A Secret Weapon in the Fight Against Financial Misconduct:

Sectoral Collective Bargaining

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October 2018

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The author thanks without implication David Richardson, Geoff Derrick, Alison Pennington, Josh Bornstein, Julia Angrisano, Clive Pattison and David Taylor for helpful input.

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I. Introduction and Summary

Australians have been transfixed by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. Commissioner Kenneth Hayne received evidence regarding tens of thousands of incidents of misconduct by banks and other enterprises in the broader financial sector. The Commission has held six rounds of hearings, focusing on various dimensions of financial services: including consumer loans, financial advice, small business and agricultural lending, and superannuation. Its Interim Report documents a clear pattern of misconduct: ranging from breaches of community expectations and norms of responsible lending, to outright fraud and lies. The reputation of the financial industry, which plays an obviously critical role in Australia's overall economy, has been badly tarnished – as has public confidence in the willingness and capacity of existing regulatory institutions (such as the Australian Securities and Investments Commission and the Australian Prudential Regulation Authority) to hold financial firms accountable and uphold legal and ethical standards.

While the Royal Commission's Interim Report (Royal Commission, 2018b) provides exhaustive detail on this litany of misconduct, it is much less definitive in identifying the potential solutions. Indeed, the Interim Report asks more questions, than provides answers, in terms of how this pervasive record of misconduct is to be addressed, and the public's confidence in the financial industry rebuilt. As the report indicates,

> "Why did it happen? What can be done to avoid it happening again?
> These are now the key questions." (p. xix)

Proposals for stronger laws and regulations to govern the financial industry, and more ambitious and consistent enforcement of those laws, are one obvious and compelling response to the behaviour exposed through the Royal Commission. In many cases, it is clear that unfair, unethical, and wasteful practices must be explicitly and directly prohibited through stronger laws and regulations – and the independence and accountability of the public regulators charged with enforcing those rules must be buttressed considerably. But the Interim Report expresses some ambiguity in its commitment to toughening the legal and regulatory framework for the industry. Indeed, the Commissioner was skeptical that stronger legal or regulatory oversight alone could lead to the wholesale changes in culture and behaviour that are clearly required:

> "The law already requires entities to 'do all things necessary to ensure' that the services they are licensed to provide are provided 'efficiently, honestly and fairly'… Passing some new law to say, again, 'Do not do that', would add an extra layer of legal complexity to an already complex regulatory regime. What would that gain?" (p. xx)

This is an unduly pessimistic conclusion. The fact that existing laws and regulations have been ignored or evaded by profit-seeking financial interests, and that regulatory authorities have failed so visibly and consistently to uphold those rules, hardly implies that legal restrictions have no value or effect. Strengthening both the legal and regulatory framework, and the enforcement of that framework, should feature prominently in the Royal Commission's final recommendations – and should be a core priority for policy-makers as they design their responses to those recommendations

Nevertheless, there is some truth to the Commissioner's concern that relying exclusively on the power of regulators to force the industry to change from above, may not fully succeed in protecting customers and reducing misconduct. Some other common suggestions for dealing with the pervasive and structural failures of the financial industry, however, are even less promising. For example, suggesting that better consumer education, or more ambitious self-regulation by financial firms, could somehow overcome the greed, conflicts of interest, perverse incentives, and outright criminality so vividly documented in the Commission's hearings surely constitutes wishful thinking on a grand scale.

To help answer the Commissioner's central challenge – "What can be done to avoid it happening again?" – this paper proposes an overlooked strategy for addressing financial misconduct. It suggests that the implementation of sectoral collective bargaining processes in financial services would constitute a powerful additional tool in the fight for ethical standards and consumer protection. A system of sectoral collective bargaining would establish one or more collective agreements applying simultaneously to firms across the industry.[1] Those agreements would specify compensation structures (including setting clear and enforceable limits on the use of incentive pay systems, which the Royal Commission found to be a key driver of financial misconduct). Sectoral agreements would also address working conditions; representation, accountability and reporting mechanisms (including protection for those who identify and report wrong-doing); and qualification and certification requirements for employees in the industry.

[1] As described later in this report, it is possible that separate sectoral agreements would be negotiated and implemented in various sub-sectors of the broader financial sector (such as major banks, smaller banks and intermediaries, insurance companies, superannuation funds, etc.), in order to reflect the specific economic circumstances of those business segments.

Sectoral agreements would thus permit the design and implementation of rational, ethical and consistent compensation practices across the whole financial industry. They would bring an additional regulatory instrument to bear on corporate practices in finance – one that is not dependent on government regulators to monitor behaviour and investigate complaints. Instead, the enforcement of standards specified in a collective agreement would become part of the regular and transparent administration of that collective agreement, rooted in the day-to-day activity of managers, union stewards, and delegates located throughout the "machinery" of the whole industry. The whole point of a collective agreement is to establish clear, consistent and enforceable rules for what happens in a workplace. Why not dedicate those rules to improving the ethical practice of the industry, as well as lifting wages and working conditions? In short, this is an "industrial solution" that could help to address the misconduct identified by the Royal Commission (in addition to whatever "regulatory solution" the Commissioner eventually recommends).

In today's financial industry, it is clear that more rules are necessary – as is a more embedded and effective structure for ensuring that rules are followed. By establishing sectoral collective agreements as a foundation for ethical, professional behaviour throughout the industry, the nefarious influence of greed and conflicted interests exposed by the Royal Commission can be challenged through an entirely new channel. Moreover, by specifying those norms on a consistent, transparent and sector-wide basis, this approach would ensure that competitive pressure does not inhibit financial providers from implementing more ethical and efficient compensation practices – thus overcoming the "first mover" problem which the Interim Report identified as a barrier to reforming current conflicted compensation practices.[2]

Unfortunately, Australia's present industrial relations laws prohibit in most circumstances the negotiation of collective agreements that apply on a multi-firm or sector-wide basis.[3] These prohibitions are motivated by a misplaced assumption that standardizing compensation and other features of the employment contract across firms somehow constitutes "anti-competitive" behaviour, or a fear that it would lead to excessive compensation and labour costs. The experience of Australia's financial industry is proof positive that the absence of sector-wide standards has promoted neither competition nor modesty in compensation: to the contrary, the unconstrained

[2] See, for example, pp. 56, 68, and 94 of Royal Commission, 2018b.

[3] The Fair Work Act prohibits multi-employer or industry-wide industrial action in support of common contract provisions (such as those in a sectoral agreement), and employers cannot be compelled to participate in multi-employer negotiations. For both reasons, multi-employer or sector-wide collective bargaining is effectively prohibited. A hypothetical exception to this prohibition is provided by the Fair Work Act's "low paid stream," but it has never been used in practice.

greed which the Commissioner properly identified as the root source of financial misconduct has given rise to a myriad of anti-competitive, misleading, fraudulent, and excessive profit-taking.

Australia's prohibitions against multi-firm and sectoral collective bargaining are unusual among industrial democracies. Sectoral collective bargaining is not only fully legal in most other OECD countries, it has been found to be consistent with superior economic performance according to numerous indicators (including employment, productivity growth, wage equality, and economic inclusion).[4] Australia's unique and restrictive rules should be reconsidered in light of the findings of the Royal Commission, and the inadequacy of existing financial regulations to effectively combat the misconduct which the Commission identified. This "industrial solution" could be of considerable value in filling this regulatory void, and industrial relations law should be amended to at least open the possibility of activating it.

To date the Royal Commission has not considered the potential usefulness of collective bargaining and union representation in addressing pervasive financial sector misconduct.[5] This is curious, given the importance of collective agreements to the process of determining compensation structures and levels – the very issues which the Commissioner found to be so central to the misconduct he documented. Moreover, the Commission did not receive in-person evidence from non-management employees of banks and other financial firms in the course of its hearings (it only heard evidence from management and executive-level financial employees). Considering the issue of conflicted financial compensation from the workers' perspective, and considering how those workers could play a role collectively (through sector-wide bargaining processes) in reforming compensation practices, should be at the top of the Royal Commission's agenda.

In short, the value of standardised sector-wide collective agreements should now be considered by the Royal Commission as it moves to develop and recommend policy responses to the problems it has so damningly documented. If, as this report suggests, sectoral collective agreements could play a positive and effective role in reforming compensation practices, and addressing other shortcomings in current financial practices, then the Commissioner should recommend, as part of his final report, changes to existing industrial relations laws that would be necessary to facilitate this important step forward.

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[4] This economic evidence is discussed in the last section of this report; see especially OECD (2018).

[5] In fact, no reference to "union" or "collective agreement" appears anywhere in the 3 volumes, and roughly 1000 pages, of the Interim Report (with the exception of mention of the Finance Sector Union in the list of submissions received from the public).

