12 February 2017

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,

Retail Remuneration Review - Issues Paper

The Consumer Action Law Centre (**Consumer Action**), is pleased to provide a submission in response to the Retail Remuneration Review Issues Paper (**Issues Paper**).

As stated in our joint response to the Terms of Reference, we believe product sales commissions and product based payments inevitably distort banking sales-staff behaviour, elevating the sales imperative above considerations of consumer well-being. This can generate very poor consumer outcomes often occasioning significant financial harm. The frequency and extent of this harm is such that the role of commissions and product based payments, (indeed the whole sales-based culture of banking), should be fundamentally reconsidered.

The strong correlation between sales incentives and consumer harm has been identified by a number of credible international studies, which ought to inform this review.[1] Inappropriate sales incentive schemes appear to be central to a banking culture that promotes high risk, short-term gains and have contributed to crises and scandals since the global financial crisis. Consumers International estimates that the losses to consumers measure more than $US 53 billion globally.[2]

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[1] For examples, see: 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; 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; 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

[2] Consumers International, *Risky business: the case for reform of sales incentive schemes in banks*, October 2014, available at: http://www.consumersinternational.org/media/1529404/sales-incentive-report_riskybusiness_final2_151014.pdf.

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A fundamental shift in the culture of Australian retail banking is needed, away from a hard-sell approach and towards a service focus. Minor adjustments to current remuneration systems will not affect this change. Only a root and branch, industry-wide overhaul of commissions, product based payments as well as other incentive schemes (i.e. targts) will arrest the consumer harm currently generated through inappropriate sales.

We have responded directly to the Issues Paper by addressing the questions in the order they are posed, noting that our comments are brief in some instances as some questions are intended primarily for industry, and fall outside our expertise or evidence base.

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 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.

6.1 – The role of targets

Q.1 – Is there a realistic alternative to setting targets as an aid to the management of a large organisation?

The fundamental challenge facing Australian retail banking is the need to shift from a sales culture to a service culture, and incentivised sales targets are an impediment to that goal. Changes to financial incentive schemes alone will not be enough to improve standards, and sales targets can be equally problematic.

In its 2014 report, Consumers International notes two broad types of sales incentive schemes:[3]

- Financial incentives and bonus schemes: Thresholds and sales target will be set and employees who meet or exceed those targets will receive a financial incentive, which could take the form of a bonus, an increase in pay or a prize. Staff who do not meet the targets would not receive a bonus or would be given a reduction in pay.
- Performance management: Those employees who do not meet the threshold or targets may be subject to more intensive monitoring or coaching. If performance does not improve then employees may be subject to disciplinary action or dismissal. Performance could also be monitored and reported within the bank using league tables, with employees placed under explicit or implicit pressure to improve their ranking by selling more products.

The evidence presented in the Issues Paper suggests a very similar approach taken by Australian banks.

[3] Ibid, p 5.

A key problem with targets is when they relate to sales or referrals volumes alone. Where targets are used as part of a performance management system that responds to the needs of customers, including after-sales customer service and complaints handling, risks may be reduced.

Another key problem with sales volume targets is where failure to achieve them results in performance management or threats of dismissal. There does appear to be regular rounds of redundancies in large organisations like the banks. The potential loss of a job is likely to focus the mind of an individual more acutely than a financial incentive. It might be said that even if financial incentives are removed, targets can mean that a sales-based culture remains.

Achieving cultural shift across such a large and established industry is incredibly difficult, and must be achieved by generating strong employee engagement with service goals and devising assessable targets that are genuinely service related. The Issues Paper makes the point that service targets can be difficult to assess owing to varying communication skill levels across staff and managers, but this is not sufficient reason not to begin the process. It must be acknowledged that the process will be slow and must be accompanied by extensive and effective staff training. While this is a significant undertaking, it is clearly preferable to the ongoing consumer harm that inevitably results from a strongly driven sales culture.

Q.2 – What is the appropriate role of targets in managing performance and assessing rewards payable to an individual?

As discussed above, targets should be recalibrated to value performance goals other than sales—and should give particular weighting to customer outcomes and the appropriateness of products sold.

It is noteworthy that the ANZ bank has recently reformed its frontline retail incentive framework to adopt a "balanced scorecard" which gives a 30% weighting to sales targets, and a 70% weighting to customer and teamwork metrics—representing a significant shift away from the previous system, when sales metrics were dominant. Under the new system (which will come into effect on 1 April), customer satisfaction metrics will take into account "A to Z reviews"—an interview process which assesses customer financial needs and matches them with appropriate products. This appears to be a step in the direction recently set by RBS and NatWest in the UK,[4] and has been described in similar terms (of rebuilding trust, and focusing on consumer need) by Catriona Noble—managing director of retail distribution Australia at ANZ:

> *"We recognise the need to improve our ability to look after customers and meet their expectations, so customers can trust the bank, and [know] the solutions we recommend to them are appropriate and in their best interest and not just in the best interest of the bank," Ms Noble said.*[5]

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[4] 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.

[5] Eyers, James. *ANZ is changing its rules to emphasise customer service over sales targets*, Business Insider, 20 January 2017. Available at: http://www.businessinsider.com.au/anz-is-changing-its-bonus-rules-to-emphasise-customer-service-over-sales-targets-2017-1.

Such a system may still cause problematic outcomes if it overly focuses on products. An ‘A to Z’ review may be implemented as an opportunity to sell more or different products, rather than focus on whether existing products are meeting needs or advice about not getting (or disposing of) particular products. Unless it can be shown that these sort of programs respond to customer service more broadly, they risk becoming a sales target by another name.

However, if well implemented and executed, this system could represent a positive local shift towards a genuine service based culture.

Q.3 – What is the nature of the risk attached to setting targets that are sales- or product-related compared to others such as service metrics?

