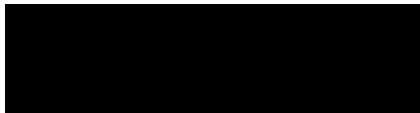


Commonwealth Bank
Commonwealth Bank of Australia
ABN 48 123 123 124



Commonwealth Bank of Australia Group

**Submission to the independent review of product sales
commissions and product based payments in retail banking**

Australian Bankers' Association industry initiatives

30 September 2016

Email: submissions@retailbankingremunerationreview.com.au

Submission to the independent review of product sales commissions and product based payments in retail banking Commonwealth Bank of Australia Group

Introduction and Purpose

The Terms of Reference state that a key objective of the Review is to “assess whether and how product sales commissions and product based payments in retail banking could lead to poor customer outcomes”¹. We believe that there are a range of factors that could contribute to poor customer outcomes and therefore have not limited the scope of our submission to product sales commissions and product based payments.

In this submission, our intention is to share our experience, insight, and perspective and provide context for the relevant policies and incentive schemes we have provided in the Review’s Request for Information (RFI) by outlining:

- A. The evolution of Commonwealth Bank’s approach to retail performance management and remuneration systems to support good customer outcomes;
- B. The insights we can derive from global experience in pursuit of good customer outcomes;
- C. Key lessons informing our remuneration and incentives practices; and
- D. The critical role of organisational culture in customer outcomes and the investment Commonwealth Bank is making to strengthen its values-based culture.

We are committed to supporting the Review to establish tangible outcomes and viable solutions that will benefit customers and the industry as a whole.

In accordance with the Terms of Reference, the focus of this submission is on incentives that relate to “staff who are employees, contractors and others in customer facing roles, such as managers and supervisors, involved in selling, offering or distributing retail banking products to retail and small business customers”². At Commonwealth Bank, we have 51,000 staff in total, approximately 40 per cent are in scope of this Review, serving more than 13 million customers across Australia.

¹ Terms of Reference, Independent Review of Product Sales Commissions and Product Based Payments, Australian Bankers’ Association

² Terms of Reference, Independent Review of Product Sales Commissions and Product Based Payments, Australian Bankers’ Association

A. The evolution of Commonwealth Bank's retail performance management and remuneration systems to support good customer outcomes

Commonwealth Bank believes that, in the context of the financial services industry, good customer outcomes arise when customer needs have been understood and appropriately met and commitments have been fulfilled, complemented by a convenient, efficient and transparent customer experience.

In recent years, Commonwealth Bank has evolved retail performance management and remuneration systems and we believe that in combination, these enhancements contribute to good outcomes for our customers by:

- Strengthening internal governance and controls;
- Ensuring a balanced approach to performance and remuneration to achieve outcomes consistent with customer interests;
- Incorporating incentive design features to mitigate risk and removing features in retail schemes that could contribute to unintended consequences; and
- Building risk management into performance and remuneration systems.

Strengthening internal governance and controls

At a Group-wide level, the Commonwealth Bank Board or its delegate is responsible for approving any new or material changes to incentive plans, overseeing spend, assuring regulatory compliance and reviewing the Group Remuneration Policy. This policy underpins Commonwealth Bank's approach to remuneration, including incentives, and is designed to meet all applicable regulatory requirements and align with the Group's vision, values and strategy.

We are strengthening remuneration and incentives governance by continuing to look for opportunities to enhance Board and management oversight of incentive changes together with refining a consistent set of core principles to guide future incentive changes and ensure their effectiveness.

Within the Commonwealth Bank's retail business we are trialling a rewards and incentives forum comprised of cross-discipline members (e.g. HR, Finance, Risk, Sales and Service etc.). The forum's charter is to ensure reward and incentive changes support the retail strategy, including good customer outcomes, from design through to post-implementation reviews.

The retail business has also strengthened its internal controls by introducing comprehensive management reporting. These reports provide senior leaders with integrated insights across incentive payments and customer outcomes, risk issues and sales metrics. This enables leaders to identify potential areas for further investigation relating to outlier performance, potential risks and adverse customer outcomes. Other internal controls include risk compliance and accuracy monitoring, sampling of lender files and audits.

