributing suitable products that meet customers' long-term needs.

Financial firms must embed the principles of the DADO's within their remuneration systems. Staff should be rewarded for providing people with products that are safe, well-designed, and suitable to their needs.

APRA needs to mandate that companies run regular audits of each product and service they sell. They must assess whether the products and services they provide are suitable and fit for purpose for their 'target market'. This will serve as an important indicator to identify whether a firm is taking advantage of their customers.

This new approach will shift the focus away from the short-term view of selling poorly targeted and inappropriate products to consumers. Companies instead will be financially incentivised to provide products that are fair and match the long-term needs of consumers. The audit should be the foundation of performance management. A failure of financial services firm to sell products that are suitable and fit for purpose must disqualify people from receiving a bonus.

Prohibiting all sales-based bonuses

The Banking Royal Commission made clear that rewarding staff members for the single-minded pursuit of profit leads to misconduct. We strongly affirm that financial services firms must not provide bonuses to staff members that are based on sales or financial metrics. As Commissioner Hayne concluded,

> *"it is now not disputed, poor remuneration and incentive programs can lead, and have led, to poor customer outcomes."*[2]

We acknowledge that APRA has mandated that 50% of variable bonuses for executives must be from non-financial metrics. This is an important step forward. However allowing corporations to still devote half of their variable bonuses to financial metrics will not solve the systemic issues of financial markets. We encourage APRA to go further.

In addition, APRA must ensure that the non-financial metrics are effective and capture whether a product or service that a consumer engages with is well-designed and fit for purpose.

Moving beyond Net Promoter Score (NPS) as a measure of good consumer outcomes

APRA must prescribe in their Prudential Standards that financial institutions not rely on the Net Promoter Score (NPS) as a measure of good consumer outcomes.

It is widespread industry practice for financial institutions to use the NPS as a proxy for measuring good consumer outcomes. NPS is a score of satisfaction that a consumer provides at the time of interaction with a banking staff member. We share the Banking Royal Commission's deep concerns about the quality of NPS to capture the quality of service provided to people. As the Commission noted:

> "*The Net Promoter Score does not measure whether a customer has been serviced according to their best interests, or indeed their needs and it does not measure whether the service they have received is legally compliant."*[3]

The NPS conflates the perceived friendliness or trustworthiness of the banking staff member with the quality of the product, service or advice provided. ASIC has shown the challenge people face in assessing the quality of service or advice, especially for complex financial products. In their shadow shop of the quality of retirement advice,[4] ASIC found while 86% of people considered the advice they received to be good, an expert panel found that only 3% of the advice would be considered good, with the rest being poor or adequate. The research also found that four in five (81%) people surveyed "trusted" the advice by the adviser, despite 3% of the advice being ranked "good". This creates the perverse outcome where a bank staff member appears trustworthy could be rewarded for selling products that are harmful to people.

[2] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report, p.309-312

[3] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Interim Report, 2019 p.311

[4] ASIC, Report 279 Shadow shopping study of retirement advice (REP 279), March 2012.

Any measure that seeks to capture good consumer outcomes must focus on the quality of product, service or advice provided to consumer, and must consider whether the service provided was in the suitable and fit for purpose. The NPS simply fails to achieve this.

(Un)balanced scorecards

Balanced scorecards are being increasingly used at every layer of Australia's banks: from retail bank staff to the executive. Balanced scorecards are a wolf in sheep's clothing. These scorecards merely pay lip-service to being 'customer focused' while still rewarding staff for pushing products to consumers.

Case Study #1 - ANZ's balanced scorecard:[5]
Since April 2017, ANZ has been using balanced scorecards for the payment of bonuses to branch staff members. To be eligible to receive a bonus, a staff member must meet certain thresholds in four key result areas (KRA's):

- Customer (weighted at 35%)
- People and Reputation (15%)
- Financial and Discipline (30%)
- Risk and Process (15%)

The Banking Royal Commission found that the "Customer" KRA was a thinly-veiled guise for ANZ to reward staff for selling more products. Under the Customer KRA, staff members were rewarded for the number of accounts opened, the number of sales-driven "A-Z reviews" conducted, the number of sales made, and a customer satisfaction rating. Notably lacking was any indicator or metric that measured whether a staff member's service met a consumer's best interest or enhanced their financial wellbeing. The Royal Commission concluded that, "despite the scorecard's complexity, sales lie at its heart and the chief purpose of the whole incentive program remains to enhance the bank's 'overall results'."[6]

This intentional obfuscation of balanced scorecards has been highlighted by the Financial Conduct Authority:

> "Sales targets might be given less prominence by changing terminology, for example where staff are given objectives for how many 'customer needs' are met, but this might still have the same effect as a sales target."[7]

The latitude given to firms to essentially equate good consumer outcomes with more products sold in a balanced scorecard lies at the heart of the problem. We strongly support the use of performance evaluation - across all levels of the firm, including front-line staff, middle managers and senior executives - that is not tied to sales or selling products to individuals. Given the banks track record of misconduct, any scorecards should be made public and in clear English. This is an essential change in

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[5] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Interim Report, p.309-312

[6] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Interim Report, p.312

[7] Financial Conduct Authority, 2015 'Risks to customers from performance management at firms. Thematic review and guidance for firms.' https://www.fca.org.uk/publication/guidance-consultation/gc15-01.pdf

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ensure banks consider the long-term interests of consumers and stop viewing their customers as vehicles for selling more unsuitable products.

Bonuses must not be paid when a company has had a significant breach

In spite of recent widespread misconduct, the industry continues to reward executives with large bonuses. As an example, in FY2017 the Commonwealth Bank Board approved 108% of the CEO's short-term bonus.[8] This is despite major scandals affecting the Commonwealth Bank including the AUSTRAC money laundering court proceedings, the fees-for-no-service scandal and CommInsure scandal. Confidential documents brought to light in the Banking Royal Commission revealed that since 2011, only five executives at the Commonwealth Bank had their bonuses cut due to misconduct.[9] We maintain deep scepticism that Boards are incentivised to clawback or block bonuses, even when misconduct occurs. Instead, APRA must provide clear guidelines that bonuses are not paid to executive if a company has had significant breach of the law.[10]

Further, APRA must explicitly acknowledge that other important non-financial metrics be considered by boards when allocating bonuses to executives, including complaints to internal dispute resolution (IDR), external dispute resolution (EDR), and time spent handling complaints. We are aware that these metrics must be clearly monitored as they could create a culture of cover-ups where staff members may not be incentivised to pass complaints up to their management. However, we argue they are important measures of a company's treatment of their customers and must be considered. We believe a strengthened ASIC RG 165 Internal dispute resolution guidance (currently being reviewed) may assist in providing improved data for regulatory oversight in this matter

Bringing transparency and accountability to remuneration systems

After the scandals of the Banking Royal Commission, it's clear that financial institutions can not be trusted themselves to implement remuneration systems that promote good consumer outcomes. APRA must clearly specify in the Prudential Standards that independent oversight and approval of remuneration systems is required. This includes an independent assessment that non-financial metrics are not tied to sales targets, and actually promote good consumer outcomes. These assessments must be accountable and made public. This is an important step forward to guarantee improved standards in the industry.

[8] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, P-6755, 19 November 2019 (transcript)
[9] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, P-6767, 19 November 2019 (transcript)
[10] Significant breaches could be linked to ASIC's proposed new breach reporting standards, as per ASIC Enforcement Review, https://treasury.gov.au/review/asic-enforcement-review

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Yours sincerely,

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