Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

SUBMISSIONS OF THE FINANCE SECTOR UNION IN RELATION TO THE LOANS TO SMALL AND MEDIUM ENTERPRISES MODULE OF CASE STUDIES

Contents

A Outline of submissions

1. These submissions deal with the third module of case studies.
2. Issues around culture, and the community's loss of trust in the banks have been central to many of the case studies.
3. This breakdown is primarily a consequence of the promotion of an aggressive sales and short term profit culture within financial institutions, at the expense of the ethical and long term servicing of customers.
4. This module, like the first two modules of the Royal Commission, has highlighted the need for the Commission to recommend:
   (a) programs and behaviours that require fundamental cultural change within Australian financial institutions;
   (b) measures to avoid aggressive sales culture and practices;
   (c) reduced reliance on models of self-regulation, particularly in connection with standards, dispute resolution and remediation; and
   (d) the development of more a streamlined, accessible and comprehensible system of regulation.

B Being a business banker

5. Relatively little attention was paid during the hearings of the third module to the role of business bankers within the structures of financial institutions.
6. For many finance sector workers, becoming a business banker is a significant promotion achieved after years of hard work and experience. For client-facing employees, business banking is the culmination of an employment path that stretches from teller, to personal banking specialist focusing on personal loans, to a home loan specialist to a business banker.
7. For some business bankers, the role is a stepping stone towards becoming a financial adviser, where they may continue to be client facing, but with a potential to have greater involvement in decisions, and greater remuneration. A business banker role may also be a pathway towards management roles.

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8. To greater and lesser degrees within different banks, business bankers operate outside the banks' retail network. In each bank, some banking to small and medium enterprises [SMEs] is done by the retail branches while the balance is done within district commercial/business banking centres. Business bankers operating in business banking centres will deal with customers who range from SME's though to larger enterprises where transactions may be in excess of $100 million.

9. Business bankers have generally developed high levels of skill and expertise. Business banking work can be complex and involve consideration of regulatory and governance issues facing customers. Business bankers maintain, and seek to further develop, a high level of professionalisation.

10. It is revealing that none of the case studies in this module have involved substantial allegations that business bankers acted fraudulently, corruptly, or so as to enrich themselves. Rather, the issues that were examined were cultural and systemic – the extent to which banks undertake assessments of viability of small business; the disconnect between the banks' public statements and private conduct; the nature of the obligations owed to guarantors; and the circumstances in which banks should call in credit facilities.

C Responsible lending to small businesses

C-1 [What are the] likely consequences of owner manager branches of Bank of Queensland being recipients of trailing or other commissions particularly having regard to the findings of the Sedgwick report into retail banking remuneration?[1]

Key Points

- Franchise models, such as that operated by Bank of Queensland [BOQ], are problematic due to:
  - remuneration structures based on sales volume and quantum;
  - limited franchisor oversight or capacity to influence culture within the franchisees; and
  - employment practices, including KPIs, bonuses, pay models and training being a matter for the franchisee and out of the control of the franchisor.
- The Banking Code of Practice should address specific issues relating to franchise arrangements.

11. The Union submits that the franchise model operated by BOQ, in which revenue to the franchisee is based on a system of commissions, is problematic.

12. The model shares a number of characteristics with broker and introducer arrangements. Reliance on commissions (both up front and trailing) means the primary incentive for the franchisee is sales which creates a form of conflicted remuneration. Further, the fact that BOQ has no meaningful control of the recruitment, terms and conditions of employees, training provided to employees and the workplace culture creates significant risks of poor customer outcomes.

13. Mr Snell, the General Manager Performance, Product and Governance within the BOQ provided the Commission two statements that were tendered,[2] and was cross-examined by Counsel Assisting.[3]

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1 T3032.42.
2 Exhibits #3.34, #3.42.
3 T2303.20.

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14. Mr Snell's evidence focused primarily on the structure in place at the time the BOQ loaned money to Ms Riches in 2011. There do not appear to have been significant changes to the structure since then.[4]

15. In his evidence Mr Snell described the franchise structure of Owner Managed Branches, or OMBs noting:

    (a) Owner Managers [OMs] pay to BOQ an initial franchise fee and ongoing fees;

    (b) OMs are also responsible for the other running costs of the agencies, including rent, fit out, etc; and

    (c) OM's remuneration is commission based.

16. Aside from minimum expectations (such as paying award rates of pay), BOQ has a very limited role in the terms, conditions and remuneration offered employees in OMBs. In his statement Mr Snell says:

> *"…the extent to which these commissions [the payments made to OMs] in accordance with KPIs or other performance targets was at the discretion of the OM was not a matter over which the BOQ Group had control or visibility."*[5]

17. The BOQ is not unique in employing a franchise model. Other banks, particularly Bendigo Bank, operate on a similar basis. The issue of remuneration structures to OMs and then to employees within OMBs goes beyond issues around loans to small enterprises, or business banking. It remains a largely unaddressed example of the type of conduct that Mr Sedgwick sought to deal with in his review.

Issue of payments to OMs

18. There are two distinct pools of payments to BOQ OMs: commission payments, and a bonus scheme known as Fit 4 Biz.

19. The commission payments are the dominant form of payment to OMs. In connection with commercial lending, payments are broadly set at an upfront payment of .5% of the loan value, plus 50% of the application fee up to a maximum of $35,000. It is assumed that comparable arrangements exist for retail lending and other identified activities.

20. Other than at the extreme margins, issues of conduct, compliance, and ethical behaviour are not relevant to the payment of the commissions. BOQ conducts regular audits. BOQ may withhold commission payments in the event the OM is in material breach of the OMB agreement. Given these payments are not supplemental to any base payment, but are required to meet the running costs of the OMB, it seems unlikely that BOQ would significantly limit such payments. Rather, BOQ would be faced with the binary options of continuing to pay commissions or terminating the franchise agreement as occurred in the Pirie Street Branch.