A balanced approach to performance and remuneration

Performance management is an important lever that organisations can use to direct the focus and effort of their workforce. When linked to remuneration, performance systems can also reinforce and reward desirable behaviours and outcomes and penalise and deter

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undesirable ones. Over recent years, Commonwealth Bank has evolved its performance framework to encourage the balanced outcomes that we believe are important to deliver on the expectations of all of our stakeholders.

At Commonwealth Bank, the core components of our performance framework are values, risk management and business performance. Separately, and in combination, each of these components support the delivery of good customer outcomes by recognising both the outcomes that are achieved and the way in which they were achieved.

More specifically the key changes we have made to our performance framework include:

- Values; while our values have been part of Commonwealth Bank's performance framework for several years, in FY17 they have been incorporated in a more meaningful way. The values articulate consistent behavioural expectations for all employees and each employee is separately assessed twice a year on the consistency and manner in which they demonstrate these behaviours.
- Risk management; we include risk management as a formal component of the performance framework. Clear expectations are set for employees and they are formally assessed on the extent to which risk responsibilities and expectations have been met. Those individuals who do not fully meet risk management expectations may have their Short Term Incentive (STI) payment reduced (where the issues are not severe enough to warrant more serious action such as dismissal). For retail staff this is overseen by a Risk and Remuneration Committee to ensure that there are fair and consistent consequence outcomes.
- Key Performance Indicators (KPIs); we have mandated a minimum KPI weighting relating to customer outcomes for all roles, and a mandatory People KPI for all people leaders. This articulates Commonwealth Bank's expectation that all leaders contribute positively to their team and culture.
- Achieving a combination of all three components of the framework, i.e. values-based behaviour, sound risk management and business performance outcomes, is directly linked to an individual's remuneration outcome.
- In addition, across the Retail Bank, front-line employees will not have their performance assessed to force a distribution curve. We believe this removes risks attributable to employees competing for a small number of higher ratings.

Changes to retail incentive design features

Removing front-line incentive payments has often been proposed in the public domain as an obvious and easy solution to preventing poor customer outcomes in banking. At the Commonwealth Bank, we believe incentives can, and should, act as an effective method to align, motivate, and engage employees to achieve balanced and sustainable performance consistent with our vision, strategy and culture. It is important that we continue to recognise and reward employees for identifying and fulfilling customer needs within a robust and effective control environment. We have evolved, and continue to evolve, the design of retail incentive schemes with good customer outcomes at the core of these changes.

Our approach to performance management uses a balanced scorecard and includes measures such as customer satisfaction, branch performance and delivering customers more choice and convenience through self-service options. Additionally, retail incentive schemes incorporate risk and values as a "gate-opener" to participate. This means that

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employees who do not meet risk expectations or fail to demonstrate our values will forfeit their incentive payment for the period under review.

In recent years, branch-level or team-based KPIs have also been introduced for retail branch non-lender roles, which reduce an individual's sales performance in their incentive payment. Branch-level KPIs reinforce collaboration and good behaviours by requiring employees to work together to achieve their goals. Individual incentive payments are determined by the performance of the branch and moderated by a qualitative assessment of an individual's contribution (providing sound risk management and values-based behaviour have been appropriately demonstrated).

Many of the changes Commonwealth Bank has made, and continues to make, are to ensure that we meet the needs of our customers and that we mitigate any risk of mis-selling. Changes to our sales crediting, which refers to the process by which the sale of a product is attributed, are examples of this. Specific changes to sales crediting in the retail arm of the Commonwealth Bank are:

- Removing a point-per-product system which created a direct link between the number and value of products sold and an individual's reward;
- Creating a product neutral sales model providing equal credit for like products i.e. those within the same product category attributed at the branch level; and
- Reviewing all retail product sales crediting to ensure a sale is only recognised where a customer need has been met. For example, a transaction account is recorded as a quality sale only after multiple transactions have been completed independently by the customer.

We are also introducing accounting methods that support channel neutrality and thereby promote customer choice and convenience. In practical terms this means that regardless of the channel, our people receive credit for fulfilling the customer's needs and therefore they are not motivated to promote the use of one channel over another.