Sales and product based targets create an inherent conflict of interest for banking staff, who know they are required to achieve a certain outcome (and receive a financial incentive for doing so) and therefore may prioritise that target over the legitimate needs of the customer. This places the customer at risk of being mis-sold a product or service which is unnecessary and potentially very expensive. It should also be noted that an inherent information asymmetry places the customer at a disadvantage in most sales interactions, which means they are likely to trust the information provided by the bank. This dynamic is exacerbated for particularly vulnerable consumers, who may be facing significant life pressures and have less capacity to make the cognitive effort to engage with the sales process, and interrogate the appropriateness of the product for their needs.[6] Given such a combination of factors it is not surprising that products are routinely mis-sold, nor is it unreasonable to suggest that measures should be taken to prevent this from occurring.

Since January 2016, Consumer Action has operated an online service which generates automated letters for consumers who believe they have been mis-sold consumer credit insurance (CCI) —a commonly mis-sold “cross selling” product, often sold by banks. So far, our “DemandARefund.com” service has generated 269 letters for consumers claiming refunds amounting to a collective total of almost $500,000. Significantly, 27% of claimants have indicated that they believed the CCI was mandatory for them to obtain the loan or credit card, and 21% were unaware that they had even purchased the product. These figures would indicate that mis-selling (either through open and wilful deception, or at best a strategic omission of information) is very common, at least where CCI is concerned.

Financial Services Union (FSU) qualitative data also indicates that banking staff experience significant conflict between meeting the sales targets required to maintain job security, while at the same time selling consumers products that are appropriate for their needs. In a 2016 survey of banking staff conducted by the FSU, workers commonly reported sentiments such as these:

> *“Customers get annoyed that they have someone trying to sell them something every time they walk in the door. They believe the bank is just out to make money, not help them.”* [7]

At the time of the survey, the FSU’s acting national secretary Geoff Derrick described the culture of banking (and its impact on staff) in the following terms:

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[6] See: Mani, Anandi; Mullainathan, Sendhil; Shafir, Eldar; and Zhao, Jiyaing, *Poverty Impedes Cognitive Function*, Science, Vol 341, 30 August 2013.

[7] Ong, Thuy. Banks’ pursuit of profit having ‘devastating’ impact on staff, ABC News, 22 August 2016. Available at: http://www.abc.net.au/news/2016-08-22/union-warns-banks-pursuit-of-profits/7772232.

> "…*they are being pushed to deliver on sales targets to the point where some feel that (they) have no choice but to do anything they can to keep managers off their backs, including selling banking products to consumers who don't need them."*

Mr Derrick indicated that while mis-selling is occurring, this often cause an internal conflict for banking staff—who feel pressure to hit the targets set for them:

> *"Bank workers know when their customers really need a service or a product and they are also clear about what is ethical and unethical behaviour."*

In fact, (and as raised in our submission in response to the Terms of Reference for this review), international research has found that a strongly sales driven culture defined by targets can undermine 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*."[8]

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*."[9]

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*."[10]

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[8] 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.
[9] 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.
[10] 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.

While neither finding seems surprising, 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*."[11]

Although we are not privy to the detail of 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.

Q.4 – Is such a risk lowered if targets are set and eligibility for rewards is assessed less frequently (e.g. annually compared to monthly)?

Assessing targets less frequently will not modify banking staff behaviour, if anything it will raise the perceived stakes in the lead up to the assessment period. In order to modify behaviour and shift the culture of retail banking it is necessary to reconfigure the targets themselves, away from a sales focus and towards a genuine service focus.

6.2 – Does the size of rewards or their structure matter most?

6.2.1 - Complexity

Q.5 – How best can we address the trade-off between simplicity, on the one hand, and on the other, elements to guard against the risk of incentivising poor outcomes for consumers?

If staff are accurately assessed on their ability to meet customers' genuine needs (and the consumer outcomes that result from their interactions), then there is no need for complex commission and bonus payment structures. Complexity only serves to complicate the drivers motivating the staff when engaging with a customer, and those drivers should be very clear and straightforward. In very simple terms, it is the role of sales staff to assess which product or product will serve the customer's best interests and provide them with the greatest benefit, given the customer's needs and financial situation—and then provide them with that product or products. In some cases, it may be that the customer won't be well served by any product at all, in which case, that should be the recommendation. If staff are properly motivated and incentivised to generate positive consumer outcomes—and accurately assessed on how well they meet that goal—then elements to guard against the risk of incentivising poor outcomes become unnecessary.

[11] 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.

6.2.2 – Accelerators and similar devices

Q.6 – Should banks discontinue the practice of using accelerator-type payments?

Yes. Accelerator payments are inherently dangerous in that they encourage staff to intensify their sales activity once they have reached a certain sales volume threshold. The incentive to "make more, the more you sell" only increases the conflict of interest (and therefore the risk of mis-selling) described in our response to question 3.

We note that as part of their recently announced reforms, (to take effect on 1 April), the ANZ has chosen to discontinue the use of accelerator payments for all sales staff.[12] This is commendable, and should be followed by all other participants in the retail banking sector.

Q.7 – If yes, what other devices are suitable to reward high performers?

The notion of a "high performer" may need to be re-thought in line with a new service culture in retail banking, and while more difficult to assess this will generate far less consumer harm. In a new service culture, high performers may not necessarily be those staff who generate the most sales—but instead those who staff who generate the *best service*, measured in terms of how well they meet consumers' needs, whether they offer the customer a positive benefit and how likely they are to sustain a positive and healthy client relationship into the future. This requires a fundamental realignment of values in retail banking and will not happen quickly or easily, but in such an environment high performers would be regarded as those who provide the best service—and they would be rewarded accordingly. Mis-selling products to consumers would count against performance in this context, so sales volume in itself would not indicate "high performance".