21. The second element of remuneration to OMs is through an incentive scheme known as Fit 4 Biz. Fit 4 Biz is a branch reward scheme that provides additional payments to OMBs (and corporate branches) by reference to their achievement against identified goals. Under the Fit 4 Biz scheme Branches are awarded points by reference to targets contained in a "balanced scorecard".[6]

22. The Union submits that the structure of the Fit 4 Biz scheme contributes to poor customer outcomes - what Mr Snell described as a "balanced scorecard" is overwhelmingly sales and revenue based. 83% of the targets relate to lending, deposits and cross selling. The other 17%, referred to as compliance, is also at least partially revenue based - matters such as meeting targets

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4 T2347.01 There have been changes to the bonus/incentive plan, but this is marginal.

5 Ex #3.34, Statement of Snell, para 104.

6 Ex #3.34, Statement of Snell, para 123.

around arrears and review benchmarks are identified. The Fit 4 Biz does not meet the expectation of a balance scorecard envisioned by Mr Sedgwick in which sales measures "(if included at all) will not be a dominant component".[7] The scheme also includes a capacity to deduct points in the event of "game changer" behaviour such a breach notices being issued.

23. More significantly, the awards available from Fit 4 Biz are modest (the maximum is $5,000 per quarter). Fit 4 Biz is of marginal importance in driving culture and behaviours in OMBs. For OMBs, all revenue is contingent upon sales. It is up to the OM to determine the extent to which the Fit 4 Biz award is distributed to employees.

24. Aside from the risk of having the franchise agreement terminated, the only incentive is around increased sales. As they are not the lender, OMs are not subject to licencing or obligations under the National Consumer Credit Code. OMs do not suffer the adverse effects of poor loans being issued. This creates a moral hazard.

25. The drivers on OM behaviour are the same as the drivers on the behaviour of mortgage brokers. However, where there is visible separation between brokers and the banks, OMBs appear as part of BOQ – they operate from BOQ branded offices, staff wear BOQ branded uniforms and printed material is issued by BOQ. Unless unusually vigilant, customers would likely be unaware that they are dealing with an OMB rather than a corporate branch.

Issue of payments to OMB employees

26. In his evidence, Mr Snell repeatedly identified that BOQ had very limited "control or visibility" on the terms and conditions of employee remuneration. Aside from marginal issues there do not seem to be any incentives in the structure to:

(a) avoid aggressive sales focus within the branches;

(b) train staff on their ethical and professional obligations; and

(c) recruit and remunerate staff on the basis of compliance and ethical behaviours.

27. In his report, Mr Sedgwick included a recommendation that dealt with franchises. Recommendation 21 provided:

> *Banks that provide products or services through Franchisees examine their governance and, as appropriate, remuneration arrangements and seek to make changes that are consistent with the recommendations of this Review.*

28. The Union notes that Mr Sedgwick's review was limited to retail banking, and did not extend to commercial or business banking branches and entities. Its analysis of lending to SME was accordingly limited. However, on the basis of Mr Snell's evidence, OMBs seem to all meet the definitions of retail banking.

29. It does not appear that BOQ has done anything material to address this recommendation from Sedgwick.

30. The BOQ is a signatory to the Banking Code of Practice. The Code includes obligations in respect of staff and representatives. It is unclear how BOQ meets this obligation in relation to OMB employees.

31. More generally, for the reasons set out in response to Question H-17, and at Part I below, the Union submits that the Royal Commission consider recommending that:

(a) the provisions of the Banking Code of Practice should be developed by the regulator, and issued in legally binding form;

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[7] Stephen Sedgwick, "Retail Banking Remuneration Review – Report" 19 April 2017, Executive Summary page ii.

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(b) the Banking Code of Practice should address and seek to minimise and eliminate where possible conflicted remuneration. This should be applicable to OMs, the employees of OMBs as well as direct employees (including senior managers and executives) of financial institutions.

32. More generally, the Union submits that provisions to avoid conflicted remuneration should be incorporated within a Financial Services Code.

C-2 How much responsibility does the borrower and lender bear in assessing the cash flow forecasts and other factors when deciding whether to enter into the loan contract?[8]

Key Points

- ❖ Financial institutions operate in a highly regulated environment with a range of legal obligations.
- ❖ Practical changes in banking operations like the centralisation and automation of banking functions make it harder for banks to meet their legal obligations, including properly assessing the potential viability of a business borrower.
- ❖ Employment practices such as sales targets and conflicted remuneration contribute significantly to the issues identified in the case studies.
- ❖ Any potential recommendations should focus on supporting and improving the professionalisation of people who work in business banking.

33. This balance of responsibility, expressed in various ways, has been central to this module. At its core, it is an assessment of where banks should sit on a spectrum which extends from banks assessing the viability and future profitability of business borrowers prior to lending, to simply ensuring that any loan is offset by adequate security.

34. The Union identifies that financial intuitions already have significant obligations in terms of loan assessment, however, there is a lack clarity in the practical implementation of that process, and a disconnect between bank and consumer understanding. The Union supports increased professionalisation of business bankers, and with that, a clear articulation of responsibility, and appropriate training to ensure that the business bankers can perform their role.

35. The Union makes the following submissions in relation to the issue.

Current obligations

36. There already exist a number of obligations on banks to assess the viability of the business. These obligations include:[9]

(a) The obligation under the ASIC Act to not engage in misleading conduct;

(b) The obligation under the ASIC Act to not engage in unconscionable conduct;

(c) The implied warranty that financial services be rendered with due care and skill;

(d) The implied warranty that the services will be fit for purpose; and

(e) The protections against unfair contracts.

37. The obligations also include (for those lenders subject to the Banking Code of Practice) an obligation under the ABA Code of Practice to "*exercise the care and skill of a diligent and*

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8 T3034.19.