The rest of this report is structured as follows. The next section summarises the Royal Commission's findings to date regarding the importance of flawed compensation systems in explaining unethical, unfair, or criminal activity by financial businesses. The problems with conflicted pay systems in the financial industry are not new and have been recognised by industry practitioners, regulators, and academics for years; therefore, Section III summarises supporting evidence regarding these problems as documented by other previous inquiries and independent research. Section IV of the report considers the "first mover" problem in further detail, exploring the impact of competitive pressures in inhibiting reforms in compensation systems by individual companies. This problem can be overcome by strategies which enforce better practices on a sector-wide basis.

The remainder of the report discusses the potential of sectoral collective agreements in improving financial industry practices. Section V discusses how sectoral agreements could address the conflict of interest issues embedded in current incentive and sales-based compensation practices. Section VI discusses other potential benefits of sectoral agreements in addressing issues raised in the Royal Commission: including better voice and representation structures; protection for whistleblowers; standardisation of qualifications and certification for financial professionals; and facilitating greater mobility within the sector (thus reducing the extent to which financial employees are "captive" to potentially damaging culture within specific firms). The final section of the paper consolidates the evidence in support of sectoral collective bargaining as a powerful strategy against financial misconduct, and urges the Commissioner to recommend requisite changes to industrial relations law so that this potential can be realised.

II. Compensation and Misconduct: What the Commission Found

In its six rounds of hearings, the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry documented tens of thousands of instances of misconduct and abuse of consumers, experienced in many different aspects of financial services in Australia. Some of the major categories of misconduct include:

- Overcharging interest and fees.
- Collecting fees when no service was provided at all ("fee for no service").
- Inappropriate advice and misconduct on the part of financial advisors.
- Violations of responsible lending conduct.
- Fraudulent behaviour in loan applications, other credit sales, and other activities.
- "Calling" loans (in the agricultural sector and elsewhere) on the basis of inappropriate property value metrics.
- Misleading or lying to regulators.
- Aggressively cross-selling a firm's products or services to customers of other products or services.

Even though the Commission has yet to publish its final report and recommendations, the misconduct uncovered in the hearings has already resulted in several major consequences: including hundreds of millions of dollars in fines and compensation paid by banks and other financial businesses, and the departure or removal of several senior financial executives. Financial executives and industry associations have acknowledged and apologised for the pervasive misconduct, and undertaken various initiatives of their own to "clean up" their practices and public reputation – motivated at least partly by a desire to forestall more intrusive and obligatory measures that could be imposed by regulators and government. The head of the Australian Banking Association (the most important financial industry association) acknowledged the Commission had brought "shame" onto the financial sector, contritely promising "there is no place for greed in the Australian banking system."[6] That promise will strike many Australians (including borrowers, consumers of financial advice, workers in the

[6] Cited in Janda et al. (2018).

industry, and others) as laughably ironic. They have experienced the direct consequences of profit-driven excesses on the part of the banks and other financial firms, and are under no illusions regarding the prevalence of greed in this industry.

Indeed, the Commissioner himself identified greed as the ultimate driving force of the many forms of misconduct his investigations uncovered:

> "It is important to recognise that, behind or beneath these issues may lie a deeper observation about unifying causes. Much if not all of the conduct identified in the first round of hearings can be traced to entities preferring pursuit of profit to pursuit of any other purpose." (p.54)

Here, too, many observers would be surprised that this is considered surprising or newsworthy. After all, the purpose of any private business is precisely to maximise the wealth of its owners, and this depends on maximising the future stream of the firm's profits. Indeed, it is the fiduciary duty of a company's directors to place that goal above others in their decisions and investments. No-one should be surprised that banks (or any other private firm) is motivated by a hunger for profit. And to the extent that profit-seeking behaviour results in negative or unacceptable consequences for other stakeholders, society at large, or the environment, it is incumbent upon government, regulatory agencies, and other institutions in society to place firm limits on corporate behaviour to protect the broader public interest. Merely hoping that some sense of higher purpose or social responsibility might constrain business leaders in their quest for profit can only lead to disappointment. Constraining self-interested business activity is the *raison d'être* for laws, regulations, and standards. And trade unions fulfil a similar role: they aim to constrain the normal drive for profit within socially acceptable bounds, by requiring employers to meet higher standards of compensation, job security, working conditions, safety, and fairness.

Having identified the hunger for profits as the core driving force behind the various forms of misconduct catalogued in its report, the Royal Commission went on to consider how overarching greed is then transmitted and expressed into the behaviour of the thousands of individuals whose decisions and actions make up the industry's conduct and performance. In this regard, the Royal Commission's Interim Report correctly and repeatedly identified flaws and conflicts of interest in compensation systems as a crucial factor in translating the general greed of the industry into specific manifestations of inappropriate or damaging behaviour. In numerous places the Interim Report accurately emphasises the impact of conflicted compensation and poorly designed incentives on product design, sales effort, adminstration, communications and reporting, and other indicators of conduct.

For example, the Interim Report identifies employee compensation and incentives as a crucial channel through which the broader culture and ethics of a financial firm are reinforced within a financial firm:

> "Staff and others engaged by an entity will treat as important what they believe that the entity values. Rewarding volume and amount of sales is the clearest signal that selling is what the entity values. What staff and others believe that the entity values informs what they do. It is a critical element in forming the culture of the entity." (p. 55)

The Interim Report also emphasises that the problem with perverse compensation incentives is not limited solely to the front-line sales staff who deal directly with affected customers. If the compensation of top executives, who do not participate directly in the sales effort, remains heavily dependent on sales, revenue and profit targets, then their influential decisions and actions will clearly be influenced by the same potentially damaging incentives:

> "Eliminating incentive based payments for front line staff will not necessarily affect the ways in which they are managed if their managers are rewarded by reference to sales or revenue and profit. The behaviour that the manager will applaud and encourage is behaviour that yields sales or revenue and profit. The behaviour that is applauded and encouraged sets the standards to be met and forms the culture that will permeate at least that part of the entity's business." (p. 308)

The Interim Report clearly found that the use of sales- and volume-based incentives is still common in many segments of Australia's financial industry, despite partial measures taken by regulators (such as new provisions in the Corporations Act regarding conflicted remuneration[7]) and independently by the industry itself (such as the partial implementation of reforms proposed through the Sedgwick inquiry[8]) to limit the use of these commissions and incentives. The Commission found that exemptions to restrictions on incentives, the broad grandfathering of previous practices, and the continuing influence of sales or revenue benchmarks hidden within rebranded "scorecards" and ranking systems, means that the problem of perverse incentives on financial conduct has certainly not been removed:

> "Despite the Sedgwick recommendations, banks continue to remunerate employees in ways that emphasise sales." (p. 316)

[7] These legislative provisions arose from the Future of Financial Advice process (Treasury, 2013), discussed further below.

[8] *Retail Banking Remuneration Review Report* (Sedgwick, 2017), discussed further below.

Research by the Finance Sector Union submitted to the Royal Commission also confirmed that the shift to so-called "scorecards" has not eliminated the influence of sales and revenue targets in employee evaluation and bonus systems. In an examination of typical scorecard metrics used by major banks, they found that 70 percent of the scorecard's final composition retains direct links to the sale or potential sale of the employer's products and services:

> "The 'balanced scorecard' model gives a misleading appearance that sales are no longer the determining factor used to assess performance." (Finance Sector Union, 2018a, p. 2)

The Interim Report confirms that incentive payments and other forms of variable pay constitute an important component of total compensation in the financial industry, although the size and nature of incentive payments vary greatly from role to role. Compensation over and above base wages and salaries constitutes a greater proportion of total income in finance than in almost any other industry in Australia.[9] Information compiled by the Financial Services Union indicates that incentive payments typically constitute a small portion of total compensation for front-of-house bank tellers, but much larger proportions for higher managers (see Table 1):

Table 1
Variable Pay as Proportion of Total Compensation

Role	Bonuses Relative to Annual Base Compensation
Tellers	5-10%
Branch Managers	40-60%
Area or Division Managers	60-100%
Senior Executives	Over 100%
Source: Adapted from Financial Services Union (2018a), p.3.	

[9] Data compiled by the Workplace Gender Equality agency (2018, Tables 3 and 4) suggest that average supplemental income for workers in financial services (including commissions, incentives, bonuses, other performance pay, and overtime premiums) increases their total compensation by more than one-third above regular base pay (and significantly more for men than for women, as discussed in Section VI below). That is the second-highest ratio of total to base pay of any industry, behind only the mining sector; however, in mining the main component of non-base pay is overtime premiums (not performance pay). It is therefore reasonable to conclude that performance- and sales-related pay is more important in finance than any other sector of the economy.