6.2.3 – The emphasis attached to volume-based financial targets

Q.8 – Should banks discontinue the practice of applying gateways to incentives payments based on the achievement of financial measures?

Yes. As noted in our response to question 3, we have significant experience with consumers who have been mis-sold CCI products. These are a typical example of products sold via cross-selling, and can operate as a gateway whereby an employee's commissions are forfeited unless they have sold a sufficient number of CCI policies in a given period. In our view this is an extremely dangerous incentive structure which invites an unhealthy conflict of interest between the seller and the consumer, inevitably leading to poor consumer outcomes. Such gateways should be discontinued—just as accelerator payments should be discontinued.

Q.9 – Should banks discontinue the practice of assessing performance and eligibility for rewards on the basis of product-based payment? If yes, on what basis?

Yes, because such incentives generate a clear conflict of interest in the context of an inherent power imbalance—as described in our response to question 3. Discontinuing this practice would

[12] Eyers, James. *ANZ is changing its rules to emphasise customer service over sales targets*, Business Insider, 20 January 2017. Available at: http://www.businessinsider.com.au/anz-is-changing-its-bonus-rules-to-emphasise-customer-service-over-sales-targets-2017-1.

be a powerful measure to reform the culture of retail banking in Australia, tilting it away from a strong sales focus and towards a service focus as discussed throughout this submission.

Q.10 – Alternatively, should banks limit the weight applied in total to financial measures to say, 35% in these assessments?

This is less desirable that discontinuing the practice completely, and would seem to reflect the "scorecard" approach that is soon to be introduced by the ANZ (see our response to question 2). The bolder simpler step of outright discontinuance would be more effective for the purposes of preventing harmful selling practices. While we do view the ANZ reforms as a step in the right direction, we are conscious that the "scorecard" approach is relatively complex—and for the reasons described in response to question 5, simplicity in incentive structures is always preferable to complexity, as it is less likely to conceal the financial incentives that drive poor behaviour.

6.2.4 – Cross-selling incentives

Q.11 – Should banks discontinue the practice of applying cross-sales gateways or modifiers?

Yes, absolutely. We have addressed this question in our response to question 8.

Q.12 – If yes, what other approaches are available to encourage and reward staff that assist customers to identify and meet their needs?

This requires an entire rethink of the factors on which banking sales staff are assessed, as described in our response to questions 1, 3 and 7. If staff are genuinely motivated to provide strong customer service (particularly after sales service), and are accurately assessed on the extent to which they do that—then incentives can be based on their performance in that respect.

Q.13 – Are cross-sales incentives more likely to lead to poor outcomes for customers than general sales targets?

Cross-sales incentives are likely to generate poorer consumer outcomes, because they encourage consumers to purchase products that they did not originally seek out—and probably don't actually need. It's worth noting that this view of cross-selling was recently expressed by Suncorp CEO, Michael Cameron who stated in an interview with the Australian Financial Review on February 9 2017:

> *"I haven't seen cross-selling being a good concept for customers … it has not worked anywhere in the world. When I talk to ASIC or APRA, it's very hard not to argue that that's not a sensible outcome for the customer."*[13]

[13] Uribe, Alice. *Cross-selling in banks 'unsustainable' says Suncorp CEO*, Australian Financial Review, 9 February 2017. Available at: http://www.afr.com/business/insurance/insurance-companies/crossselling-in-banks-unsustainable-says-suncorp-ceo-20170209-gu9aoe.

6.2.5 – Branch vs individual targets

Q.14 – What is the best way to mitigate any risk that business unit/branch-based targets will lead to inappropriate pressure on individuals to mis-sell?

The best way to mitigate this risk is to remove sales based targets, and assess performance on the basis of genuine customer service factors as outlined in our responses to questions 1,3 and 7.

6.2.6 – A scorecard or specific measures?

Q.15 – Is there a case for banks to adopt scorecard-based approaches in order to minimise the risks of mis-selling? If so, why?

There is a limited case for this and we welcome the recent announcement by the ANZ who are reforming their sales staff incentive structure, but as discussed in our response to question 10 it would be preferable to discontinue sales targets altogether. While the "scorecard" approach makes an attempt to de-emphasise the importance of sales, (and re-weight the performance assessment of staff to promote a service culture), it would be even more effective to discontinue sales targets completely—which would remove the need to weigh them against other factors using a "scorecard". Because they are complex, there is a risk that scorecards can be used to conceal financial measures to drive staff behaviour. A truly effective scorecard would need to include metrics around ensuring that customers are getting a good deal, that after-sales service is of high quality, and comprehensive, and that complaints and disputes are dealt with fairly and promptly.

Q.16 – Are there any market or other impediments to such a development, including in respect of mortgage brokers or other home lenders? How might any such impediments be addressed?

We are not aware of particular impediments, but would welcome understanding concerns from the industry. As described above, we are not convinced that a "scorecard" approach sufficiently mitigates risks of mis-selling.

6.2.7 – What constitutes product neutrality?

Q. 17 – Should banks adopt the principle that sales incentives should be 'product neutral'?

No. Product neutrality may be less likely to encourage forceful and clearly inappropriate selling of particular products to consumers, but it remains an unhelpful incentive. Under a product neutral approach sales staff may seek to reach a sales target by selling whichever mix of product sales helps them to achieve that goal, but a sales target is a sales target—whether it is product neutral or not. For the reasons outlined in our response to question 3, sales targets inherently create a conflict of interest likely to result in consumer harm. On that basis, sales targets should be discontinued completely—in favour of more sophisticated performance metric designed to promote a culture of service.

Q.18 – If yes, how is that neutrality best established?

Not applicable.