9 Jeannie Paterson, Nicola Howell, Andrew Goodwin, *Credit for Small Business – an Overview of Australian Law Regulating Small Business Loans: Background Paper 10*, 7 May 2018.

prudent banker in selecting and applying credit assessment methods and in forming an opinion about the customer's ability to repay before giving or increasing such a facility".[10]

38. The Union submits that given these obligations, the provision of credit chiefly or solely by reference to the security underpinning it and without any assessment of the capacity to repay, is not lawfully available.

The effect of centralisation and automation

39. The Union notes the submissions of the South Australian Business Commissioner referred to by Counsel Assisting in his opening:

> *An associated issue that was raised by a number of individuals and entities was the management of businesses in difficulties by individuals located in bank's central offices who had limited knowledge of the individual business or its circumstances. The South Australian Business Commissioner noted that local account management is a thing of the past, and there is no local knowledge or understanding of the business and its needs.*[11]

40. While the Union does not agree that "*local account management is a thing of the past*", it is true that there has been a centralisation of many bank functions (to greater and lesser extents in different entities). That increased distance and separation between the banker and the customer comes at a cost to the relationship. Similarly, there has also been an increased reliance on automated assessment procedures which exacerbate this issue.

41. These changes have several relevant effects:

(a) Part of the local relationship between a banker and consumer involve the bank having local knowledge, experience and insight. In the context of small business, such knowledge and insight can be invaluable. Discussions about why a previous iteration of a café failed, or which locations are best for a business require such local knowledge. Knowledge of this kind cannot be centralised.

(b) The increased reliance on automated processes leads to binary, check a box type processes. For example, there are conversations about *whether* external advice has been obtained, rather than the subject, content, or source of that advice.[12] The Union supports increasing professionalisation of the role of bankers. Automation encourages the use of scripts and rule driven systems, which in turn encourages bankers to assume that decisions will be assessed by automated processes.

(c) With a centralised model, consumers are more likely to shop around for loans. It was notable that in a number of the case studies the small business approached one lender, and when credit was refused, approached a second.

Professionalisation of Banking

42. The Union and its members seek to promote the professionalisation of banking. Business bankers are skilled workers who develop constructive and ongoing relationships with their customers. For many bank employees, SME business banking is a stepping point in a career that leads to a financial adviser role, or providing banking services to larger enterprises.

43. The Union believes that business bankers (and other bank employees) have a valuable and important contribution to make to a customer's business. That contribution ought to be amplified and developed by providing additional training to employees, by valuing their experience and

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10 ABA.001.007.1128 EXHIBIT #3.144.2 - "Exhibit AB-1-2 – ABA Existing Code, para 27.
11 T2002.23.
12 T2058.34.

knowledge, and by ensuring that they operate in an ethical and prudential culture rather than one based on sales and short-term profitability.

44. The Union submits that reducing the role of these employees to simply checking that forms have been filled out and that there is sufficient security to meet the loan should the business fail, means that experience that may assist the development of these businesses is wasted.

45. Central to increased professionalisation of banking is a recognition that conduct should be ethical.

46. The Union submits that a solution to these issues is to address and resolve the disconnect between the ostensible promise made by banks that they sit on one end of the spectrum ("*they operate in partnership with small business*"), whereas in reality their internal functioning prioritises the interests of the bank over the customer.

47. Business bank employees have direct experience of the disconnection between the bank promises of "acting in partnership" with customers and the reality of a limited focus on business viability and greater focus on the adequacy of the security. Business bankers are required to request and obtain various forecasts and business plans. However, in most instances the assessment of such documents is entirely superficial. So long as the documents, on their face, show sufficient profitability then no further assessment is made. This can be contrasted with the real and forensic assessment made of any security to ensure that it would meet the bank's exposure if needed.

48. The request for the provision of documents, without intending to undertake a full assessment of them, creates an illusion that the bank is doing something that it is not doing. It is crucial that the bank, in lending money, does not engender a confidence in the viability of the enterprise that is not warranted.

49. The crucial issue is that the potential customer should properly understand the extent to which the bank has assessed the viability of the business. If the bank has (to the extent it could within its other obligations) made no attempt to determine if the forecasts provided are reasonable, likely, or possible, then the customer should be made aware of that fact.

50. The current model tends to exaggerate the extent to which a bank has assessed the business, or endorsed the financial forecasts. This is corrosive to the professional standing and role of the bank employees, and the trust that customers hold in the bank. This creates false confidence for the borrowers that their business plan has been approved by a large bank and is therefore viable. It also creates a moral and ethical issue for business bankers who are aware the borrower may place credence in the implicit endorsement by the bank in circumstances where they are also aware that there was negligible assessment of the business in the loan assessment process.

Conflicted Remuneration of Business Bankers

51. Small business lending was only partially within the scope of the Sedgwick Review. It was included to the extent that business banking was done as part of retail banking, as distinct from business or commercial banking sections of financial institutions. In any event, the Review did not address the different and distinct issues that arise around small business lending at all in its Report.

52. Issues around sales and revenue targets and conflicted remuneration must be central to the response of financial institutions. Staff reliance on contingent remuneration in the area of business banking remains significant.

53. The potential effect of conflicted remuneration is particularly significant in circumstances where small businesses do not have the protection of the *National Consumer Credit Protection Act*.

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54. Ms Separovich, head of Reward and Performance Management for Consumer Bank, Business Bank and Support Functions at Westpac, gave evidence at the Commission as to the remuneration of business bankers.[13]

55. The Union does not submit that Westpac is an outlier on these issues. On the contrary, the Union believes that Westpac's approach is consistent with that of the other banks. Specific submissions are made in relation to Westpac simply because there is significant evidence in relation to their remuneration processes before the Commission.