In sales-oriented roles (including financial advisors, insurance sales, mortgage brokers, "introducers," and others), variable pay typically constitutes a higher proportion of total pay than for administrative or back-office staff. But even when monetary rewards are relatively small in relation to overall compensation, recent psychological research on goal-seeking and cognitive fixation suggests that workers can become disproportionately attracted to and motivated by reward objects – even, in some cases, by modest non-monetary awards (such as in-kind prizes, recognition among peers, etc.).[10] The motivational power of incentives, even modest ones, is reinforced through the deliberate construction of a group culture within workplaces that publicizes, promotes, and enforces the quest for rewards. This practice is common in the financial industry: firms establish high-pressure sales rooms, confronting sales staff with repeated messages to boost their sales effort and achieve the next target, public ranking of employees according to sales success, and other techniques. Apart from the nefarious impact of these techniques on consumer welfare (compelling sales staff to push financial products consumers may not need or understand), it also degrades the quality of the work environment for those confronted with this pressure – potentially leading to excessive stress, depression and other mental health consequences, and physical health effects (such as hypertension, heart disease, diabetes, and others).

Discussion of the impact of commissions and other incentives on the nature of financial service work should not consider only the use of positive income incentives for affected staff. New research in behavioural economics and related fields has discovered that individuals are often motivated more by risk of *losing* something they already possess (or expect to possess), than by the possibility of capturing incremental gains.[11] This cognitive lever can also be reinforced in the design of workplace incentive schemes: employers aim to develop a strong expectation among staff of the likely or potential value of rewards and bonuses, while simultaneously emphasising the possibility that those rewards will be taken away if targets are not met.

A complementary strategy through which these "risk-of-loss effects" can be accentuated is by using intense performance management practices, whereby firms impose a range of punishments (up to and including outright dismissal) on employees who are considered not to have met sales or revenue benchmarks.[12] For this reason, the policy response to the perverse incentives exposed by the Royal Commission cannot be limited solely to reforming monetary inducements for sales and other

[10] Examples of this research include Hur and Nordgren (2016), Adler (2017), and Scheiber (2017).

[11] The phenomenon of "loss aversion" and its impact on economic behaviour is explored, for example, in Gächter et al. (2009) and Mukherjee et al. (2017).

[12] Submissions to the Royal Commission by the Financial Services Union (2018a, 2018b) provide case studies of intense performance management and discipline systems in Australian financial businesses.

activities; it must also include place restrictions on the application of negative incentives (including intense disciplinary measures) tied to those same sales targets. Ultimately it makes no difference whether financial employees are compelled to push inappropriate credit or financial services to customers in order to capture a monetary bonus, or to avoid dismissal from their job: in either case, the firm is eliciting employee behaviour that is ultimately damaging to the integrity and stability of the financial system.

To sum up, after reviewing the vast evidence collected through the public hearings and the findings of previous inquiries, the Commissioner concluded bluntly that compensation practices in the financial industry continue to exert a distorting, destabilizing, and damaging impact on financial services in Australia:

> "Value-based remuneration conflicts directly with customers' interests." (p. 63)
>
> "For most of the last decade, remuneration arrangements for third party intermediaries and for all staff, both frontline staff and senior executives, have rewarded sales and profitability. Doing the 'right thing' has not been rewarded. And even in the more recent past, 'balanced scorecards' and 'conduct gateways' have too often used doing the 'wrong thing' as a disqualifying criterion." (p. 69)

III. Compensation and Misconduct: What Other Research Has Found

The Royal Commission's strong finding that flawed compensation systems introduce conflicts of interest in financial service provision that harm consumers and damage the integrity of the financial system is not exactly "news." Ample previous research had already confirmed the negative impact of inappropriate or conflicted compensation systems on lending practices, advising, and wealth management, both in Australia and internationally. Concern among policy-makers, regulators, academics, and the public at large with the impact of financial industry compensation systems on the behaviour of financial firms became more acute in the wake of the Global Financial Crisis of 2008-09. That economic cataclysm was certainly aided and abetted by perverse incentives for financial sector personnel: encouraging them to design overly complex products, mislead consumers as to their true nature and ultimate cost, and then shift the risks of resulting losses to other stakeholders (ultimately including the government and the public at large).

First we summarise below the main findings of several previous inquiries into financial industry compensation and marketing practices in Australia. Later we also consider the findings of broader academic research into the problem:

Future of Financial Advice Reforms (The Treasury, Government of Australia, 2013).

A multi-year process of research and regulatory reform has taken place under the moniker of the 'Future of Financial Advice,' led by the Commonwealth Treasury Department.[13] The process was sparked by public concern about inappropriate, opaque and damaging conduct by financial advisors in various segments of the industry. The initial reforms were implemented in 2012, and included restrictions on sales-based incentives for financial advisors (but with provisions to grandfather existing practices). After its election in 2013, the current Commonwealth government altered some aspects of the reforms – including relaxing opt-in provisions, rules regarding reporting of fees, and other requirements, and expanding grandfathering of previous sales-based compensation practices.

[13] In addition to the Department of Treasury documentation, see also Australian Securities and Investments Commission (2014) for further information on the evolution of the FOFA reforms.

Financial System Inquiry Final Report (The Treasury, Government of Australia, 2014).

This review, chaired by David Murray, was the third comprehensive review of Australia's financial sector, following earlier reviews published in 1981 (the 'Campbell Report') and 1997 (the 'Wallis Report'). The Murray review covered many aspects of the operations of the financial system, including capital adequacy, prudential regulation, and taxation. It considered many problems related to consumer protection, spurred by thousands of submissions from the public (regarding overcharging, inappropriate lending, and other misdeeds). The review's 44 recommendations included a call to reform remuneration structures (especially in the insurance and wealth management businesses) to better align agent and advisor behaviour with consumer interests.

Performance of the Australian Securities and Investments Commission (Senate Standing Committee on Economics, 2014)

This Senate inquiry investigated misconduct by advisors at Commonwealth Financial Planning Ltd. (a former unit of CBA), and also considered inadequacies in ASIC's response to both the causes and consequences of this misconduct. The Senate report presaged several of the problems in compensation practices and inadequate control systems within the banks later documented through the current Royal Commission. The inquiry concluded that the problem could not be ascribed to the actions of one or a few "rogue" employees. Rather, the Senate report emphasised the structural roots of misconduct, arising from inappropriate corporate culture and compensation practices:

> "[The industry has] an aggressive sales-based culture wherein advisers pushed clients into inappropriately high-risk products both to earn bonuses and 'avoid getting the sack'.... CFPL/the CBA appeared willing to turn a blind eye to non-compliant advisers, so long as they were earning significant revenue for the company." (pp. 113-114)

Financial Advice: Fees for No Service (Australian Securities and Investments Commission, 2016)

In response to public concern about unfair or misleading fee collections by financial service providers, ASIC initiated an investigation into the common practice of collecting fees for services (such as annual reviews of customers' financial situation) that were not ultimately provided. The investigation confirmed that incentive compensation schemes were a driving factor behind this misconduct:

> “The financial advice industry still had a culture of reliance on automatic periodic payments, such as sales commissions and adviser service fees. Some advice licensees prioritised advice revenue and fee generation over ensuring that they delivered the required services. Cultural factors in the banking and financial services institutions covered by this report may have contributed to the systemic failures we observed.”

Independent Review of Product Sales Commissions and Product Based Payments (Consumer Action Law Centre, Financial Rights Legal Centre, and Good Shepherd Microfinance, 2016)

This cooperative research project, undertaken by several consumer advocacy organisations and financially supported by the banking industry, highlighted the susceptibility of low-income and other vulnerable households to high-pressure commission-seeking sales practices:

> “We are sufficiently convinced of the negative outcomes of commission driven sales to contest the value of retaining such incentives, and believe that a major cultural shift in banking practice is necessary for the public good.” (p.1)

Retail Banking Remuneration Review Report (Sedgwick, 2017)

This task force was established by the Australian Banking Association to respond to repeated criticisms that incentive systems in financial firms encouraged sales staff to mislead customers, sell products or services that were inappropriate or not needed, and otherwise undermine the interests of bank customers. Its terms of reference (also established by the ABA) limited its inquiry to remuneration for non-executive employees of banks; it did not consider the impact of executive compensation schemes on bank behaviour. The task force was headed by Stephen Sedgwick, and made 21 recommendations. Several touched on the issue of remuneration structures in financial services, including:

- Banks should remove variable reward payments and campaign incentives that are directly linked to sales or the achievement of sales targets (including, but not limited to cross sales, referral targets, and profit and revenue targets).
- Eligibility to receive variable reward payments should be based on an overall assessment against a range of factors that reflect the breadth of the responsibilities of each role.
- Variable reward payments should no longer include any: accelerators related to financial measures; accelerator-like modifiers to financial measures; financial gateways (including but not limited to those that relate to the number or value

of cross sells); and other mechanisms related to financial measures that have accelerator-like effect on the value of variable rewards available.