Q.19 – Should banks discontinue the practice of applying accelerator-like arrangements?

Yes. Please see our response to question 6.

<u>6.2.8 – Formulaic or discretionary approach?</u>

Q. 20 – What conditions need to be met to ensure that Manager discretion is exercised in ways that minimise the risk of poor outcomes for customers?

A genuine shift to a service based culture in retail banking will necessarily involve managerial assessment of staff based on non-sales based metrics, and this is likely to involve a degree of subjectivity and discretion in deciding bonuses. This will require skilled and well-trained managerial staff who are themselves not subject to sales or revenue-based performance criteria. As the Issues Paper correctly notes, the current role of managerial discretion—embedded as it is within a strong sales culture in which managers themselves are subject to sales-based performance metrics—can magnify employee focus on sales target, rather than moderating it as intended. Managerial discretion is important and necessary for healthy workforce development and to realise corporate aims, but it still has to operate within the context of the organisation's performance incentive structure, and it will inevitably mould itself around whatever goals that structure prioritises. Thus, relying on managerial discretion to temper the excesses of mis-selling in an environment which strongly incentivizes aggressive sales practices is unlikely to be effective. This is particularly true if managers themselves are assessed on the basis of sales targets. Instead, it is important to remove sales targets and re-set the criteria by which employees are assessed to more service focused metrics, promoting managerial discretion within that context instead.

<u>6.3 – Should bank obligations be strengthened?</u>

Q.21 – Should the regulatory framework for retail banking be strengthened? If so, how?

A strong regulatory response is necessary to curb the potential harm of caused by a strong sales culture. In banking, implementing a ban on unsolicited credit card increase offers (including the ability to seek prior consent) would be a positive development, and this has been proposed as part of suite of reforms floated by Federal Treasury in May 2016.[14] Prohibitions on unsolicited invitations for other forms of credit should also be adopted, including overdrafts or line of credit arrangements linked with existing products.

Adopting an opt-in model for the sale of add-on products such as CCI would also be extremely effective. As outlined in our response to question 2, Consumer Action has identified significant mis-selling of CCI products—some of which comes through the banking sector.[15] We have established a web-based service (DemandARefund.com) which enables consumer to seek refunds for policies

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[14] Australian Federal Treasury, *Credit cards: improving consumer outcomes and enhancing competition,* May 2016. Available at: http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2016/Credit%20card%20reforms/Key%20Documents/PDF/Credit_card_reforms_CP.ashx.

[15] A September 2016 report by ASIC also revealed that mis-selling of add-on insurance is also rife in throughout car dealerships. See: http://asic.gov.au/about-asic/media-centre/find-a-media-release/2016-releases/16-301mr-asic-puts-insurers-on-notice-to-address-serious-failures-in-the-sale-of-add-on-insurance-through-car-dealers/.

that have been mis-sold by generating refund demand letters—and in the past twelve months have claimed close to $500,000 worth of refunds.

The below case studies illustrate the kinds of practices we commonly see in the selling of CCI products:

John's story

John* had consumer credit insurance both on a personal loan he took out with his bank and with his credit card. However, he has been receiving a disability support pension (DSP) for years, meaning he would not be able to claim on the policy. John's bank knew he was receiving the DSP because the payments went into an account that John held with them. John was unaware that the insurance was optional.

Alison's story

Alison* obtained a car loan with her bank. She says they told her she had to have consumer credit insurance to qualify for the loan, which is prohibited by the National Credit Code. Alison worked in a casual job, so the insurance was unlikely to benefit her. The policy premium was almost $3,000 and the interest rate was over 20%.

Jimmy's story

Jimmy* didn't realise that consumer credit insurance had been added to his credit card until he noticed monthly deductions of about $25 per month. He had no idea what it was for.

* - names changed to de-identify clients.

From a behavioural perspective, the selling of CCI and other add-on products shares traits with unsolicited selling as they are generally presented to the consumer without first being requested or anticipated, are often poorly understood, and tend to be sold through high pressure selling tactics—which leverage a significant information asymmetry. Implementing an opt-in requirement (whereby the consumer would not be able to purchase the product within 48 hours of first being made the offer, and then would be required to do so by independently contacting the trader), would stall this process and allow the consumer to make a proactive choice of their own volition. We note that this is a far more effective form of consumer protection than a cooling-off period.

Consumer Action has advocated for the application of an opt-in model to unsolicited sales as a far more effective protection than the existing cooling-off provisions throughout the recent review of the Australian Consumer Law (**ACL**). We reproduce part of our submission to the CAANZ ACL Interim Report[16] to inform this submission below:

[16] Available here: http://consumeraction.org.au/australian-consumer-law-review-interim-report/

"Our support for [an opt-in model] is grounded in our experience that the current ten day cooling off period for unsolicited consumer agreements is very rarely used by consumers generally, and is even less likely to be used by vulnerable consumers balancing the pressures of low-income living with other factors. For a variety of behavioural reasons, consumers are pre-disposed not to utilise cooling off periods. Consumer Action has worked extensively with Dr Paul Harrison, co-Director of Deakin University's Centre for Consumer and Employee Wellbeing, and professor of marketing at Deakin Business School. In a recent article in online publication *The Conversation*, Dr Harrison explained the propensity not to use cooling off periods in the following terms:

"*The problem with the current cooling-off periods is that they operate after a customer has taken ownership of something or signed an agreement. Our research finds cooling-off periods simply don't overcome many of the inherent biases of human behaviour.*

Dr Josh Newton and I, from Deakin University's Centre for Employee and Consumer Wellbeing, tested how 759 consumers responded when presented with cooling-off and opt-in alternatives as part of an online survey.