56. The Union submits that it was apparent from Ms Separovich's evidence that the issues and concerns raised by Mr Sedgwick have not been embraced or led to material cultural change within Business Banking.[14] Ms Separovich's statement detailed the STI payments available to commercial and business bankers in the period 2012 to 2016. The Union understands that employees could obtain payments of up to 100% of the fixed salary based on KPIs (and potentially more in some circumstances) and that about 90% of the KPIs were attached to sales and revenue matters.[15]

57. Ms Separovich's statement did not detail the current remuneration arrangements, but attached them as an annexure.[16] The method of calculation of the KPI is more difficult to determine than in earlier iterations. However, on scrutiny it appears clear that there remains an overwhelming focus on sales and revenue in connection with the STI payment. 50% is allocated directly on the basis of financial performance. The other 50% is allocated on the basis of "customer metrics". Four customer metrics are identified: "*Customer needs per connection*", "*Net Promoter Score*", "*Growth in payments*" and "*New to bank*". The Net Promoter Score represents 20% of the scorecard, meaning the other three items represent 30% of the scorecard.

58. Each of "*Customer needs per connection*", "*Growth in payments*" and "*New to bank*" are simply sales and revenue KPIs described as customer metrics.

59. *Customer needs per connection* is described as "*Designed to help us uncover customer needs that could be met, with reference to their cash flow, financing, investing or protection needs. Customer Needs per Connection makes it easier for us to focus on whether we have met 12 distinct needs groupings centred around cash flow, financing, investing and protection needs*".

60. *Growth in payments* is described as *"designed to help more Australian business with their payment and transactional banking needs. This metric will continue to support our strategy around having deep and enduring main bank relationships with customers as we know customers consider their primary bank to be those who meet their banking and transactional banking needs"*.

61. The Union submits that *Customer needs per connection* and *Growth in payments* metrics are both simply cross selling targets – cash flow is a reference to EFTPOS and other sales facilities; financing is a reference to credit products, investing is a reference to superannuation and financial advice, and protection is a reference to insurance. *Growth in payments* is a reference to transactional bank accounts.

62. Similarly, the *New to bank* metric is simply a reference to sales to new customers and new accounts.

63. It follows that 80% of the KPIs for business bankers remain sales and revenue based. The other 20% is a customer satisfaction metric known as a "Net Promoted Score" [NPS]. NPSs are created

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13 T2266.17.
14 T2272-2274.
15 T2271.02.
16 Exhibit CS-6 (WBC.107.003.1047).

by customer surveys and create an incentive to ensure the customer gets what they want, rather than what is in their best interests, what is compliant, or what is in line with community standards.

64. There are no KPIs that relate to compliance, to promotion of a good culture, to professional development or to ethical conduct.

65. The Union submits that the case for reform of remuneration structures within business banking is as strong as it was for retail banking. As with retail banking (and also as with changes to remuneration of financial advisers) such an exercise cannot be an excuse to effectively reduce bank employees' pay. The Union's experience is that for a significant proportion of business bankers, STI payments are not bonuses but are relied upon to meet normal household expenditure. However, as has been repeatedly shown in evidence before the Commission, remuneration structures that promote and incentivise sales will lead to instances of sales of products that are not appropriate for the consumer.

66. In support of this, the Union refers to the evidence before the Commission in connection with Ms Messih and the Pie Face franchise.[17] The evidence before the Commission was that the relevant banker had been described in glowing terms in performance assessments at the time of loan being issued.[18] Issues were subsequently raised. Those issues were overwhelmingly compliance based (though there was no suggestion that the banker had taken any steps to enrich themselves).[19] The banker identified (and the bank accepted in its correspondence to him) that his conduct had arisen in part because of culture and training issues. The disciplinary letter[20] to the banker provides:

> *In arriving at the disciplinary outcome above, I have taken into account your responses to these allegations which included:*
>
> *…*
>
> *3. That in the excitement of closing new deals, a culture of sales pressure that you felt weighted heavily at the time, and your relative inexperience and newness to the role at the time contributed to these oversights and the lack of due diligence you showed.*

C-3 What are the outer limits of a bank's duty to act as a prudent and diligent banker in assessing a business loan application? Should the content and outer limit of this duty be codified?[21]

Key Points

- The Union submits that self-regulation is not sufficient to address the systemic and cultural issues in the finance sector. Self-regulation alone will not restore community confidence in the financial services industry.
- Finance sector regulation should be contained in an enforceable Financial Services Code which would incorporate and replace current statutory obligations and substantive obligations in Banking Code of Practice.

67. In the context of small businesses, the obligation to act as a prudent and diligent banker exists only in the Banker's Code of Practice. It is enforceable only under the terms of the Code and in litigation to the extent it can be translated into an obligation implied into the contract, or in misleading or deceptive representation litigation.

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17 T2173.25.
18 T2214.14.
19 Exhibit #3.20, ANZ.800.558.0008.
20 Exhibit #3.20 ANZ.800.558.0014.
21 T3034.23.

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68. The Union supports the development of a single, comprehensive Financial Services Code. This obligation should be contained within the Financial Services Code.

69. The Union refers to its submissions on the Financial Services Code set out at Part I below.

D The taking of a guarantee from a third party for a business loan.

D-4 Is it desirable to take steps to increase the likelihood that a third party guarantor of business borrowings will be properly advised and make an informed decision before entering into a guarantee? And, if so, what might those steps be?[22]

Key Points

- The Union submits that it is appropriate that financial institutions have an obligation to ensure that guarantors genuinely understand the nature and extent of the risk they are accepting. This obligation should be included within a Financial Services Code.
- Aggressive sales culture, with focus on sales KPIs and commission-based remuneration, provides incentives against bankers ensuring guarantors are fully advised.
- Greater professionalisation of business bankers will assist to ensure that guarantors are able to make informed decisions.