Risk management in remuneration and incentives

Recognising the potential risk that remuneration systems could contribute to unintended consequences including poor outcomes for customers, Commonwealth Bank has implemented systematic methods to mitigate these risks including:

- Simplified and more transparent incentive schemes to provide clarity and direction on where employees should focus their efforts. This helps to prevent misdirected effort that the scheme was not designed to achieve. Additionally, more simplified schemes mean it is easier for managers to understand and monitor the performance of their teams.
- Managerial discretion in front-line schemes where there are KPIs that relate to an individual's performance. This provides management with the ability to increase or decrease incentive payments based on broader factors such as risk and values-based behaviour.
- Mandatory deferral of a portion of short-term incentives for senior roles and employees, including retail staff, where the variable pay they have earned is above a threshold. The deferred portion may be cancelled or reduced where poor risk management or behaviours have been demonstrated.

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- Incentive payments constitute a small percentage (less than 6.5 per cent on average) of total remuneration for front-line non-lender roles, and are designed to work in concert with broader reward mechanisms (financial and non-financial) to deliver and reinforce Commonwealth Bank's strategic priorities, balanced performance orientation, and expectations for risk conduct and values-based behaviours.

B. Key insights from global experience in pursuit of good customer outcomes

As we consider future remuneration principles and practices for the Australian financial services industry there are valuable insights from the approaches taken in other markets that we can benefit from. Over the past decade, markets such as the United Kingdom (UK) and the Netherlands have implemented various changes to their retail remuneration and incentive schemes in an effort to prevent poor customer outcomes eventuating.

According to the Financial Conduct Authority's (FCA)³, the conduct regulator for financial services firms and financial markets in the UK, a poor customer outcome would be where:

- Customers lack confidence that they will be treated fairly;
- Customer interests are not central to the corporate culture of the organisations they are dealing with;
- Products and services marketed and sold are not designed to meet the needs of customers. Customers are not provided with clear information and are not kept appropriately informed before, during and after the point of sale;
- Customers are not provided with products that perform as they were led to expect, and the associated service is not of an acceptable standard; or
- Customers face unreasonable post-sale barriers to change product, switch provider, submit a claim or make a complaint.

The pertinent insights for the Australian financial services industry to be gained from international case studies are:

- Change requires an iterative and measured approach. The UK regulators issued specific guidelines on what they saw as risks and the way to mitigate risk with severe consequences for non-compliance before the full impact of these changes was understood. Conversely, a principles-based approach sets a common standard while allowing for scheme customisation reflecting individual organisational context, continuous improvement and a framework for measuring progress.
- Where a change is untested, there can be unintended consequences, including for customers. The UK experience highlights that the heaviest impact of rapid and significant remuneration changes is related to products that address 'unstated or unknown needs' especially those requiring sales effort. These included superannuation, advice referrals, business and home loan refinancing and risk products. The regulatory changes made some products more difficult and complex to sell and left many retail staff viewing selling as "bad" or hesitant to sell some products. As a result, there were significant declines in the number of life insurance products sold during this period (67 per cent lower), and in non-life insurance products (18 per cent lower). Consequently, some customers were potentially underinsured and their financial needs were not met⁴.
- The right balance is essential. The financial services industry plays a critical role in the health and stability of the economy and any commercial impact will have a broader impact on all of our stakeholders; our people, communities, customers and shareholders.
- To achieve sustainable and wholesale improvements for customers, the financial services industry and organisations providing financial products, need to move forward

³ Financial Conduct Authority; <https://www.fca.org.uk/firms/fair-treatment-customers>

⁴ Source: McKinsey Finalta Expert Interviews

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together. This applies to all channels – both proprietary and broker channels, and across traditional retail banks and emerging competitors. Any changes not applied consistently or wholly by financial services or related organisations will place others at a disadvantage and reduce the customer benefits intended by the change. In the UK, mortgage brokers increased market share by more than 50 per cent, largely driven by the impact of regulations on the banks causing increasing complexity for consumers who turned to brokers to make sense of the changes. In contrast, in the Netherlands a fixed-fee, consumer-pays broker model has encouraged price competition across the industry and the market share of broker and proprietary channels has remained stable.