A number of behavioural theories, such as the endowment effect, the status quo bias and consistency theory, show that once a person "owns" something, they value it more and are less likely to give it up – at least in the short term. This is particularly the case if they have put mental, physical or social effort into their decision." [17]

The research referred to by Dr Harrison was commissioned by Consumer Action and the full results will be outlined in a report in the near future. In the meantime Dr Harrison has provided the headline results of his research, which was designed to test consumer responses when presented with cooling off and opt-in alternatives. In the experiment, 759 online participants were asked to select one of two reward options:

- Receive $2 immediately; or
- Receive $1 immediately plus a chance to win $25.

The 240 participants who chose the latter option were then randomly allocated to one of four study conditions, of 60 participants each.

The groups were:

- Control
- Cooling off
- Double opt-in, provider contacts
- Double opt-in, consumer contacts.

In the control group, participants automatically received their chosen reward ($1 plus a chance to win $25). In the cooling off group, participants were given a 48 hour window to

[17] Harrison, Paul. *Cooling off periods for customers don't work: study,* The Conversation, November 28 2016. Available at: https://theconversation.com/cooling-off-periods-for-consumers-dont-work-study-69473. See also http://consumeraction.org.au/cooling-off-doesnt-work-new-research/.

revert to the alternative reward choice ($2) if they chose to do so. In the double opt-in, provider contacts group participants were contacted within 48 hours via email and asked to confirm their choice. If they did so, they received their initial chosen reward. If they didn't confirm or respond, then they received the alternative reward. The final group required participants to proactively opt-in within 48 hours to confirm their choice by email. Those who did not respond or confirm then received the $2 reward.

The findings were statistically significant and showed that:

- 100 per cent of participants who were offered a 'cool-off' option (i.e. they were required to make active contact to change their mind) did not change their initial decision.
- 100 per cent of participants who were offered the 'opt-in' option (i.e. they were required to make active contact to confirm their decision) also did not change their initial decision, even though doing so would have provided them with the same choice as the 'cooling off' group;
- 70 per cent of participants who were contacted and asked to 'opt in' to receive the same choice as the cooling-off group did not change from their initial choice.

Dr Harrison concludes that the findings are explained by the behavioural concept of consumer "inertia". Those who make a decision are very unlikely to use their cooling off rights to change their mind. Similarly, people are highly unlikely to confirm an initial decision if they are required to opt-in to it at a later time. Even if they are prompted to opt-in by the provider, the research shows that most people (in the study, 70%) stick with an initial decision—although this was the only category in which active confirmation behaviour was observed.

In short, the study overwhelmingly found that passivity is the dominant behavioural trait when faced with either a cooling off or opt-in option—and this has direct relevance to the options presented in the Interim Report."

…

"The opt-in model has the benefit of "re-setting" the power dynamic between the trader and the consumer, and allowing the consumer to make a considered choice of their own volition—away from the high pressure sales tactics that are so often employed in an unsolicited sales practice.

By temporally displacing the consumer's decision from the sales interaction, an opt-in model can ensure that consumers who choose to proceed with a purchase are doing so because they genuinely want or need the good or service—and are not simply doing so to please a salesperson, or because they wish to be left alone. When considering the opt-in model, it is important that CAANZ consider that unsolicited sales staff are often coached with scripted sales pitches designed to manipulate consumer emotions, and that they can be highly practised—and often driven to make sales by commission based payment structures.[18] Consumers, on the other hand, are caught off-guard and not prepared for a

[18] While not concerned with unsolicited sales, Dr Paul Harrison's 2010 report, *Shutting the Gates: An analysis of the psychology of in-home sales of educational software*, outlines the ways in which such sales practices are taught, how

> sales interaction. The cognitive resources required to resist insistent sales practices while at the same time not being rude or otherwise causing offence can be considerable, and (as discussed earlier in this submission), the pressures of low-income living are in themselves sufficient to deplete those cognitive resources."

Regulating to require an opt-in model for the sale of CCI and other add-on products would prevent the occurrence of consumers who purchase these products without understanding what they really are, or that they will be of no benefit to them. It would also remove the opportunity for sales staff to "sell" the product without the consumer being aware that they have bought it. Given the systemically poor consumer outcomes associated with CCI and other add-on products, an opt-in model is both justified and necessary, and would be a welcome addition to the regulatory framework.

Consumer Action is also strongly supportive of the product-safety approach being proposed by the Government, discussed in the Proposals Paper on new Design and Distribution Obligations and Product Intervention Power.[19] However, we submit that prohibition on unsolicited offers of credit and opt-in arrangements for cross-sales is likely to be more effective consumer protections.

Q.22 – Are further changes required to the regulatory environment to reduce the information gap between a seller and the retail purchaser?

While improved disclosure is always welcome, Consumer Action is aware that disclosure in and of itself is a very weak form of consumer protection—and should not be heavily relied upon. Improved disclosure is certainly not enough to overcome the dynamics of high-pressure selling, which arise in any strongly sales based culture.

Research which shows that disclosing commissions can have the behavioural impact of making consumers more trusting of a trader, and less wary—leading to the seemingly perverse outcome of increasing the consumer risk the more disclosure is provided. For example, a rewrite of mortgage disclosure information to disclose broker commissions actually increased trust in the broker when it should have led customers to be more critical about the advice.[20] This is not dissimilar to the false security that cooling-off periods can provide, where they become an advantage to salespeople who reassure consumers that they 'can always change their mind' despite knowing that, in practice, very few consumers ever do.

We also note that improved disclosure is likely to benefit different consumers to differing degrees, and is likely to benefit vulnerable and low-income consumers (i.e. those who most need protection) least of all. Significant recent research has shown that poverty has a material negative impact on cognitive resources, which are needed to realise the potential benefit of improved disclosure.