70. The Union submits that there is a need to ensure that guarantors, particularly in circumstances where the guarantor is a family member of the borrower, or the guarantee relies on a primary residence, to properly understand the nature and extent of the risks they are accepting.

71. The Union refers to its submissions in response to question C-2 above. Many of the observations and submissions are equally applicable to issues around advice to guarantors.

72. Specifically, the Union notes:

(a) Financial institutions already have significant regulatory obligations. These obligations are set out in a variety of sources and include specific obligations under the Banking Code of Practice. These obligations are appropriate but, for reasons set out below, should not be part of a self-regulatory regime but should be incorporated into a Financial Services Code.

(b) Aggressive sales culture which includes employment practices such as sales targets and conflicted remuneration incentives that prioritise "getting the deal done" provide no incentive for ensuring that the guarantor is properly informed. The possibility that a potential loan should not proceed because the guarantor, having become aware of the nature of the risk and obligation, is no longer willing, is not factored into any of the KPIs, sales targets or remuneration models.

(c) The centralisation and automation of banking functions reduces the likelihood that the banks will ensure that potential guarantors obtain advice which fully explains the nature and extent of their risk and obligation. Rather, this trend increases the possibility of the bank doing no more than checking a box to confirm that the guarantor says that they have received external advice. Such an approach is more about avoiding liability in litigation than properly discharging a duty.

73. To a significant degree, greater professionalisation of business bankers is part of a solution. Skilled bankers who operate in a culture of ethical, prudential service will be far more likely to

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22 T3041.14.

assist and ensure guarantors obtain the necessary advice. This must be supported by culture within financial institutions and appropriate regulation.

D-5 ***What difficulties will be created for banks or borrowers by steps that require more information to be provided to legal or financial advisors of a guarantor before the guarantee is signed?***[23]

74. The Union does not belive it has any useful insight to provide on this issue at this time.

E Consumer Redress Systems

E-6 ***If a business loan is determined to have been affected by maladministration, should the financial services provider be permitted to require the loan to be repaid within a timeframe shorter than the remaining term of the loan in circumstances where the borrower is willing and able to meet the repayment schedule under the loan?***[24]

75. The Union does not belive it has any useful insight to provide on this issue at this time.

E-7 ***Could FOS improve its processes for dealing with loans that are determined to have been affected by maladministration and, if so, how? Should the incoming body, AFCA, adopt a different process?***[25]

76. The Union does not belive it has any useful insight to provide on this issue at this time.

F The Bankwest business lending book

F-8 ***First how, if at all, are banks to deal with circumstances in which, for reasons extraneous to the conduct of the borrower, the bank no longer wishes to fund a particular business or industry. That is, what is the bank to do if, for example, the market has changed such that its security is no longer adequate? What are the obligations, if any, on a bank in those circumstances?***[26]

77. The Union does not belive it has any useful insight to provide on this issue at this time.

F-9 ***Is there any reason why valuations or investigative accountant's reports ought not be provided to customers in circumstances in which the reports have been paid for by the customer and the bank wishes to take reliance, at least in part, on such reports? Is there any reason why such transparency obligations should be limited by the size of the loan or limited to providing only parts of the report***[27]***?***

78. The Union does not belive it has any useful insight to provide on this issue at this time.

F-10 ***Is it appropriate for a bank to take enforcement action when no monetary defaults have occurred and the bank can rely only on non-monetary defaults? Why or why not? Should there be some additional protection for borrowers in these circumstances and ought the bank be obliged to explain such matters?***[28]

79. The Union does not belive it has any useful insight to provide on this issue at this time.

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23 T3041.17.
24 T3043.11
25 T3043.15
26 T3052.40
27 T3053.01
28 T3053.05

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F-11 Is there a disconnection between what the banks are saying in their advertising, their annual reports, their other public documents, and their conduct? If there is a disconnection between them, what, if anything follows from that?[29]

80. The Union submits that there is a disconnect between what banks say in their advertising, annual reports, and public documents, and their conduct.

81. Banks market their business banking products as a holistic business banking service, from writing business plans, through to cashflow, planning and tax. They often speak of "*being in partnership with the customer*".

82. The Union submits that a number of banks seek to develop a perception with customers that they offer some level of commercial advice and support. They may create a perception that they will work in the interests of the customer.

83. From the Union's experience, this language is deeply entrenched in the bank's operations. It extends not just to public statements, but also internal material.

84. The remuneration documents discussed above at paragraphs 54 to 66 are apposite. The banks describe such KPIs as being part of a balanced scorecard. They speak in terms of developing a "deep and enduring …relationship" with the customer.[30]

85. As seen above at paragraphs 54 to 66, the language of the KPIs obscures the reality that the primary metrics are about sales and revenue. Similarly, the evidence before the Commission remains that banks were focused far more on ensuring that there was a guarantee, or adequate security, than performing any function in "partnership" with the customer.

86. The dissonance between the language and outward expression of the banks, and their internal conduct creates a tension.

87. The Union submits that the underlying issue behind this disconnect is a sales and short term profit oriented culture. The Union further submits that regulation may assist the development of such culture, particularly by imposing general obligations on individuals. For reasons discussed at Part I in connection with the Financial Services Code, the Union submits that individuals responsible for the generation of marketing, advertising and public statements of banks should ensure that such material fairly represents the conduct, culture and operation of banks.

G Power and communication

G-12 Should the sales culture for small business reflect that of consumer lending in that business bankers are discouraged from focusing primarily on financial incentives in their key performance indicators[31]?

Key Points

- The Union submits that a culture of sales and short-term profit should be discouraged and, to the extent possible, replaced with ethical and prudential service culture.
- SMEs are more vulnerable to poor cultural and staffing practices as they do not have National Consumer Credit Code protection.
- Sales targets and conflicted remuneration should be minimised, and where possible eliminated for all staff, not just front line employees.

