Sales incentives and the UK FSA's Guidance – *More than just a reactive review is needed*

By Julian Ingleby and Duncan Brown
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This Alert summarises the final FSA guidance on the risk to customers from financial incentives; outlines the minimum that firms are required to do; sets out what firms have done to date; and suggests how to makes these changes as effective as possible.

OVERVIEW

Earlier this month, the UK's Financial Services Authority (FSA) published its final guidance for financial companies on the risks to customers from financial incentives. A consultation on proposed guidance concluded last October, following a review of 22 FSA-authorised firms between September 2010 and September 2011. The final guidance is largely unchanged from the consultation text, apart from some clarified wording and additional examples of good and bad practices.

The final guidance 1) gives examples of how incentive schemes can encourage mis-selling ("*a failure to deliver fair outcomes for customers*"); 2) shows how firms are not adequately managing this risk; and 3) sets out how the FSA expects firms to reduce the risk of mis-selling in terms of incentive design, management and governance.

The FSA expects firms to:

1. Consider whether their incentive schemes increase the risk of mis-selling, and if so, how.
2. Determine whether their governance and controls are adequate.
3. Take action to address any inadequacies, by changing governance or controls and, where risks cannot be mitigated, changing the schemes themselves.
4. Where a recurring problem is identified, investigate, take action and pay compensation to consumers who have suffered detriment.

As a result of this guidance, all impacted firms must review the design, operation and governance of incentive plans to ensure they meet the FSA's expectations. The FSA will monitor how firms act on this guidance and may take action against the worst offenders. The programme of regulatory activity around risks to consumers from financial incentives will be managed by the Financial Conduct Authority (FCA).

SUMMARY OF THE FINAL GUIDANCE

1. Roles in scope

The guidance applies to all retail financial services firms in the UK with employed or self-employed staff who participate in an incentive scheme and deal directly with retail customers. This includes staff selling products or services, advisors and

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investment managers, as well as intermediary firms. Similar risks to customers might also arise from incentives in areas such as complaints handling, claims processing, mortgage arrears or customer retention, or roles further up the product supply chain.

2. Incentive scheme features that increase the risk of mis-selling

The guidance gives specific examples of incentive scheme features that increase the risk of mis-selling, including but not limited to the following:

- Competitions or promotions, where staff can win prizes or payments
- Thresholds, where incentives are payable only on sales above a minimum level
- Accelerators or stepped payments, where a higher rate of incentive applies to sales over a certain target
- Inappropriate incentive bias between products
- Disproportionate rewards for marginal sales, such as features that multiply-up incentives for cross-selling, or 'first past the post' competition bonuses
- Incentives linked to the value of a loan, amount invested, or level of insurance cover taken out; similarly, links to product term and single versus regular payments
- Variable salaries, where failure to meet sales targets in a period can result in a reduction in basic pay
- Inappropriate gateways for incentives to be paid, so incentives are accrued but not paid unless minimum sales are achieved for specific product types
- 100% commission / variable pay
- Inappropriate level of incentives for sales of additional products, relative to the incentive payable for sales of the primary product

The focus of the guidance is on financial incentives but the FSA also expects firms to manage the risks that arise from setting sales targets and performance management criteria, recognizing that these also influence employee behaviours.

3. Examples of controls and governance that might mitigate that risk

The guidance also gives examples of controls and governance practices that may help to identify and manage the increased risk of mis-selling arising from features of incentive schemes, including:

Control and Governance Activity	***Guidance***
Use Management Information (MI) to flag individual sales staff activity that might indicate an increased risk of mis-selling.	*Monitor individual sales staff, analysing trends and causes, with particular attention to those selling the most or other staff who may be at higher risk of mis-selling. Consider incentive scheme features and tailor MI around features that might increase risks.*
Robust sales / business quality monitoring.	*Review sales quality using techniques such as call monitoring and mystery shoppers to ensure that individuals are selling products in an appropriate way and delivering fair outcomes for customers. Target additional quality monitoring at areas of higher risk, based on analysis of relevant MI.*

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Control and Governance Activity	***Guidance***
Proper management of conflicts of interest, where sales managers perform business quality assurance for staff whose sales also drive the manager's incentive.	*Reduce or manage these conflicts of interest, by ensuring sufficient independence of staff undertaking business quality monitoring or carrying out independent quality checking of the assessments undertaken by sales managers.*
Controls for inappropriate sales staff behaviour (eg omitting information on product limitations, pressuring customers to purchase or personal recommendations in a non-advised sales process).	*Identify inappropriate behaviours via sales quality monitoring to ensure sales process compliance. Check that complete and correct information is provided to customers and that appropriate records are kept. Seek customer feedback on customer satisfaction and customer outcomes.*
Effective oversight of incentive schemes by appropriate senior management, including approval of the incentive schemes.	*Use risk reviews to identify incentive features that might increase the risk of mis-selling and ensure controls are in place to mitigate risks. Regularly review incentive schemes and the effectiveness of controls. Ensure customers' interests are adequately represented in incentive design and reviews.*