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sales scripts are frequently designed to emotionally manipulate the consumer and how difficult it can be for consumers to extract themselves form such interactions once they have engaged with a salesperson. While the report concerns pre-arranged in-home sales, the sales tactics used are the same in unsolicited sales – particularly door to door.

[19] Treasury, *Proposals Paper: Design and Distribution Obligations and Product Intervention Power*, December 2017, available at: http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2016/Design-and-distribution-obligations-and-product-intervention-power.

[20] James Lacko and Janis Pappalardo, 2004, The effect of mortgage broker compensation disclosures on consumers and competition: A controlled experiment, *Federal Trade Commission Bureau of Economics Staff Report* referenced in Financial Services Authority, 2008, Financial Capability: A Behavioural Economics Perspective.

Again, Consumer Action drew on this research in our recent submission to the CAANZ ACL Interim Report, and we reproduce part of that submission below to inform our discussion here:

> "In particular, behavioural research around the impact of poverty on cognitive capacity should inform the reform process to ensure the ACL adequately protects vulnerable and disadvantaged consumers.
>
> This research is widely known. For example, high profile multi-institutional research[21], published in *Science* on August 30 2013 hypothesised that:
>
> "*The poor must manage sporadic income, juggle expenses, and make difficult trade-offs. Even when not actually making a financial decision, these preoccupations can be present and distracting. The human cognitive system has limited capacity. Preoccupations with pressing budgetary concerns leave fewer cognitive resources available to guide choice and action.*" [22]
>
> Through their laboratory studies, the researchers determined that this hypothesis was correct:
>
> *"The data reported here suggest a different perspective on poverty: Being poor means coping not just with a shortfall of money, but also with a concurrent shortfall of cognitive resources. The poor, in this view, are less capable not because of inherent traits, but because the very context of poverty imposes load and impedes cognitive capacity. The findings, in other words, are not about poor people, but people who find themselves poor.*
>
> *How large are these effects? Sleep researchers have examined the cognitive impact (on Raven's) of losing a full night of sleep through experimental manipulations. In standard deviation terms, the laboratory study findings are of the same size, and the field findings are three quarters that size. Put simply, evoking financial concerns has a cognitive impact comparable with losing a full night of sleep. In addition, similar effect sizes have been observed in the performance on Raven's matrices of chronic alcoholics versus normal adults and of 60-versus 45-year-olds. By way of calibration, according to a common approximation used by intelligence researchers, with a mean of 100 and a standard deviation of 15 the effects we observed correspond to ~13 IQ points. These sizable magnitudes suggest the cognitive impact of poverty could have large real consequences.*
>
> *This perspective has important policy implications.*"[23]

The major policy implication for current purposes is that improved disclosure will not assist vulnerable consumers in avoiding the poor outcomes that a strongly sales-focused banking culture tends to generate.

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[21] Authors of the study were from the University of Warwick, Harvard University, Princeton University and the University of British Columbia respectively.

[22] Mani, Anandi; Mullainathan, Sendhil; Shafir, Eldar; and Zhao, Jiyaing, *Poverty Impedes Cognitive Function*, Science, Vol 341, 30 August 2013, p. 976.

[23] Mani, Anandi; Mullainathan, Sendhil; Shafir, Eldar; and Zhao, Jiyaing, *Poverty Impedes Cognitive Function*, Science, Vol 341, 30 August 2013, p. 980.

Q.23 – Is the legal distinction between 'provision of information', 'general advice' and 'personal advice' useful or effective in the retail banking context?

No, it is neither useful nor effective. The distinction is hazy because it is often unclear to the consumer whether they are being provided with information, or being given advice (be it general or personal). Further, these categories create a culture of compliance within banks which does not enhance effective communication between banks and customers.

In keeping with the goal of shifting banking away from sales culture, and towards a service-based culture, it would be simpler to require that the trader should always act in customer's best interests, rather than legislating specifically for the more narrow requirement that this only be legally required when giving 'personal advice'.

Q.24 – Having regard also to the mitigation strategies available to banks, is there excessive risk of mis-selling attached to the practices outlined in Chapters 3 and 4 regarding incentives to retail banking staff and third parties on behalf of banks?

Yes, because mitigation strategies can never be fully effective. As long as sales staff are driven by sales-based incentives the risk of excessive consumer harm will persist. Rather than attempting to blunt harm arising from misconceived behavioural drivers, it would be more effective to remove those drivers—and align staff incentives with the interests of consumers instead, thereby promoting a service culture.

6.4 – What is the difference between a 'sales' and a 'service' culture?

Q. 25 – What constitutes a 'service' culture in the retail banking sector?

At a September 2016 hearing of the Federal Parliamentary Standing Committee for Economics Dr Philip Lowe, Governor of the Reserve Bank, was asked whether he believed there was a problem with the culture of banking in Australia. He gave the following response:

> *"I can't help but agree with you that there have been too many examples of poor outcomes, particularly in the wealth management and insurance industries, and that's disappointing to us all" …*
>
> *"I think it comes down to incentives within the organisations and that's largely remuneration structures. And that's a responsibility of management and probably [the banking regulator, the Australian Prudential Regulation Authority] can play some constructive role in encouraging remuneration structures that create the right incentives within organisations,"...*
>
> *"If there was one thing that I could focus on, [and] it's not my responsibility, it's not the Reserve Bank's responsibility, is making sure the remuneration structures within financial institutions promote behaviour that benefits not just an institution, but its client."*
>
> *"What I would like to see is really banking return to be seen as a strong service profession. I don't know how far away from that we are."*

> *"Banking has historically been a profession, a profession of stewardship, custodians, service, of advisory ... It's not a marketing or product distribution business. Banking is a profession."*[24]