29 T3053.12
30 Exhibit CS-6 (WBC.107.003.1047).
31 T3055.13.

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❖	Reductions in commissions and bonuses should not be an excuse to reduce remuneration to front line bankers.

88. The Union submits that KPIs and STI payments should not be linked to revenue or sales targets in any areas of bank operations. Such KPIs and STI payments are:

(a) indicative of poor culture, with an overemphasis on sales and revenue over prudent service;

(b) likely to lead to employees being subjected to performance management, including potentially the termination of their employment as result of failure to meet sales targets;

(c) likely to lead to products being sold to customers in circumstances where the sale is not appropriate.

89. As indicated above, the recommendations of the Sedgwick Review applied only tangentially to small business lending. The review was limited in scope to retail bank activities and did not extend to business and commercial bank activities. Small business lending occurs in both retail and business banking.

90. The Union understands that the extent of conflicted remuneration, and reliance on sales targets and incentive payments is far greater in business banking than in retail banking. Business bankers describe considering such remuneration as part of their normal pay. This understanding is corroborated by the evidence of Ms Separovich. Her evidence was that business bankers could obtain up to a further 100% of their base salary as an incentive payment. This can be contrasted to the situation of tellers and sellers in retail branches who can typically obtain up to 20% of their base.

91. A response identified by Ms Separovich has been to impose "gate openers" associated with compliance.[32] These "gates" are barriers for entry into bonus schemes, and are often triggered by compliance breaches. The imposition of such gates as a barrier to contingent payments do not resolve the issue.

92. The gates do not address the underlying drivers of behaviour not in the interests of customers. For all bankers, the primary driver to sell products is that failure to do so will imperil their employment, as adequate performance is assessed by reference to sales figures.

93. Such gates simply encourage a tick a box attitude where employees take steps to ensure that there is an appearance of compliance, rather than encouraging a genuine engagement with clients as to whether products are appropriate.

94. The Union submits that the case for limitations on conflicted remuneration is stronger in the context of business banking than in consumer banking. As with consumer banking, the disparity of bargaining power can be significant, and the risks to the borrower (in terms of loss of primary resident) enormous. However, unlike consumer banking, business banking customers do not have the comfort and assistance of being able to access the *National Consumer Credit Protection Act*.

95. Most of the consideration of conflicted remuneration has been around the conduct of front line staff, and their immediate managers. The Sedgwick report did not consider the issue of conflicted remuneration on middle or senior management. Such an approach is flawed. Conflicted remuneration models exist at all levels of financial institutions. In both retail and business banking middle and senior level managers are generally remunerated by a package which leans heavily on contingent remuneration determined by reference to the performance of those they supervise.

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32 T2268.45.

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96. In circumstances where limitations on conflicted remuneration are extended, care should be taken that this not be an excuse to simply reduce employee remuneration.

G-13 Specifically in relation to this case study [the Wallis Case Study], should lenders be required to clearly draw the cross-collateralisation clauses and its effects to the attention of borrowers? If so, how should this done[33]?

97. The Union does not belive it has any useful insight to provide on this issue at this time.

G-14 When and how much disclosure should a bank provide a director of a business in respect of a decision of the bank's workout division, in this case, the SBS division of NAB, where that decision will affect a customer's use of a personal asset which indirectly secures the obligations of their business to the bank?[34]

98. The Union does not believe it has any useful insight to provide on this issue at this time.

H Regulation and self-regulation of the SME lending sector

H-15 Is ASICs approach to the UCT provisions and the consumer protection provisions under the ASIC Act more generally, appropriate and moulded to the risks of the contraventions and practical resources constraints on ASIC?[35]

99. The Union repeats its answer to question H-18 below.

H-16 Has ASICs approach been effective in ensuring compliance with the UCT provisions that came into effect in November 2016 and the consumer protection provisions of the ASIC Act generally?[36]

100. The Union repeats its answer to question H-18 below.

H-17 Is the proposed code – whether or not it is approved by ASIC – adequate to address any residual concerns about the coverage of obligations imposed on the banks? Would the absence of ASIC approval undermine the effectiveness of the code?[37]

Key Points

- ❖ The Union submits that the proposed Banking Code of Practice [BCP] is not adequate.
- ❖ Having such important obligations contained within a self-regulatory regime is not appropriate, and will not engender community trust in the regime.
- ❖ The Union, representing staff as key stakeholders, must be consulted in the development of BCP.
- ❖ A BCP should be developed and issued by the regulator in consultation with banks and other stakeholders, not by banks in consultation with regulator.
- ❖ Substantive obligations in any BCP should become part of Financial Services Code.
- ❖ A BCP should include commitments to minimise and, where possible, eliminate conflicted remuneration, and obligation to provide sufficient training to bankers to discharge obligation to assess loans to SME.

33 T3055.16.
34 T3056.45.
35 T3059.04.
36 T3059.09.
37 T3059.11.

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101. The Union does not believe that the proposed Code is adequate or appropriate.

102. The Union is concerned as both as to content of the Code, and to the form, specifically the fact that is a self-regulatory code. These concerns are linked.

As to form

103. The Union notes that the Code asserts that it:

> *"has been developed in close consultation with key stakeholders including consumer groups, regulators and the banking industry".*

104. The Union submits that it is clear that bank employees are a key stakeholder. So far as the Union is aware, there has not been close, or substantial consultation with bank employees. The Union is the only union representing employees in the sector. The Union's consultation on the Code has been extremely limited.

105. The failure to consult with the Union or staff generally is both a specific issue, and symptomatic of the flaws in the self-regulatory approach. At the specific level, the failure to consult means that specific insights that staff may be able to provide were never sought, and accordingly were not incorporated into the document.

106. The Union is writing to ASIC and the ABA seeking an opportunity to contribute to the Code.

107. The Union submits that it is not appropriate for many of the obligations and commitments contained in the Code to be part of a self-regulatory regime.