4. What firms have been doing so far

Since the FSA first discussed their review findings, firms have taken actions including:

- Changing incentives so that they are not based exclusively on sales volumes, increasing emphasis on sales quality and customer service. This change in emphasis includes incentives for executives as well as staff.
- Removing high-risk incentive features and conflicts of interest for sales managers, such as paying them a proportion of the commission earned by their staff.
- Reducing the value of incentives linked to sales or capping maximum payments.
- Linking incentives more effectively to customer service metrics and the results of business quality monitoring; creating team incentives.
- Improving controls to actively identify inappropriate behaviour by sales staff during face-to-face sales conversations.
- Targeting Management Information and controls around specific risk areas, such as higher-performing sales staff and focused on incentive features that increase risk to customers.
- Strengthening governance around the review and approval of incentive design.
- Undertaking past business sampling to identify any systemic mis-selling resulting from higher risk features in the incentive schemes.

OUR PERSPECTIVE

Sales incentives are just one element of staff effectiveness, as set out in the diagram that follows:

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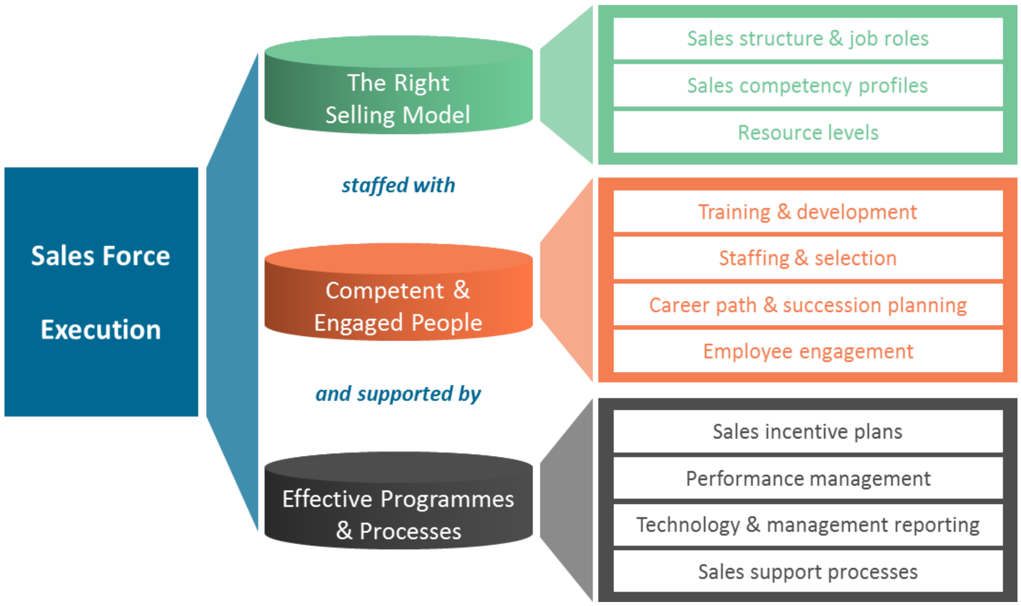

Retail financial services firms face many challenges: embedding new business models following the Retail Distribution Review; the economic climate; and powerful social and political pressures. Firms must look more widely than incentives and ensure all the performance/reward elements outlined above are still appropriate and effective.

Firms should also consider going further. This is the time to drive broader cultural change to rebuild consumer trust in financial services. Among our clients, those with the most admired customer service and sales quality have the following in common:

- ***Customer focus and customer engagement is a passion***, not just a means to protect the firm's reputation, manage financial risk and satisfy regulators.
- ***Customer service and fairness is championed and driven by top management***, so it is clearly and visibly a priority at all levels of the organisation.
- ***A culture of strong customer service is deeply embedded***, so incentives reinforce the customer-service focus and create a virtuous circle.
- ***Customer service success is monitored, identified and analysed*** to understand what creates excellence and how this can be replicated more broadly.
- ***Incentives sit within a principle-based reward framework***, so the need for fair customer outcomes is central and underpins reward design.

McLagan is the financial services industry's leading reward consulting, productivity and performance benchmarking firm. Aon Hewitt is one of the leading compensation consulting firms, helping clients ensure their pay strategy is designed and executed to meet business needs, while focusing employees on what they need to do to help the company meet its goals.

GLOBAL CONTACTS

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