10 minutes on...

Commissioner Hayne's findings on incentives

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Commissioner Hayne has produced an Interim Report of the Financial Services Royal Commission that was tabled on 28 September 2018. The Interim Report can be found here. Despite the fact that the final report is yet to be issued (on 1 February 2019), the Commissioner has already offered a number of strong observations about remuneration practices and has identified incentives as key causes of misconduct. A number of substantial questions have then been posed regarding future remuneration practices.

Excessive focus on incentives and financial gain

In the Commissioner's view, the majority of misconduct observed involved financial gains for either the institution or the individual involved, and in many cases both: *"All the conduct identified in this report was conduct that provided a financial benefit to the entities and individuals concerned. If there were exceptions, they were immaterial. For individuals, the conduct resulted in being paid more. For entities, the conduct resulted in greater profit."*

Remuneration practices have been identified as a key cause for the misconduct and strongly criticised throughout the Report. *"The culture and conduct of the banks was driven by, and was reflected in, their remuneration practices and policies."*

The banks have generally acknowledged that there have been examples of incentives being associated with poor customer outcomes, but have continued to debate the extent to which they have done so, and that associated controls and governance have alleviated such risks. But the Interim Report indicates patience has run out for such arguments. The Commissioner emphatically states that remuneration has been "an important contributor" to misconduct and poor customer outcomes.

Observations on the weaknesses in remuneration policy and structures

Weakness	Observations
Central focus on rewarding sales, revenue and profit	• While policies are tailored to different parts of the industry, the focus on volume and sales is clearly set out in remuneration arrangements for third parties such as brokers, aggregators and introducers, and for customer facing employees • Some have sought to dilute this focus recently (in response to the Sedgwick Report), however, profitability remains a dominant feature of management and senior executive remuneration • Managers continue to reinforce, and employees continue to see, sales, revenue and profit as the most important performance outcome
The notion scorecards have become more balanced is arguable	• Scorecards seek to reward both financial outcomes and ways in which a particular employee has contributed to the institution's success (via customer, operational and strategic metrics). But how success is achieved is still of lesser importance than achieving the outcome • Customer measures typically focus on satisfaction at point of sale (e.g. NPS), rather than reflecting the quality of the customer outcomes being serviced • Other "customer" measures assume that the customer "needs" what the institution sells (e.g. number of "needs met", number of conversations/ contacts) and are seen to further encourage identification of sales opportunities • Penalties for failing to meet a standard (e.g. compliance gateways or modifiers) are common features of remuneration arrangements for employees. However, the bar is often low (e.g. attendance at mandatory training). Such penalties can lead to employees focusing as much attention on avoiding error discovery as on avoiding errors in the first place.
Remuneration regulation has not sufficiently mitigated misconduct	• It is argued that remuneration regulation has not sufficiently mitigated the risk of misconduct either because it hasn't been specific enough, or because it hasn't been properly enforced • Regulation has not explicitly identified the types of risk it sought to address and has neglected specific risk such as conduct and reputation • Regulation has been applied, either by design or by application, to quite a narrow proportion of the industry – generally to senior management and those providing personal financial advice to retail consumers. Even then, this has permitted conflicts to persist beyond a reasonable transition period e.g. grandfathered commissions in the context of the FOFA reforms.

Other features of bank pay practices to be considered

We expect these observations will substantially inform the recommendations in the final report as the points are made so consistently and so regularly by the Commissioner. However, in our view, there are other features of bank pay practices that warrant further attention, which were not so much of a focus in the Interim Report.

Feature	Consideration
Performance-based remuneration	• Namely, the attention to or degree of remuneration that is performance-based. For some financial advisers and third parties such as brokers, their entire remuneration may be performance-based which clearly exacerbates the influence of remuneration (i.e. if your entire livelihood depends on it).
Governance	• Governance of remuneration policies, including the oversight processes and management information to inform appropriate risk adjustment and application of remuneration consequence.
Performance management practices	• Performance management practices outside of remuneration that shapes and informs what behaviour and outcomes are valued. Examples include use of leader boards, recognition programs, development, promotion and progression opportunities, and the tone from managers and leaders, including their coaching interactions with employees.

Possible future recommendations and implications

It is clear from the Interim Report that drastic changes to remuneration policy across the industry can be expected. The Commissioner has been clear that the conduct identified and criticised was driven by a pursuit of profit and financial incentives. Significant policy recommendations can be expected in the final report due 1 February 2019.

Since the Interim Report was released, the ABA have announced that it will seek new legislation to abolish grandfathering commissions under the Future of Financial Advice legislation that has been in force since 1 July 2013. And we should expect further change to remuneration regulation across the industry, and greater consequences for misconduct.

Other possible changes (either in expectations regarding policy or regulation) that may be considered include:

1. The further reduction, or even removal of volume-based remuneration across the industry, including third party channels
2. Redefining the role of variable pay (even considering its removal for some / all roles), beyond customer facing staff and their immediate supervisors (i.e. up to executives)
3. Identification of customer measures that are focused on the quality of service/outcome aligned with the customer’s best interests
4. More ‘carrot’ and less ‘stick’ with regard to incenting good standards and compliance.

While some institutions have acknowledged that such changes are needed, they have been reluctant to move first. The Royal Commission has altered public attitudes such that early adopters may be prized by differentiating themselves and attracting talent most adept to effect change.

How can PwC help?

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