In his statements, Dr Lowe encapsulates the extent to which remuneration incentives act to create a culture, and how the culture of retail banking in Australia has become so strongly sales focused that it generates significant consumer harm. As Dr Lowe states, a service culture prioritises the benefit of the client—not just the institution making the sale, and does not at the expense of the client's financial wellbeing. A strongly service focused industry relies on a mutually beneficial relationship with its consumer base. It does not see each client as a profit opportunity to be maximised, but as an individual to be served by providing the most appropriate advice and making the most appropriate sales, *for the best interests of the client*. While this is hardly a revolutionary concept, it is disheartening to see the extent to which it is has been supplanted by an aggressive sales mentality in retail banking. This mentality, in turn, is reinforced (and super-charged) by commission and product sales based incentives designed to push staff to make maximum sales. As identified by the FSU survey referred to in question 3, this generates significant anxiety in the banking workforce. Even staff who may naturally tilt towards a service mentality feel compelled to engage in hard-selling practices—for the sake of their own job security.

A true service culture relies on a workforce motivated by the intrinsic driver of wanting to provide their clients with the best possible service over the course of a long term customer relationship, and taking a degree of professional pride in doing so. Financial services generally involve long term products and a positive service culture should prioritise the client-trader relationship, rather than churn and sales. A sales culture, by contrast, relies on the more simplistic and extrinsic driver of immediate financial reward, and may leverage anxiety related to job security in order to motivate staff.

Metrics can be developed to identify a good service cultures, or one that focuses on customer outcomes. We would suggest the following metrics:

- Percentage and distribution of customers not getting a 'bad deal'. This would aim to ensure that people are not sold inappropriate products, and that they are not paying too much due to ill-informed choices or because they are sticking with defaults. It might involve sampling for each bank's customer base, or looking at return rates for particular product lines to ensure there is competitive pressure.
- Customer comprehension. This measure would investigate whether customers understand key pieces of product information, and are able to make choices confidently and with ease (whether through advisers or not).
- Customer satisfaction when things go wrong. This might consider the number of customers who have made a complaint, and the number who are satisfied following a complaint resolution. This metric is much more focused on 'service' rather than 'sales'.

We would warn against simplistic measures of customer satisfaction such as 'net promoter score'. This measure appears really designed to ascertain customer loyalty rather than customer outcomes, and there is already ample evidence that customers are 'sticky' in the finance sector—

[24] Wilkins, Georgia. *New RBA chief Philip Lowe hits out at incentives culture at Australia's banks*, The Sydney Morning Herald, 23 September 2016. Available at: http://www.smh.com.au/business/banking-and-finance/new-rba-chief-philip-lowe-hits-out-at-incentives-culture-at-australias-banks-20160922-grlwxa.html

they stay with their providers for behavioural reasons, and not necessarily for reasons of good customer service or experience. The other issue with 'net promoter score' is that it is a stated-preference measure. Methods of discovering customers' revealed preferences (what they really do, not what they say they will do) are likely to be more insightful. The suggested metrics above are likely to reveal customer outcomes more clearly.

Q.26 – What approaches to performance management and rewards and incentives are most conducive to achieving it?

Performance management and rewards and incentives should be more focused on the metrics described above.

6.5 – What role may the remuneration arrangements applicable to very senior managers play in conditioning the behaviour of frontline staff?

Q. 27 – What weight should be attached to sales targets in the assessment of the performance of a bank's most senior executives?

Any weight attached to sales targets in the assessment of the performance of senior executives will inevitably be referred down through the managerial lines of the organisation, and result in a sales based culture. In the case of senior executives, such targets also have the powerful cultural effect of signalling what is valued by the organisation, and will be communicated as top corporate priorities. This has the effect of establishing the primacy of an extrinsic reward system at the expense of emphasising the more intrinsic rewards of a genuine service culture. If the banking sector is to achieve a true cultural shift, then sales targets should not be used as an assessment tool to gauge the performance of senior executives.

Q.28 – What are the key principles that banks should apply in designing the incentives that apply to their most senior executives?

In very simple terms, the performance of senior executives should be based on how well the corporate aims of the organisation are met. In a shift towards a service culture in banking, this would mean devising mechanisms to gauge how well the bank is serving its customer base—and how much its clients are benefiting from the advice and service provided by banking staff. We again point to the metrics suggested in response to question 25.

It may also be possible to devise negative incentives. For example, evidence of significant consumer harm caused by the actions of the bank could result in a loss of financial reward or position for senior executives, which should service to promote high standards of client service throughout the organisation. In a genuine service culture, the bank would attract senior management who are driven by a strong intrinsic desire to ensure that the bank is serving the needs of its clients, not causing consumer harm, and take a professional pride in maintaining high standards. While this may result in a more conservative banking sector, the benefits in the terms of stability and consumer well-being would be significant.

It should also be noted that the remuneration of senior banking executives, both in terms of scale and the way in which remuneration is devised, sends a powerful cultural message regarding what is valued by society, and what fundamentally drives the banks. While bank advertising may

emphasise the importance of human outcomes and that life is about "more than money", this message is fatally undercut by conversations around executive wages, and growing income inequality[25] which frequently feature their own leadership.[26] The cultural place of banks is partly set by the way in which they remunerate their leaders, which sends a powerful message to the broader community about what the banks stand for. While this issue is part of a broader conversation, it is worth raising in the context of this review. It may also be worth routinely reporting the disparity between executive pay and the pay of average workers within an organisation, as a means of placing some constraint on escalating executive remuneration.[27] Over the longer term, this could help to address rising wage inequality—which currently sits at record levels.

6.6 – Issues specific to remuneration of third parties

Q.29 – Is there sufficient evidence to support a case for banks to discontinue the practice of paying volume-based commissions to third parties in respect of new and increased mortgages?