- Variable reward payments should ultimately amount to a relatively small proportion of fixed pay, with a progressive reduction in the maximum variable rewards amount payable in any schemes that require a transition period to implement this recommendation.
- Any financial measures included in an overall assessment should be product neutral; and in the case of a scorecard, together attract a maximum effective weight of 50 percent as quickly as systems and other changes can be introduced, falling to 33 percent or less by 2020.
- Credible behavioural or equivalent values gateways should be applied to determine whether an individual can access any variable rewards to which they might otherwise be entitled.

Independent Governance Expert Report: Australian Banking Industry, Package of Initiatives (McPhee, 2018)

Parallel to the Sedgwick report, the Australian Banking Association also launched a separate initiative to review the industry's progress toward reform (including its implementation of the Sedgwick recommendations). This process was headed by Ian McPhee, former Auditor-General, and issued a series of reports (the last in June 2018). The initiative was clearly part of the banking industry's effort to avoid more stringent regulations from government – and to forestall demands for a Royal Commission, in particular. McPhee reported partial but incomplete implementation of the Sedgwick recommendations, and called on the banks for more transparent reporting of its experience under the reforms.

Remuneration Practices at Large Financial Institutions (Australian Prudential Regulation Authority, 2018)

Australia's prudential regulator, the APRA, recently investigated compensation systems for senior bank executives. The research included a review of the specific structure of salary, deferred, stock-based and other compensation components for corporate leaders. They are the individuals with most influence over both the business direction of the banks, and their internal ethical standards and culture. The review found that senior executive compensation practices often created incentives for bank leaders that undermined the goals of both customer service and financial stability:

> "Remuneration frameworks and practices across the sample did not consistently and effectively meet APRA's objective of sufficiently encouraging

> behaviour that supports risk management frameworks and institutions' long-term financial soundness." (p.4)

The report was not specific about how these weaknesses would be addressed, other than promising to address the issues in its forthcoming "Banking Executive Accountability Regime." The Interim Report of the Royal Commission was critical of APRA's relatively passive response to these serious findings.[14]

Financial Advice: Vertically Integrated Institutions and Conflicts of Interest (Australian Securities and Investments Commission, 2018)

Another ASIC investigation focused on conflicts of interest in the sales effort of financial employees who simultaneously offer financial advice to customers, while also selling financial products issued by their employer. A detailed sampling of financial advice case studies confirmed that advisors are far more likely to recommend and sell products offered by their own firms, than other competing products. Over two-thirds of total sales were concentrated among in-house products – but those in-house products constituted only about one-fifth of the inventory of approved products which advisors *could* have recommended. Shockingly, ASIC found that proffered financial advice was non-compliant with ASIC standards in 75 percent of cases reviewed.

Combined Industry Forum Progress Report: Working Towards a Better Mortgage Broking Industry for Customers (Mortgage and Finance Association of Australia, 2018).

Similar to the Sedgwick Report and the Independent Governance Expert Report ("McPhee Report"), the Combined Industry Forum (CIF) initiative is another industry-led effort (this one sponsored by the Mortgage and Finance Association of Australia) to address widespread public concerns regarding conflicts of interest – in this case regarding the actions of mortgage brokers. The report recognised the conflict of interest embedded in sales-based commissions, and suggested they should be abolished. Whether a non-enforceable industry-led initiative like this could achieve that outcome seems questionable.

Experience in Other Jurisdictions

Problems with conflicts of interest in remuneration schemes for financial services have been confronted by regulators and policy-makers in other jurisdictions, all the more so in the wake of the Global Financial Crisis. The U.K. implemented an outright ban on commissions in the sale of financial advice, moving to a more transparent up-front fee-for-service model (Collinson, 2012; Baumanns, 2017). This greater transparency has

[14] See Royal Commission (2018b), p.320.

had uneven effects: advice for high-wealth individuals is considered to have improved in quality, but mass market financial investors are deterred from purchasing advice by the up-front cost, raising questions about how they will make appropriate financial decisions in the future.[15] In the U.S. an initial effort to impose a basic fiduciary responsibility requirement on financial advisors (which would have simply required them simply to act in the best interests of their clients) was recently overturned in court – to the glee of the financial industry (Conish, 2018). In the European Union, a new Markets in Financial Instruments Directive (MiFID) only requires greater transparency regarding commissions and other fees, rather than restricting or prohibiting sales-based incentives. The assumption is that better-informed consumers will then be able to choose their advisors more wisely, and at least be aware of potential conflicts of interest (Stafford, 2017). Past experience suggests that this faith in an "educated consumer" will not lead to significantly better outcomes. These experiences in other jurisdictions reinforce Mr. Hayne's concern that we cannot rely solely on top-down regulatory oversight to enforce better behaviour from an industry driven by a hunger for profit. Instead, a more embedded commitment to fair practice, ethical standards, and transparency, buttressed by the ability of participants within the industry to uphold those standards themselves (rather than waiting for regulators to do the job), is required. Sector-wide collective agreements, which clearly spell out compensation practices, ethical standards, and mechanisms for monitoring and enforcing those provisions, could play a very important role in this regard.

Other Research

In addition to these previous government, regulatory, and industry-led initiatives, abundant academic research has also confirmed the numerous and varied consequences of perverse incentives and conflicted compensation in the financial industry. Inappropriate or conflicted compensation systems have had negative consequences for consumer welfare, financial efficiency, and even for the stability of the entire financial system. We cannot provide a complete survey of the published literature in these areas, but we present a few references to highlight the scale and seriousness of the consequences that have been identified in independent research:

- A detailed study of loan approval and default experiences at a major U.S. bank found that a shift in compensation practices from salaried to commission-based

[15] Some might suggest that this problem proves the commission-based system should have been left in place. But that implies it is better to offer consumers conflicted advice, financed from hidden revenue streams, than to offer them no advice at all. The ultimate reason for this "advice gap" is a pension and savings system that is based on individuals (even those of modest means and financial literacy) making personal decisions about investment allocation and other crucial financial choices – instead of managing those decisions and risks on a collective basis.

payments had a very large impact on loan volumes, quality, and repayment rates (Agarwal and Wang, 2009). The case study found that switching to an incentive-based compensation system resulted in a dramatic increase in the approval rate for loan applications (which increased 47 percent), but also a noted increase (of 24 percent) in the default rate. Ironically, the costs associated with more frequent defaults actually outweighed the additional revenue from increased sales, resulting in reduced net profitability of lending activity at the bank.

- A controlled experiment tested the response of loan officers at a major Indian bank to a large sample of loan applications under varying compensation schemes (Cole, Kanz, and Klapper, 2012). Even after controlling for the quality and credit-worthiness of specific applications, more aggressive incentive-based compensation practices (tied to the volume of loans issued) led to clear increases in the rate of approval of new loans, but also to lower loan quality and repayment. This outcome further confirmed the negative impact of sales incentives on responsible lending.
- A detailed academic review of various efforts to regulate sales commissions in the banking industry (Pearson, 2017) found that partial limits on commission-based selling of loans and other products had generally unsatisfactory results, and that the perverse outcomes associated with compensation incentives have proven resilient. The review concludes that "incentives propel unnecessary and sometimes illegal risk taking and help create a 'bad' corporate culture. They increase sales of financial products that are inappropriate or unsuitable for the buyer." (p. 155)
- A joint research project conducted by several consumer advocacy organisations (Care Inc. Financial Counselling Service et al., 2016) confirmed that sales incentives and commissions played an influential and counterproductive role in the sale of expensive, inappropriate, or unnecessary financial products and services to low-income or vulnerable people (pp. 79-84).
- A direct survey of Australian consumers revealed widespread experience with unsolicited offers of credit and related services (including new credit cards, increased lines of credit, various insurance products, and others) from Australian banks and other financial firms (Fear, Denniss and Richardson, 2010). Consumers reported that the vested interest of salespeople in "pushing credit" (experienced through sales commissions and other rewards) was an important factor behind these unsolicited credit offers.