- The speed of change and support required needs to be carefully considered. The industry will need to be able to absorb the degree and pace of change. The capacity of front-line staff and the extent to which enabling systems need to be refined will need to be considered.

C. Key lessons informing our remuneration and incentive practices

Reflecting on Commonwealth Bank's own experiences and insights gained from other markets, there are a number of important lessons that have informed our understanding and thinking on this topic. These lessons are reflected in our current remuneration and incentive practices and evolving future approach:

- Performance and remuneration arrangements should encourage balanced performance including a strong focus on customer-centric measures, and always address the needs and interests of all stakeholders, including customers, employees, and shareholders.
- Effective oversight, governance and controls are critical to ensuring consistent positive outcomes and supporting continuous improvement. Additionally, the level of oversight and governance needs to be commensurate with the level of risk. For example, where schemes include potentially higher risk features such as no caps (that is, where there is no maximum dollar value that can be earned), challenging targets or rapid payment accelerators (that is, where there is a significant increase in variable pay after a threshold performance level has been achieved), stronger oversight is critical.
- Recognition of performance relating to individual employee sales should strive to be product or channel neutral in order to remove any conflict of interest between subsequent remuneration outcomes and customer needs being met.
- Remuneration systems should be appropriately simple and transparent. Complex incentive design increases the risk of poor customer outcomes, often unintentionally. Complex schemes are often harder for employees to understand and therefore their efforts may be misguided and performance may be more difficult for leaders to monitor.
- Performance targets or thresholds should be achievable so as to not encourage inappropriate risk taking or behaviours misaligned with organisational values.
- Longer measurement periods e.g. bi-annual rather than monthly or quarterly, support good risk management in incentives schemes. The longer time span allows patterns of performance to be observed and validated.
- Managerial discretion is an important risk management tool that allows incentive payments to be modified based on broader factors, for example risk and values-based behaviour, that are beyond the pure metricated outcomes of a scheme.
- Non-financial rewards such as recognition programs are also strong behavioural motivators for employees and therefore are an important consideration to support good customer outcomes. Similar to monetary rewards, recognition schemes should recognise staff for balanced performance, including the demonstration of positive behaviours, including risk.

D. Beyond remuneration and the critical role of organisational culture

A strong organisational culture, including risk culture, is fundamental to supporting high collective operating standards and conduct, and ultimately delivering positive customer experiences and outcomes. At Commonwealth Bank, remuneration forms part of a 'total employee reward', i.e. monetary and non-monetary benefits, and operates within the context of the broader employee value proposition and organisational culture. While extrinsic motivators, including incentive remuneration, can be strong reinforcers of positive or negative culture, they are only one lever organisations can utilise to reinforce and enable their desired culture.

Commonwealth Bank is making a significant investment to strengthen its organisational culture to enable good customer outcomes. Key initiatives include:

- Standards for formal and informal recognition programs to recognise employees for a balance of factors; customer centricity, values and performance.
- A reward and recognition program was also introduced to celebrate outstanding examples of people demonstrating our values and to encourage more frequent recognition of these behaviours by peers and leaders.
- Limiting marketing campaigns with an associated staff incentive and introducing standards and governance when campaigns are run.
- Removing league ladders (that is, visually ranking and publicising individuals by their sales performance) and practices where front-line staff compete solely on individual and product-based sales targets.
- Significant investment in the technology and training of staff to deliver a consistent approach to high quality customer needs-based conversations.
- Increased monitoring of sales quality and outcomes and a systematised consequence management process for poor risk behaviours for front-line staff.
- Formal and regular review, approval and governance of the design and distribution of new and existing retail products.
- The development of a conduct risk dashboard for senior leaders, utilising a range of data including outlier performance, highlighting areas of potential conduct risk that require further investigation.

Conclusion

By its nature, the financial services industry is complex and far-reaching. Commonwealth Bank alone employs more than 51,000 staff, has 800,000 shareholders and serves more than 13 million customers across Australia. Consistently delivering good customer outcomes requires diligence and effort on many fronts. Incentives are one of the levers that the industry can utilise. By way of example, the inclusion of the Customer Experience Survey (CES)⁵ in all Commonwealth Bank branch incentive schemes has been instrumental to us maintaining the number one position among the four major banks in Australia in the Roy Morgan Customer Satisfaction Survey for the entire 2016 financial year, in 36 of the last 44 months and recording the highest ever score achieved by a major bank.