We are conscious that ASIC are currently undertaking an extensive inquiry into remuneration structures in the mortgage broking sector, and believe this will provide a strong evidence base for reform. We understand that this review will consider the outcomes of the ASIC inquiry.

However, the evidence presented in the Issues Paper that 'suggested that third party mortgages are likely to be larger, paid off more slowly, and more likely to be interest only loans'. This is concerning and appears indicative of poor customer outcomes.

Q.30 – If a move away from commissions cannot be justified, should banks desist from paying on the basis of accelerator-like arrangements (including bonus commissions)?

Yes. For the reasons described in our response to question 6, accelerator payments of all forms should be discontinued. They provide a dangerous incentive to sales staff to intensify selling pressure, the more sales they make. This only serves to magnify the potential conflict between their interests and those of the client—increasing the risk of consumer harm.

Q.31 – Is there evidence that the contractually based risk mitigation devices available to banks in respect of third parties are deficient in avoiding poor customer outcomes?

Again, we reserve further comment until after ASIC releases their inquiry report into mortgage broking remuneration. This will provide a stronger evidence base from which to provide comment. We do note, however, that risk mitigation measures are unlikely to be fully effective if the incentives used by the industry encourage mis-selling, and propel an irresponsible drive for excessive sales

[25] Patty, Anna. *Divide between rich and poor in Australia is growing*, The Sydney Morning Herald, February 6 2017, Available at: http://www.smh.com.au/business/workplace-relations/divide-between-rich-and-poor-in-australia-is-growing-20170203-gu5bkw.html.

[26] Jericho, Greg. *CEOs bank on bonuses as average Australian worker left to flounder*, The Guardian, 2 October 2016. Available at: https://www.theguardian.com/business/grogonomics/2016/oct/02/ceos-bank-on-bonuses-as-average-australian-worker-left-to-flounder.

[27] Walker, Julie. CEO pay: Australia should compare with average worker pay like UK and US, ABC News, 28 September 2016. Available at:http://www.abc.net.au/news/2016-09-28/australia-should-compare-ceo-and-average-worker-pay-like-the-us/7884240.

volume. As a general principle, it is more effective to remove incentives which cause harm than to attempt to contain that harm with contractually based risk mitigation measures.

6.7 – What is a poor customer outcome (and what is the link to agent remuneration)?

Q.32 – What do you think of the adequacy of adopting the FSA's approach for the purpose of defining a poor customer outcome?

The FSA definition of mis-selling is inadequate for the purposes of identifying what constitutes a poor customer outcome. The FSA conception neglects to address whether the consumer derives a benefit or value for the product or products purchased, and does not address the need for after-sales service or the long term nature of financial services—which require the maintenance of an ongoing client-trader relationship. .

If it is implied that a "suitable" product is one which operates to the consumer's benefit, then the FSA notion of mis-selling is slightly more adequate, but this would be a significant (and arguable) implication, so should be made more explicit. Without this element, the FSA conception may apply to product sales which actually cause the consumer harm—which is clearly perverse.

To avoid this, any product sold to a consumer which does not benefit or value to them should be considered mis-sold, and regarded as a poor customer outcome. In addition, the need for strong after-sales service and a long term, ongoing relationship of service should be written into any conception of a positive consumer outcome. Any outcome that is less than positive should, by default, be regarded as a poor consumer outcome.

Q.33 – Is there evidence that the risks of mis-selling are currently significant, not sufficiently mitigated by existing strategies, and systemically important?

Yes. The Comminsure scandal of early 2016[28], the extensive mis-selling of CCI products (see our response to questions 2 and 21), the 2015 Senate Inquiry into credit card interest rates and the subsequent reforms that have been proposed in response[29], the current ASIC inquiry into mortgage broker remuneration, the recent comments by the Governor of the Reserve Bank (see our response to question 25 above), and the fact that Australian households are the most indebted in the world[30] (with bankruptcy rates the strongest they've been since the GFC[31]) are all strong indications that consumers are consistently being mis-sold financial products—and this is causing systemic harm. As the major financial service providers in our economy, these issues lie at the feet of the banks.

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[28] *Comminsure Exposed*, Sydney Morning Herald. Available at: http://www.smh.com.au/interactive/2016/comminsure-exposed/heart-attack/.

[29] Australian Federal Treasury, *Credit cards: improving consumer outcomes and enhancing competition,* May 2016. Available at: http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2016/Credit%20card%20reforms/Key%20Documents/PDF/Credit_card_reforms_CP.ashx.

[30] Creighton, Adam. *Higher Australian household debt mounts to 'unsustainable' levels,* The Australian Business Review, 4 June 2016. Available at: http://www.theaustralian.com.au/business/opinion/adam-creighton/higher-australian-household-debt-mounts-to-unsustainable-levels/news-story/be4ab3a4286cb0e802f2f396e8a126e7.

[31] Taylor, David. *Fastest rates of Australians going broke since the GFC, figures show*. ABC News, 14 April 2016: Available at: http://www.abc.net.au/news/2016-04-14/financial-distress-on-the-rise/7326610.

All of these indications point to a banking culture that is strongly sales driven, where existing risk mitigation strategies have failed to protect consumers. Further, it is likely that mitigation strategies will never be fully sufficient to reign in the excesses of a strongly sales-based banking culture—the profit drive will always threaten to over-ride the drive for regulatory compliance, and has a habit of leading to regulatory arbitrage. As we have stated previously in this submission, rather than devising further mitigation strategies to blunt the natural effect of a sales culture, it would be far preferable to re-set the drivers motivating staff—and tilt the industry towards a service culture.

While this is a hugely ambitious undertaking, it should form the fundamental recommendation of this review.

Please contact Zac Gillam, Senior Policy Officer on 03 9670 5088 or at zac@consumeraction.org.au if you have any questions about this submission.

Yours sincerely

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