The consequences of conflicted remuneration schemes and other perverse incentives within the banking system are not limited solely to their negative impact on the interests of financial consumers, nor to their consequences for quality and stability of worklife for financial sector employees. The inappropriate sales and lending activities sparked by these incentives can even pose broader risks to the stability of the banking system, and hence to overall macroeconomic performance. These risks were highlighted, of course, during the Global Financial Crisis of 2008-09, which was sparked to a significant degree by imprudent lending practices in U.S. property markets, in turn stimulated by irresponsible incentive programs. Numerous scholars and expert inquiries have drawn the connection between conflicted compensation schemes and the resulting precarity of loan quality, which eventually resulted in the collapse of several major lending institutions and the near-collapse of the financial system in general. For example, former U.S. Federal Reserve Governor John Tarullo highlighted the impact of flawed compensation in stimulating unduly risky lending activity:

> "Compensation practices at banking organizations preceding the financial crisis… did, in fact, contribute to safety and soundness problems… some firms gave loan officers incentives to write a lot of loans, or traders incentives to generate high levels of trading revenues, without sufficient regard for the risks associated with those activities. The revenues that served as the basis for calculating bonuses were generated immediately, while the risks might not have been realized for months or years after the transactions were completed. When these or similarly misaligned incentive compensation arrangements were common in a firm, the very foundation of sound risk management could be undermined by the actions of employees seeking to maximize their own pay." (Tarullo, 2009, p. 3)

The former President of the American Finance Association, Luigi Zingales, reminded economists that incentives and competition are powerful tools in steering human behaviour, from the bottom to the top of an organization. Hence it is essential that those incentives be aligned with behaviour that is ethical, efficient, and sustainable:

> "If the most profitable line of business is to dupe investors with complex financial products, competitive pressure will induce financial firms to innovate along that dimension." (Zingales, 2015, p. 1351)

U.S. financial executive Michael Jacobs bluntly summed up the impact of remuneration practices on macro-prudential performance:

> "Misaligned incentive programs are at the core of what brought our financial system to its knees." (Jacobs, 2009)

Similarly, a former Australian bank executive, Chris Cuffe, put the matter in equally clear terms:

> "In my view, the scandals in financial advice, life insurance and rate-setting are primarily caused by one thing: the remuneration structure. Pay someone to behave a certain way and there's a good chance they will." (Cited in Yeates, 2016)

These warnings about the impact of perverse incentive structures on the integrity and stability of the broader financial system seem especially timely and relevant for Australia's financial sector at the present juncture. Concerns are now growing about the contribution of aggressive and irresponsible lending practices to the rapid escalation of property prices in recent years, especially in Sydney and Melbourne. Commissions paid to lending officials, and robust profits captured by their employers, provided ample motivation to push potentially dangerous products (including interest-only mortgages, variable rate loans, and others) into an already-overheating property market. Now that housing prices have turned down in those cities, the fragile financial underpinnings of the property boom are suddenly (and painfully) clear: many homeowners will find themselves in zero- or negative-equity positions, banks will need to reevaluate the value of collateral, loan losses and foreclosures could mount, and damage to the capital foundation of the financial system could become significant. Of course, if they had been implemented years ago, reforms to compensation systems in the financial industry would have helped to avoid this fragile situation. Now prompt, determined action to fix the problem is all the more important – better late than never.

In summary, these governmental, regulatory, and industry-led inquiries and task forces, along with independent academic research, point to several robust conclusions. All the analysts surveyed, and even banking executives themselves, acknowledge that misconduct by the financial industry is widespread, and cannot be attributed to the actions of a few rogue individuals. All have identified the structural impact of conflicted or inappropriate compensation systems, creating incentives for product design, marketing, and sales that often undermine the true interests of financial consumers – and in worst-case situations imperilling the integrity and stability of the whole financial system. Industry-led attempts at reform and self-regulation in the wake of these scandals (such as the Sedgwick and CIF exercises) have clearly not constituted an adequate or complete response, given the scale of the misconduct. But neither have official regulatory agencies adequately confronted the problem – despite their power and responsibility to ensure compliance with laws, regulations, and community norms. Clearly, additional tools are required to resolve the issues highlighted by the Royal Commission (and which were well-known even before that

Commission was established). Establishing sector-wide benchmarks for ethical and prudent compensation structures, and empowering representatives from both management and trade unions to monitor and enforce those standards, would constitute a powerful supplement to conventional regulatory initiatives.

IV. Competitive Pressure and the "First Mover" Problem

While the problems with conflicts of interest, inappropriate selling, and opaque or misleading communication have been tied to flaws in compensation practices at financial institutions, it has been difficult for individual businesses to attempt to rectify their own practices because of their concerns regarding the resulting consequences for sales volumes and market share. Regardless of the large size and combined market share of the major banks, there is no doubt that Australia's financial sector is intensely competitive: banks, near-banks and other financial businesses compete fiercely for customers. And the senior executives of those companies are evaluated relative to the performance of their counterpart institutions. It is difficult to imagine an individual firm, no matter how enlightened or responsible its senior leadership, moving unilaterally to reform compensation practices that – despite their adverse impacts on consumer welfare and transparency – indubitably add to the firm's revenue and profit performance.

The Royal Commission received evidence regarding the role of market competition in compelling firms to maintain conflicted compensation practices despite their acknowledged negative consequences.[16] And the Interim Report acknowledges the relevance of the "first mover" problem in several passages. For example, the Interim Report cites correspondence from the former Chief Executive of CBA indicating that the de-linking of incentives from the value of loans issued by banks would need to occur "across the industry." (p. 56). The Interim Report was later more explicit, noting

> "Evidence … showed that even if doing business in a particular way was of actual or possible disadvantage to customers, the banks would not alter that way of doing business if unilateral change would bring significant competitive disadvantage." (p. 68)

Later, the Interim Report referred again to the constraining impact of competitive pressures on efforts to reform compensation systems:

> "To outlaw all conflicted remuneration would diminish income that licensees now receive. It would follow, so the argument went, that

[16] See, for example, testimony received by the Commission on March 14, 15, and 23, available in the transcripts posted by the Commission at https://financialservices.royalcommission.gov.au/public-hearings/Pages/Exhibits.aspx.

> clients would have to pay more for advice. And more than one witness suggested that no one licensee could afford to be the 'first mover' in this area for fear of suffering a commercial disadvantage in relation to those who chose to maintain the payments." (p. 94)

The Interim Report's judgment that competitive pressures will constrain efforts to reform compensation systems one firm at a time, is consistent with independent academic research that firms will maintain flawed compensation practices so long as they assist in defending market share, revenue, and profitability. Pearson (2017), for example, cited that commission-based pay systems are considered essential "for retaining market share." (p. 155) Fear, Denniss and Richardson (2010) highlighted the impact of extensive cross-ownership of financial firms (particularly among the large banks) in promoting a "herd mentality" across the whole industry. Any move by one bank which could undermine profits of other banks will be resisted by that bank's shareholders – who also typically have major investment holdings in the other banks. This feature of the industry's industrial structure would further inhibit initiatives to improve ethical practices at individual institutions.

One way, of course, that this first mover problem can be overcome is through comprehensive regulatory strictures applied simultaneously to the financial sector as a whole. Because of the complexity and poor enforcement of existing regulations regarding consumer protection, transparency, and compensation schemes, however, the option of simultaneous sector-wide regulation confronts its own challenges of design and implementation. A deep-seated culture of ignoring or evading ethical and regulatory standards when they conflict with goals of profit-maximisation is another barrier to the efficacy of top-down regulation – not to mention the considerable cost of undertaking more intensive oversight and compliance efforts.

An alternative strategy for reforming compensation practices across all participants in the industry (rather than expecting any particular company to "move first") is through the negotiation and implementation of sectoral collective agreements specifying harmonised compensation principles, pay levels, and ethical standards for all competitors. This approach would preserve a "level playing field." All competitors would be compelled to meet equivalent and clear standards regarding the design of compensation schemes – consistent with principles of fairness and transparency. Complementary provisions of a sectoral collective agreement would establish consistent reporting and representation systems – so that financial industry employees would be fully aware of their rights and obligations to uphold clear standards of behaviour, and would be protected in reporting violations of standards. Other benefits of a sector-wide collective agreement for ethical and transparent practice would include an emphasis on consistent training, accreditation and certification procedures for workers across the industry (so they can become better aware of the principles and expectations associated with their work), and resulting improvements in employee mobility between firms. A uniform and transparent dispute-settlement procedure (including conciliation and arbitration mechanisms) to ensure that the terms of sectoral agreements are fairly and consistently applied, and clear processes for disciplinary action in the case of employees who violate professional and ethical standards, would further reinforce the integrity of this consistent approach to regulating practices across the industry.

V. Sectoral Collective Bargaining: Regulating & Standardising Compensation

A collective agreement typically specifies a range of job classifications (often associated with specific skill, qualification, responsibility, and/or experience metrics), and a corresponding pay grid describing the structure, composition and level of compensation for each classification. The definition of and requirements for the various job classifications would be subject to negotiation, as would be increments in compensation associated with movement between classifications, and annual or more frequent adjustments to pay levels specified in the grid. The relevant Modern Award sets a floor for job classifications, pay and conditions in any collective agreement, through application of the "Better Off Overall Test" (BOOT).