Commonwealth Bank believes that remuneration, including incentives, can positively contribute to good customer outcomes where they are designed and operated in adherence with a core set of principles. Our strong recommendation is that an agreed set of core principles are adopted industry-wide and by non-financial services organisations offering financial products. Only through industry-wide adoption, can we deliver full and sustained benefit to customers and build long-term Australian consumer confidence and trust in banking.

Commonwealth Bank puts forward the following principles for the Review's consideration. We believe full adoption of these principles will have a significant and positive industry-wide impact on remuneration practices and will strongly support good customer outcomes:

1. **Front-line staff should never be rewarded solely on the sale of a retail banking product (that is, 100 per cent commission-based product payments).** Where there is a direct linkage, sales credit should strive to be product and channel neutral.
2. **Incentive schemes must always:**
 - a) **Recognise a balanced achievement of performance outcomes (the 'what') and the manner in which those outcomes were achieved (the 'how').** To be balanced, performance should include a meaningful component related to customer-centric outcomes (e.g. experience, satisfaction, quality) and the demonstration of consistent ethical behaviour.
 - b) **Exclude design features proven to increase inappropriate risk taking where strongly linked to product sales.** Examples include rapid payment accelerators, uncapped payments and unreasonable performance thresholds or targets.
 - c) **Ensure that the sale of non-core products is not recognised disproportionately to core products.**
 - d) **Provide management discretion and oversight to reduce or fully forfeit any incentive outcome, with consideration given to behaviours relating to risk misconduct, including mis-selling.**

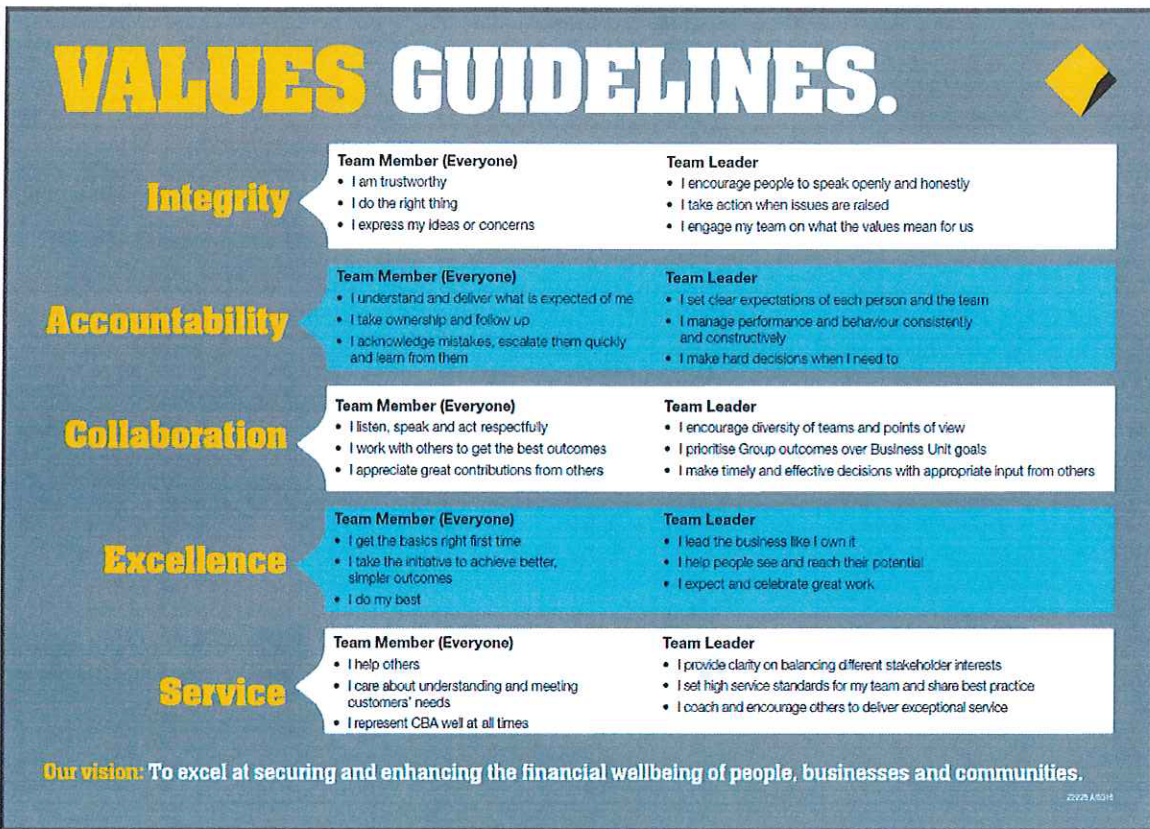
⁵ CES is conducted by Roy Morgan Research on behalf of the Bank and measures a customer's overall satisfaction with their recent service experience with one of our front-line services as well as with key service behaviours. This relates to Commonwealth Bank's retail business. It does not relate to Bankwest.