108. The first reason is credibility and trust. At an early stage of Ms Bligh's evidence there was the following exchange:[38]

Counsel Assisting	*And the ABA is seeking the approval of ASIC for the code?*
Ms Bligh	*Yes*
Counsel Assisting	*And, as we understand it, the ABA hasn't previously sought ASIC approval for the code?*
Ms Bligh	*That's correct*
Counsel Assisting	*And do you know why the decision has been made now to seek approval of the code?*
Ms Bligh	*As I indicated, I wasn't there at the time this decision was made, but the documents indicate that the industry was giving consideration to submitting the code for ASIC approval over a number of months during and after Mr Khoury's report, and that the considerations were that providing the code or submitting it to a body outside of the industry, in this case a regulator, may well add public reassurance that this code was a code that would be of benefit to customers, that it had been assessed, and that it had been developed in accordance with the appropriate regulatory guidelines*

109. The clear inference from Ms Bligh's answer is that the ABA recognises that the fact that the Code is a product of the banks (though their Association) will undermine public confidence in the document.

110. The Union submits that the ABA's understanding is correct.

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38 T2913.45.

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111. However, the solution to this is not to obtain the endorsement of ASIC. Rather, a code of this kind should be developed and issued by the Government or a regulator in consultation with banks and other stakeholders.

112. The Code is not bank largesse, but is a central plank of the regulatory environment. The most significant obligation owed by banks to small businesses, the obligation to act as a prudent and diligent banker, exists only in and because of the Code.

113. The dispute over the definition of small business, as articulated by Ms Bligh, is illustrative.[39] While she identified that there had been consultation with stakeholders, the ultimate players in the dispute were the banks who were concerned about the effect of the extension of certain regulatory protections, and ASIC. The document (as a result of the desire to obtain the imprimatur of ASIC) has become a negotiation between ASIC and the ABA. The banks ultimately hold the upper hand - if no agreement is reached the banks can simply introduce an amended code in the form they seek, without the support of ASIC. Such a position would be a maintenance of the status quo.

114. The Union submits that, given the significance of issues (like the definition of small business), the Code should be a matter for an appropriate regulator to determine following consultation with the ABA, banks and other key stakeholders (including, not least, employees).

115. A second reason relates to enforcement of the terms of the Code. The capacity for a code issued by a statutory authority, or as regulations, to be enforceable by the courts on its terms is clear. Equally, an instrument of self-regulation will only be enforceable on its terms (such as through internal dispute processes), or to the extent its commitments are introduced into other legal obligations like contracts (such as occurred in *Doggett*[40]). The Union supports informal dispute processes, but also submits, for reasons set out above, that there is a crucial need for the obligations imposed by the Code to be adjudicated by the courts.

As to substance

116. As noted above, the Union is writing to ASIC and the ABA seeking an opportunity to provide input into the Code. Without limiting the suggestions it intends to make, the Union refers to Chapter 4 of the Banking Code of Practice deals with staff. It provides:

> ***Chapter 4 Trained and competent staff***
>
> ***Our staff and representatives will be trained and competent - including about the Code***
>
> *9. We will make sure that our staff and our representatives are trained so that they:*
>
> *a) can competently do their work; and*
>
> *b) understand the Code and how to comply with it when they are providing banking services.*
>
> ***How our staff will engage with you***
>
> *10. We will engage with you in a fair, reasonable and ethical manner.*

117. The Union identifies two additional commitments that should be incorporated in connection with issues raised in this module.

118. The first is that the Code contain a commitment that all staff (not just front line staff) will not be renumerated in a manner that creates a likelihood of conflict with their obligations to the customer.

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39 T2914.42.

40 *Doggett v Commonwealth Bank of Australia* [2015] VSCA 351.

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119. The second is that the code contain a commitment that business bankers (and others dealing with businesses) are adequately trained and resourced to be able to make undertake the level of assessment of business viability expected of the bank. The Union's experience is that such training is often not provided, but rather bankers are expected to rely upon experience and common sense.

H-18 Is ASICs approach appropriate and effective?[41]

Key Points

- ASIC's approach of settling disputes rather than prosecuting matters is neither appropriate nor effective
- There is a perception that the relationship between ASIC and banks is too cosy – this undermines public confidence.
- Without litigation, there is a lack of case law being created to clarify important obligations.
- Asymmetries of power and knowledge are less between ASIC and banks, than between individuals and banks making ASIC a more appropriate body to enforce the legal obligations on financial institutions
- The risk of litigation encourages improvements in culture and behaviour in financial institutions. Remediation is an insufficient deterrent to financial institutions.

120. The Union submits that ASIC's approach to enforcement has not been as appropriate and effective as is required.

121. The Union submits that AISC has too frequently elected to settle disputes and/or to not prosecute the banks. Completed litigation has significant, positive effects, and should be pursued on occasions.

122. The Union makes the following observations in support of this submission.

123. Firstly, the description of broad legal duties is relatively easy. The more complex and important step is the analysis of what those duties involve and require. This is a process that courts and litigation is uniquely well positioned to undertake – each party can prosecute a position on the basis of facts, and a decision which provides precedential guidance will flow. Such litigation is likely to be commenced by either individual bank customers, or ASIC. The Union submits that ASIC, for whom asymmetries of resources are likely to be less than a private individual, and which is able to select and identify the best vehicle to test legal propositions in litigation, should be encouraged to do so.

124. There is community need for courts to assess the issues and provide insight as to community and legal expectations. ASIC's chosen path of generally settling matters denies all participants in the financial services industry of the greater clarity on obligations that would arise if there was a significant body of case law.