The collective negotiation of compensation on a sectoral basis would be of significant potential value in helping the financial industry develop more ethical and appropriate compensation practices. First, these collective agreements could codify prohibitions on conflicted compensation systems, and specify what sorts of base compensation and performance bonuses are legitimate and ethical. Consistent rates of pay and bonus formulae would be established for various job classifications. Those rates would be consistent for similar positions, in various workplaces and companies where similar types of work are performed. It is possible that different pay grids would be specified for different sub-sectors of financial activity (potentially enshrined within separate collective agreements, or as subdivisions within a single overarching collective agreement). For example, both the structure and the level of pay could vary between major banks, smaller banks and intermediaries, financial advisors and brokers, superannuation funds, and other categories of financial service providers. In every case, compensation would become more standardised and transparent, and less subject to the particular subjective judgments and decisions of individual managers. Other aspects of the employment relationship (including working conditions, paid leave, superannuation, qualifications, certifications, and evaluation and discipline procedures) would also be standardised across workplaces. The consistency and transparency of pay thresholds would help to reinforce adherence to ethical standards, avoiding the secrecy and arbitrariness common in many present-day sales-based incentive schemes.

It is entirely possible, if the parties to negotiation were to determine so, that some components of variable pay would be maintained within the overall compensation package offered across the industry. Importantly, however, these components would need to comply with a general prohibition on conflicted pay practices. The precise form of variable compensation provisions would depend on the preferences and priorities of the parties to the sectoral agreement, as determined and balanced through negotiation. The advantages of using the structure of a sectoral collective agreement to define and manage variable pay, however, make this approach far superior to the unregulated, unreliable and often unethical nature of present-day sales- and commission-based incentive structures. For example, the sectoral agreement would be transparent and visible; its definitions of bonuses and incentives would have to be absolutely devoid of the negative features (such as tying compensation to volume of lending or sales) which have contributed to past financial misconduct. Furthermore, the prohibition of specific kinds of bonuses would be applied uniformly and fairly across the whole sector – avoiding any “first mover” problem for the firms which move quickly to adopt new practices. Methods and rules to be followed in determining and paying variable pay would also be clearly specified in the agreement, and would be enforceable under the administration and dispute settlement procedures specified in the agreement and under industrial relations law. Hence these payments would not be as contingent on the (often ethically non-compliant) subjective practices and judgments of individual managers. Moreover, any disputes over the application of variable pay components would be resolved through fair and expedient dispute resolution (including access to conciliation and arbitration), as specified in the agreement and industrial relations statute. This would give workers more confidence in the consistent application of variable pay provisions, hence ensuring that those components of pay have maximum intended impact on behaviour and performance.[17]

Examples of bonus or variable pay components that could be specified in a sectoral collective agreement, and would be compatible with more ethical compensation principles (as suggested in the Interim Report), could include:[18]

- Profit-sharing bonuses paid on a per-capita or percent-of-base basis equally across all workers in a firm covered by the collective agreement.

[17] Research has shown that when variable pay promises are not reliably and transparently implemented, their effect on individual behaviour is muted.

[18] This is an illustrative list intended solely to indicate that a wide range of variable compensation pay structures could be compatible with both a sectoral collective bargaining process and the reform principles for compensation design suggested by the preceding critique of sales- and commission-based incentives. No judgment is implied here as to the desirability of any particular bonus scheme; the point is merely to show that many options are possible even within a collective bargaining system.

- Equalised performance bonuses tied to performance metrics measured at the level of groups, divisions, regions, or branches.
- Individual performance bonuses tied to metrics such as attendance, customer satisfaction, compliance with professional and regulatory requirements, attainment of advanced training, and others.

In sum, there are many possible ways to design variable and incentive systems that would sever the current link between compensation and the volume of financial products sold or administered. Abolishing current sales- or revenue-related incentives, which have exerted such a negative impact on responsible lending and ethical practices across the industry, does not imply that all bonus or incentive measures must be prohibited – only that they be designed in a manner that supports, rather than undermines, the industry's adherence to ethical and prudential practice. Similarly, incremental changes to non-monetary performance management and discipline systems would also help to ensure that financial workers are not compelled into unreasonably aggressive sales techniques or other negative practices.[19] The claim that these high-pressure sales incentives (whether positive or negative) are essential to elicit appropriate effort and productivity by financial sector employees is not credible.

Once an appropriate and standardised compensation structure was agreed and implemented in the firms directly participating in the collective negotiations, a sectoral collective agreement would also aim to specify mechanisms for extending the application of those practices across the relevant sector or sub-sector covered by the agreement. The extension of a sectoral agreement to apply in all workplaces in the sector would help ensure that standards and principles were not watered down by factors such as new entrants; sub-contracting of work to third parties; and the use of independent contractors and third parties (instead of bank employees) to perform certain tasks. Ideally, uniform compensation for a defined category of work would be paid (in accordance with the sectoral agreement) no matter the form of business within which that work occurred. This broad extension of compensation principles through wide application of the a sectoral agreement would help to eliminate the process of "regulatory arbitrage" – whereby firms evade the provisions of a regulation or collective agreement by outsourcing and other reorganisation strategies.

[19] For example, a recent tentative enterprise agreement negotiated between Westpac and the Finance Sector Union would implement significant reforms to sales rooms and performance management systems, including establishing confidentiality for personal performance ratings; both measures would help to limit unreasonable pressure on staff to hit sales or revenue targets, on pain of public criticism or humiliation among a worker's peers. See Workplace Express (2018) for details. This is an example of how collective bargaining can lead to fairer and more ethical compensation practices.

VI. Other Benefits of Sectoral Collective Bargaining

The Royal Commission, like many previous inquiries, identified conflicts of interest and unethical practices in compensation as a key driver of much of the financial misconduct identified in its investigations. But the structure of compensation was not the only source of those problems. Similarly, there are other ways in which the standardisation and protection provided by a sectoral collective agreement could help guide the whole industry toward more ethical and appropriate behaviour.

Here are several other potential benefits of sectoral collective bargaining for improving standards of behaviour within financial businesses:

- ***Voice and representation***. A sectoral collective agreement would establish regular processes for employees in the industry to participate in management discussions and planning; provide feedback and input on all aspects of the business; and express their concerns about workplace practices. Individual employees could be confident they would not be disadvantaged by providing input, feedback, or reporting on illicit practices within their purview. Regular and safe channels for employee input would be established at all levels of the industry – from individual branches right up to corporate boards of directors. The benefits of regularized, secure channels for "employee voice" are well-documented in academic research,[20] and include improved productivity, higher employee retention, and a more innovation-conducive workplace culture.

- ***Protection for whistleblowers***. A particularly important dimension of the generalized facilitation and protection of employee "voice" is the ability of a collective agreement to provide better protection for employees who discover and report unethical, inappropriate, or illegal behaviour within their organizations. Past examples of misconduct in Australian financial institutions have confirmed that unethical or illegal behaviour often continues within organizations even after many staff became aware of the problem.[21] Reluctance to report misconduct for fear of jeopardizing their own positions is

[20] See, for example, Wilkinson et al. (2014), Boxall et al. (2007), and Blinder (1990),

[21] The example of misconduct that continued within CBA's Commonwealth Financial Planning Ltd. for years after it was first detected, is an especially egregious example; see Senate Standing Committee on Economics (2014) for details.

clearly one factor contributing to this tolerance of misconduct within financial firms. By specifying clear and reliable channels of reporting and representation, ensuring that due process is followed in any discipline or dismissal proceedings, and providing all financial workers with confidence that their welfare will not be harmed by reporting misconduct, a more honest and transparent culture can be achieved.

- ***Professionalization, qualifications and certifications***. The Interim Report highlighted the need for stronger and more regular professional education and certification procedures for financial workers, as part of the broader challenge of instilling an ethical culture in banks and other firms.[22] Sectoral collective bargaining can make an important contribution toward the professionalization of finance sector work. A collective agreement specifies specific occupational categories and levels, as part of the task of standardizing and harmonizing pay and conditions for different roles. Those categories and levels are typically defined with respect to defined, portable qualifications and certifications, along with experience and tenure. A sectoral collective agreement would be useful in clarifying and harmonizing these job definitions across different firms in the sector, and explicitly spelling out the certifications and credentials required for each. Requirements for ongoing professional training and upgrading can also be defined and attached to each job level and pay grade (including training related to codes of conduct, ethical standards, and related topics), providing reliable incentives for workers to accumulate training and certifications. A sectoral agreement would also specify the rights and responsibilities of finance workers with respect to ethical and professional obligations, ensuring they are empowered to refuse to perform work that contradicts those obligations.