- e) **Reflect the needs of all stakeholders of the organisation (customers, shareholders, employees).**
 - f) **Be governed with appropriate (e.g. commensurate with the level of risk) and effective (e.g. consistent, comprehensive, impactful) internal controls and oversight.**
3. **Performance management and remuneration systems be appropriately simple and transparent.** It is vital that these systems can be easily communicated, consistently understood, and provide direction and clarity on the balanced outcomes desired.
 4. **Recognition programs adhere to broader remuneration principles, including encouraging and recognising balanced performance.**
 5. **Sales practices, staff training and accreditation are aligned to, and support, the above principles.**

In conclusion, careful consideration is required for how the industry adopts any changes to performance and remuneration systems. Applying valuable lessons from other markets, we recommend a measured approach for implementation in the Australian market:

- A principles-based approach to any change sets a common standard across traditional and emerging financial services competitors, while allowing for iteration, continuous improvement and measured progress.
- Rigorous analytics and piloting to ensure unintended consequences are limited, including for customers.
- The right balance of outcomes for all stakeholders is essential. The financial services industry plays a critical role in the health and stability of the economy and any commercial impact will have a broader impact on all of our stakeholders; our people, communities, customers and shareholders.

Appendix I – Commonwealth Bank Values Guidelines



VALUES GUIDELINES.

Integrity	Team Member (Everyone) <ul style="list-style-type: none"> • I am trustworthy • I do the right thing • I express my ideas or concerns 	Team Leader <ul style="list-style-type: none"> • I encourage people to speak openly and honestly • I take action when issues are raised • I engage my team on what the values mean for us
Accountability	Team Member (Everyone) <ul style="list-style-type: none"> • I understand and deliver what is expected of me • I take ownership and follow up • I acknowledge mistakes, escalate them quickly and learn from them 	Team Leader <ul style="list-style-type: none"> • I set clear expectations of each person and the team • I manage performance and behaviour consistently and constructively • I make hard decisions when I need to
Collaboration	Team Member (Everyone) <ul style="list-style-type: none"> • I listen, speak and act respectfully • I work with others to get the best outcomes • I appreciate great contributions from others 	Team Leader <ul style="list-style-type: none"> • I encourage diversity of teams and points of view • I prioritise Group outcomes over Business Unit goals • I make timely and effective decisions with appropriate input from others
Excellence	Team Member (Everyone) <ul style="list-style-type: none"> • I get the basics right first time • I take the initiative to achieve better, simpler outcomes • I do my best 	Team Leader <ul style="list-style-type: none"> • I lead the business like I own it • I help people see and reach their potential • I expect and celebrate great work
Service	Team Member (Everyone) <ul style="list-style-type: none"> • I help others • I care about understanding and meeting customers' needs • I represent CBA well at all times 	Team Leader <ul style="list-style-type: none"> • I provide clarity on balancing different stakeholder interests • I set high service standards for my team and share best practice • I coach and encourage others to deliver exceptional service

Our vision: To excel at securing and enhancing the financial wellbeing of people, businesses and communities.

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