125. Secondly, the Union believes that there is a perception that ASIC has been overly compliant, and that the relationship between ASIC and the banks is "too cosy". Such a perception (whether based in reality or not) erodes both public confidence and the confidence of bank employees in the context of whistleblowing, in the robustness and independence of the regulator, and in turn the trustworthiness of the financial institutions.

126. Thirdly, the possibility of litigation has significant cultural effects within the institutions that may be subject to the litigation. As has been evident from the first round of this Royal Commission,

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41 T3059.18.

the process of compelled witnesses and documents and of examination on oath tends to shine a light on the internal actions of the party and can provoke assessment and positive change. The Union submits that the perception that there is a real chance of litigation creates incentives and drivers towards positive cultural change, as there is an awareness that the internal actions of the bank may become public and may need to be defended.

127. Fourthly, the Union submits that there is a perception that the consequences for the banks of their conduct are seldom significantly more than the cost of remediation. Put simply, the perception is that the banks are permitted to remedy their misfeasance by doing little more than remediating the customers. Such remediation is seen as a cost of doing business. There is an imperative to ensure that the financial institutions do not develop a level of comfort that they will be able to effectively buy their way out of any potential disputation.

128. Litigation creates a risk of a cost that is disproportionate to the benefit from the actions. In so doing, the cost of litigation becomes understood as a risk against which poor governance and culture need to be measured. The failure to litigate minimises the effect of this risk.

I The development of a Financial Services Code

Key Points

- ❖ The Union submits that the Royal Commission should recommend the introduction of a Financial Services Code which reflects, and in some cases extends, current obligations.
- ❖ Such a Code would assist in dealing with asymmetries of knowledge of regulation and bank obligations between banks and bank customers
- ❖ A Code should place obligations on institutions and individuals within Financial Services entities and be enforceable by a regulator and aggrieved individuals.
- ❖ Substantive obligations in BCP should become part of a Financial Services Code
- ❖ A Code should contain obligations in relation to staff, including obligation to minimise and eliminate, where possible, conflicted remuneration.

129. The Union submits that the Royal Commission should recommend that the Commonwealth enact a Financial Services Code.

130. The Financial Services Code should:

(a) encapsulate the primary obligations of financial services institutions;

(b) centralise the obligations that currently exist in a variety of statutes, regulator advices and self-regulatory instruments like the BCP;

(c) set out clear and enforceable regulations that apply not just to financial services institutions, but also to individuals engaged by and in the service of the institutions;

(d) contain processes for dispute settlement and timely remediation;

(e) confer standing to bring proceedings for breach on the relevant regulator, and in respect of the conduct of institutions, aggrieved individuals.

131. The Union notes that the primary obligations are essentially those described by the Commission as four "readily grasped ideas"[42] which can be paraphrased as:

(a) the financial institution should not mislead or deceive;

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42 T2822.21

(b) the financial intuition should not act unconscionably, or put another way, it should act fairly;

(c) the financial products provided should be fit for purpose; and

(d) the financial intuition should act with due skill and care.

132. The Union suggests that any regulation should include an obligation to act ethically.

133. The extent of the obligations imposed by the regulation would be proportionate to the capacity of the individual or entity to influence the action or outcome.

134. In this way the Code would place obligations on those that are responsible for:

(a) The development and implementation of remuneration and KPI structures;

(b) The setting of targets and expectations for sales and revenue;

(c) The design of financial services products including loans, overdrafts, etc.; and

(d) Marketing, advertising and public statements as to the culture and operation of banks.

135. The Union submits that the risk created by bad decisions and bad actions must be extended to include crucial decision makers. At present, (aside from the risks of loss of bonus or employment), senior managers who design, implement and supervise systems and processes which fail to meet legal or community standards face no adverse consequences. Decision makers should be required to consistently interrogate the effect of their decisions and actions to ensure compliance with minimum obligations. For example, those establishing remuneration systems should be required to assess and determine whether or not they are putting in place incentives that will drive or promote conduct and behaviour that fails to meet community expectations, or otherwise is below that of a diligent and ethical banker.

136. Further, the imposition of proportionate obligations on middle and junior management and staff would promote greater professionalisation within the financial services institution, and a layer protection to those staff that resist conduct falling below appropriate standards The Union's experience is that the current whistle blower protections have been of limited utility, with financial institutions generally being structurally antagonistic to identifying compliance and other issues.

137. An overarching Financial Services Code would also assist in clarifying the regulation that applies. This is an area in which there are already such enormous asymmetries of knowledge that it is crucial that obligations, and processes for complaint and remediation should be clearly articulated. There is currently such a tapestry of obligations that it is difficult for consumers, including SME consumers, to identify the nature and extent of the obligations financial services institutions owe.

138. A clear example of this is the application of the diligent and prudent banker warranty that applies to small businesses only through an extended definition of the term 'consumer'. Similarly, the varied definitions of the term small business (and the proposed complexity of the term in the amended Banking Code of Practice).

139. The Union further submits that it is inappropriate, and contrary to community expectations for the source of substantive obligations to be through self-regulation. The Union notes that the obligation to act as prudent and competent banker (in so far as it applies to small and medium enterprises) is established by the Banking Code of Practice. This has a number of consequences:

(a) the public confidence in the adequacy of the obligation is likely to be undermined by it being a product of the financial institutions, as opposed to prepared by Government or regulators (this point was acknowledged by Ms Bligh in her evidence and is addressed in more detail above);

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(b) the obligation is vulnerable to change (or being withdrawn or weakened) by change to the Code;

(c) the obligation cannot be directly enforced in court. Outside the processes for enforcement of the obligation contained within the Code, the obligation can only be enforced by convoluted means (for example by argument that is implied into the terms of the contract).

140. The Union further submits that the Code should confer standing to enforce its terms on both the regulator, and aggrieved parties. For reasons described above, an environment of robust litigation is likely to lead to cultural improvements within the banks, and to the development of case law which amplifies and develops the obligations set out in the Code.