  Negotiation of training and adjustment programs. In addition to the value of a sectoral agreement in regularizing qualification and certification standards for different roles in the financial industry, it would also include provisions supporting ongoing training and upgrading for financial sector employees. A sectoral agreement could specify how training opportunities would be allocated, provide for time away from work, and clarify funding provisions. By making it clear that career-long training and upgrading is a normal, expected part of financial services work, and indeed tying qualifications to specific job classifications and pay grades, a sectoral agreement contributes to building an industry culture in which professional standards and ongoing upgrading are both valued and effectively facilitated.

[22] See, for example, Royal Commission (2018b), p. 104.

- ***Adjustment and technological change***. A similar and complementary benefit of sectoral collective agreements could include provisions regarding information sharing and joint management of closures, relocations, and technological change in financial services. Financial services are being dramatically affected by new technologies – from online banking and transactions to blockchain systems and digital marketing techniques. The potential for unintended consequences or even outright abuse in these new technologies has not been thoroughly considered; neither has the impact on job security for finance sector workers. A sectoral collective agreement could specify provisions regarding advance notice and consultation regarding technological change, rights to input and negotiation during implementation, measures to ensure integrity and safety under new technologies, and provisions to support affected workers to be retrained or reassigned to other roles in the organisation. In all of these ways, the "human element" in banking can be preserved in ways that enhance customer experience while also providing oversight regarding compliance with standards, the integrity of ethical behaviour, and more. Similar provisions would govern adjustment to other structural changes that occasionally occur in the industry (such as branch closures and other redundancies) – to support affected workers in preparing for these changes, and retraining and redeploying to new roles.

- ***Enhanced mobility across firms***. With the implementation of standardized job classifications, consistent training and qualification requirements, and portable certifications for various roles within financial services, the industry will attain a greater degree of mobility by workers across different firms and sub-sectors of the industry. At present, the informal, company-specific nature of training and many qualifications limits the ability of even experienced financial professionals to seek work in other firms; large differences in compensation for similar jobs at different firms (reflecting the arbitrary and individualized nature of salary determination at present) further limit movement between companies. This lack of mobility is economically inefficient (inhibiting an optimal match between the skills and preferences of individual workers, and the characteristics of their jobs); it can also promote a more insular, "captive" workplace culture, in which employees who feel they have no other options put up with practices that are damaging, unethical, or even illegal. Harmonized and transparent job definitions and qualifications would facilitate more mobility and interchange between financial firms, and thus contribute to the uniform spread of better cultural and ethical practices throughout the industry.

- ***Limits on outsourcing and offshoring employment***. Collective agreements often include provisions which regulate or limit the extent to which work can be transferred outside of an enterprise – for example, shifted to independent contractors and sub-suppliers, or even “offshored” to service centres located in other countries. Experience has shown that problems of perverse incentives and financial misconduct are often concentrated among independent or “third party” suppliers (such as the mortgage brokers, mortgage aggregators, “introducers,” and sub-contracted financial advisors which are discussed at length in the Interim Report). A sectoral collective agreement could define when, and under what conditions, such work can be transferred away from direct employees to outside suppliers. The consistent application of transparent compensation practices across the whole sector would also reduce the lure for firms to arbitrage labour costs through superficial shifts in corporate structure and sourcing. A sectoral agreement could also specify minimum training, certification, and professional standards for any outside work – supplementing similar provisions already specified by some financial regulatory bodies (but inconsistently enforced in practice).

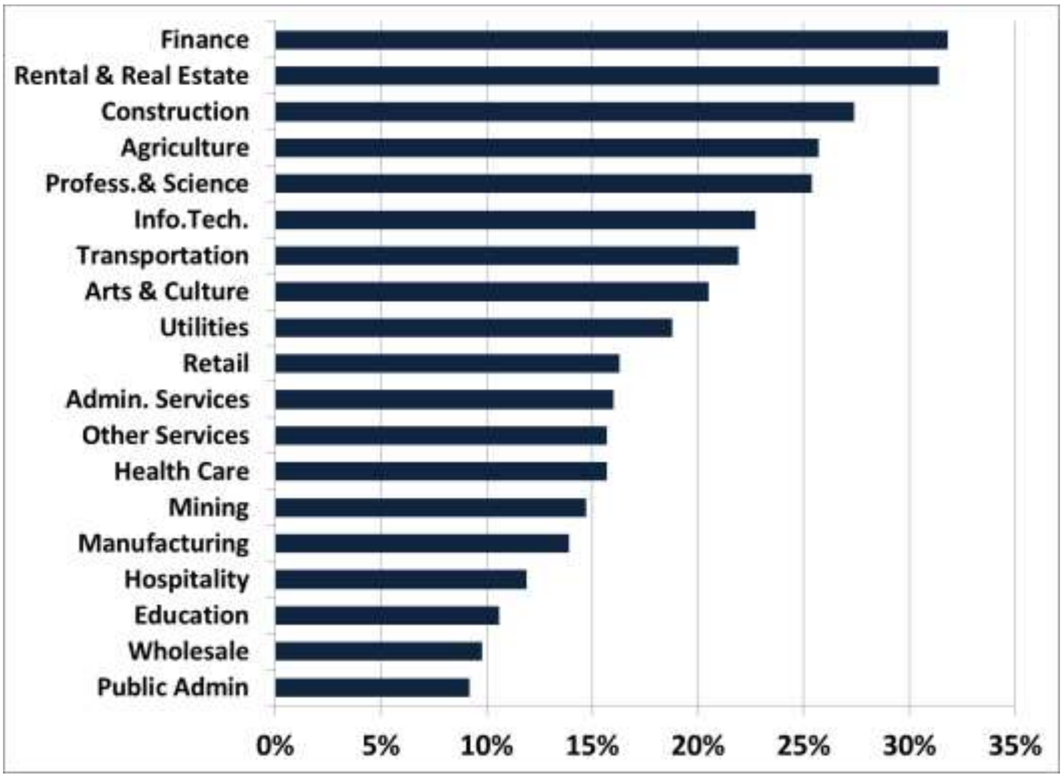
- ***Reducing the gender pay gap***. As illustrated in Figure 1, the financial industry has the largest pay gap between men and women of any sector in Australia’s economy. On average in 2016-17, men received total compensation 32 percent higher than women in the industry. That is almost half-again as large as the average gender pay gap in total compensation across other Australian industries (22 percent in 2016-17).

  The relatively large reliance on incentives and other forms of variable pay are a key reason for this relatively large gender gap. Compensation other than base pay forms a relatively large share of total compensation in finance: 37 percent over base pay for men, and 24 percent for women. That is higher than almost any other industry.[23] But average bonuses paid to men (over $43,000 in 2016-17) are more than twice as high as those paid to women (less than $21,000). The relative importance of incentive pay in finance, and the typically non-transparent nature of the payments (such that women are less aware of their relative underpayment, undermining their own pay expectations and demands) clearly contribute to the large gender pay imbalances in this sector. Moving to a

[23] Only mining has a higher average reliance on non-base pay (37 percent over base for men, and 32 percent for women). However, supplemental pay in the mining sector consists more of overtime pay (rather than performance-related bonuses). All figures based on Workplace Gender Equality Agency (2018), Table 3 and 4.

more transparent and standardised compensation system through a sectoral collective agreement, would have a major positive impact on gender equality in finance.

Figure 1. Gender Pay Gap by Industry, 2016-17



Source: Author's calculations from Workplace Gender Equality Agency (2017), Tables 3 and 4. Proportional premium paid to men relative to women, total compensation.

In sum, by regularizing workplace practices (including compensation, representation and communications), standardizing job definitions and qualifications, and ensuring the regular and uniform application of high standards of ethical and professional behaviour, sectoral collective agreements in the financial industry would constitute a powerful complement to other financial reform efforts (including the implementation and enforcement of new laws and regulations).

VII. Conclusion and Next Steps

The preceding discussion has indicated that sector-wide collective bargaining, and the implementation of sectoral collective agreements, would constitute an important tool in the effort to reform compensation practices in the financial sector, and reduce the incentives for behaviour inconsistent with ethical practice and responsible lending. Sectoral, multi-employer, and pattern collective bargaining are common and well-established features of industrial relations systems in most advanced economies, and there are many other advantages to these practices (on top of specific benefits for financial industry compensation, as described above). Industrial relations experts, academic researchers, and policy-makers around the world have confirmed the benefits of sector-wide collective bargaining processes for a wide range of economic performance indicators: including employment, real wage growth, and wage equality. Published research has confirmed that more coordination in collective bargaining (across firms and entire industries) permits a better match between real wage growth and productivity trends, reduces industrial conflict, and ensures better gain-sharing between workers and employers.[24]

Of particular note, the Organization for Economic Cooperation and Development (2018) recently published new empirical research that categorises industrial relations systems across its member countries according to degree of coordination of collective bargaining, and then benchmarks the economic outcomes associated with those different types of systems. The OECD research identified five broad types of industrial relations coordination, ranging from "fully decentralised" systems to "centralised and coordinated" systems.[25] Importantly, the OECD found that countries with the most coordinated industrial relations systems (including sector-wide agreements) demonstrate the strongest outcomes in terms of employment, robust productivity growth, more inclusive opportunities for young workers and other underemployed segments of the population, and less inequality in incomes:

> "Co-ordinated collective bargaining systems are associated with higher employment, lower unemployment, a better integration of vulnerable groups and less wage inequality than fully decentralised systems.

[24] See, for example, Aidt and Tzannatos (2002), Blanchard (2006), ITUC (2013), Unifor (2015, Part VI), Hancock (2016), Ewing et al. (2016), Isaac (2018), and Kyloh (forthcoming).

[25] Australia is assigned to the second-most decentralised category in this taxonomy, because of the influence of the awards system in establishing certain consistency in compensation and work practices across sectors.

> Previous evidence also showed that these systems help strengthen the resilience of the economy against business-cycle downturns." (OECD, 2018, p. 110)

At present, however, these multiple benefits are not attainable in Australia's labour market, since multi-firm or sector-wide collective bargaining is effectively prohibited under Australian industrial relations laws.[26] What next steps would be required in order for Australian industry to capture the benefits of sectoral collective bargaining – both benefits specific to the financial industry (arising from reforming conflicted compensation systems), and broader benefits produced by sectoral bargaining in any industry?

First and most importantly, the unique restrictions on sectoral bargaining which are in place in Australia must be relaxed. Industrial relations law must be liberalised so that normal collective bargaining (including standard features such as dispute settlement, representation, and arbitration) can occur at whatever level of aggregation workers collectively choose to pursue it: at a single firm, several firms, a sub-sector, or a whole industry. This is normal practice in other industrial countries: even in union-hostile jurisdictions like the U.S., where collective bargaining is very weak (for various reasons), there is no formal prohibition against multi-employer, pattern, or sectoral bargaining (which still occurs in a few industries[27]). Australia's intrusive prohibition against industrial action in multi-employer negotiations, and its complementary requirement that multi-employer negotiations are permitted only when each individual company volunteers to participate, has effectively barred parties from utililsing this potentially beneficial structure for negotiating standardised compensation and conditions.

After sectoral collective bargaining becomes legitimised in Australia through reform of industrial relations law, stakeholders and policy-makers will need to engage in a process to specify how sectoral agreement-making would work. This policy design would presumably draw on previous practices in Australia (prior to the effective prohibition of sectoral collective bargaining in the 1990s), the experience of other

[26] The Fair Work Act prohibits industrial action in support of multi-employer enterprise agreements, which means (in the absence of alternative dispute settlement mechanisms) there is no effective ability to negotiate. Limited exceptions to these prohibitions are allowed in specific industries characterised by pervasive low wages and weak employee bargaining power, under the so-called "low paid stream" defined by the Fair Work Act. However, as Cooper (2011) and Karp (2018) report, this provision has never been successfully utilised in practice.

[27] In the U.S. case, multi-employer or pattern bargaining takes place in the auto, steel, and hotel industries, among others. In most of Europe, Japan, and Korea, sector-wide collective bargaining is common.

industrial countries (where sectoral bargaining is a common and efficient practice), and new proposals advanced by industrial relations theorists and practitioners.[28] Features of sectoral collective bargaining that will need to be determined and implemented include: a process for defining the sector across which negotiations will occur;[29] a process for selecting duly representative bargaining agents, for both workers and employers; processes and timetables for sectoral negotiations; dispute settlement procedures (including a role for public agencies to facilitate negotiation, conciliation, and arbitration); procedures and regulations regarding industrial action; the creation of representation structures and communication mechanisms at the workplace, firm, and sectoral levels; mechanisms for extending application of a sectoral agreement to most or all workplaces in the sector; and an enforcement or umpire system to ensure that the sectoral agreement is respected in practice. Given the effective prohibition of sectoral collective bargaining in Australia over the past generation, we cannot here specify the precise details of a sectoral bargaining system – and the determination of those features is obviously beyond the scope of this Royal Commission. For present purposes, it suffices merely to note that sectoral bargaining systems function effectively in most industrial countries, and would certainly be viable and productive in an Australian setting too.

In sum, sectoral collective bargaining establishes sector-wide norms for compensation, training, working conditions, representation, communication, and dispute settlement. By establishing a sector-wide “level playing field” in the major dimensions of the employment relationship, sectoral agreements ensure that competition between firms occurs on the basis of genuine innovations and improvements in technology, quality, service, and productivity. They have been shown to be fully consistent with strong employment outcomes, reduced income inequality, superior productivity growth, and reduced industrial conflict.

In the case of Australia’s recalcitrant financial industry, sectoral collective bargaining would serve an additional “public good” function. In addition to specifying compensation practices compatible with ethical and prudent lending and sales practices (and which are fair for finance workers), a sectoral collective agreement would play an important complementary role in pushing the whole industry toward more appropriate and legitimate standards of behaviour. In this regard, sectoral collective bargaining is not just a way to improve the work lives of the hundreds of

[28] Such as those enunciated in Unifor (2015, Part VI), Hancock (2016), Ewing et al. (2016), and Isaac (2018).

[29] In the case of the financial industry, this could include separate sub-sectors (such as major banks, smaller intermediaries, superannuation funds, financial service providers, and other segments of the broader industry).

thousands of Australians working in the finance sector. It is also a way to enhance the public accountability of this vital part of the national economy.

In its six rounds of public hearings to date, and its Interim Report, The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry has exhaustively documented a pervasive pattern of misconduct in Australia's financial services industry. The self-interest of financial businesses in maximizing their own profits – even at the expense of fair practice, consumer welfare, and financial stability – has been properly identified by the Commissioner as the ultimate driving force behind this pattern. Moreover, the Commission has confirmed the many ways in which flawed compensation practices have contributed to this pattern of misconduct. An industry which rewards companies, and certain individuals working for those companies, for promoting, selling and administering products and services which are unnecessary, inappropriate, or destructive will experience scandal and consumer abuse time and time again. Until these underlying sources of misconduct are addressed and curtailed, the reputation of Australia's financial industry can never be comprehensively repaired.

Financial regulators must play a key role in preventing misconduct and enforcing better standards of ethical behaviour. Yes, the record of existing regulatory institutions in prosecuting violations and upholding expectations of behaviour is poor, as the Interim Report has confirmed. This should not, however, dissipate public expectations that regulators must do a better job in the future: enforcing existing laws and regulations, and implementing new measures to address the concerns raised through the Royal Commission process.

But thorough-going cultural change in a whole industry requires more than just the oversight of regulators from above: even if those regulators are more determined, independent, and successful in their actions than has been the case in the past. The goals of ethical and fair behaviour, and commitment to prudential and professional standards, must be taken up throughout the sector and its workforce. A crucial tool in this effort could be played by the negotiation and implementation of sectoral collective agreements covering employers and workers across the industry. These agreements would specify compensation systems that are both fair for financial sector workers, and compatible with the ethical and prudential goals identified by the Interim Report: namely, that financial enterprises and individuals must not be rewarded for activity which undermines consumer welfare or the integrity and stability of the whole system. By applying these standards uniformly and simultaneously across the whole financial industry, sectoral agreements would overcome the current barrier posed by competitive pressure – which presently inhibits individual firms, even if they did recognise the flaws of current practices, from "moving first" to reform them (for fear of undermining their own competitive position). Moreover, in addition to reforming compensation practices across the industry, sectoral collective bargaining would achieve other benefits consistent with a more efficient, transparent and ethical financial industry: including more reliable representation and communication practices, protection for whistleblowers, standardized certifications and qualifications for financial professionals, regular access to training and upgrading opportunities, and greater mobility for workers across the industry.

In conclusion, there is a clear coincidence between the desire of financial workers for more regular and ethically sustainable pay practices and working conditions, and the interest of financial consumers in an industry which serves the public interest rather than solely private profits. Sectoral collective bargaining in finance is a timely proposal that would complement other initiatives required to address the systemic misconduct exposed by the Royal Commission. However, implementing this important proposal would require significant changes in Australia's present industrial relations framework. For that reason, the Commissioner should recommend to the Commonwealth government that it reform its industrial relations laws to permit the use of sectoral collective bargaining (as commonly practiced in most other industrial countries). This would activate a powerful tool for upholding responsible lending and ethical standards across the whole financial industry.

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