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# Final guidance

## Risks to customers from financial incentives

January 2013

# Contents

# Section 1

# Overview

## Context

Consumer trust and confidence in financial services is essential. In autumn 2011 we published a review of sales incentives and asked for feedback on our proposed guidance.

We know that the way sales staff are paid influences how and what they sell to consumers. Equally, we recognise that firms may want to incentivise their staff to sell. We do not have a problem with incentive schemes, but they must never be at the customer's expense and the risks need to be managed properly. Consumers must be confident they are being sold a product for the right reasons.

Our review found that most incentive schemes were likely to drive people to mis-sell and these risks were not being properly managed.

We welcome the significant recent changes that a number of firms have made to reduce the risks in their incentive schemes.

"the way sales staff are paid influences how and what they sell to consumers"

## What this paper contains

This paper gives examples of how financial incentive schemes can be a key driver of mis-selling and how firms are not adequately managing these risks. It marks the start of a programme of work to reduce these risks. This programme will be taken forward by the Financial Conduct Authority (FCA), which will have the objective of making sure markets work well so that consumers can get a fair deal. This work aligns with the FCA's new supervisory approach of intervening earlier to reduce the underlying causes of consumer detriment.

## What has changed in the guidance?

We asked for comments on the proposed guidance. In general responses were supportive and so the guidance is largely unchanged, but we have clarified the wording in some areas and provided further examples of good and bad practice.[1]

1 Summary of feedback received www.fsa.gov.uk/static/pubs/guidance/fg13-01-summary.pdf

## Our review and its findings – a reminder

We have carried out a review conducted across a variety of authorised firms – including banks, building societies, insurance companies and investment firms.

We were concerned to find that incentive schemes with high-risk features and the potential for sales staff to earn significant bonuses were common across the firms we assessed. Most firms did not have effective systems and controls in place to adequately manage the increased risks of mis-selling arising from their incentive schemes.

The review uncovered a range of serious failings, such as:

- Firms failing to identify how incentive schemes might encourage staff to mis-sell, suggesting they had not sufficiently thought about the risks or had turned a blind eye to them.
- Firms failing to understand their own incentive schemes because they were so complex, therefore making it harder to control them.
- Firms not having enough information about their incentive schemes to understand and manage the risks.
- Firms relying too much on routine monitoring, rather than taking account of the specific features of their incentive schemes.
- Sales managers with clear conflicts of interest that were not properly managed.
- Firms having links to sales quality[2] built into their incentive schemes that were ineffective.
- Firms not doing enough to control the risk of mis-selling in face-to-face situations.

Examples of poor practice can be found in sections 3 and 4.

## Who does our guidance apply to and what do we expect firms to do?

The guidance in sections 3 and 4 sets out a number of ways, but not the only ways, firms can comply with the relevant requirements set out in the FSA handbook.

This guidance applies to all firms in retail financial services with staff who are part of an incentive scheme and deal directly with retail customer transactions. This includes: those involved in selling products or providing a service; advisers and those in discretionary and non-discretionary investment management roles; intermediary firms and firms with appointed representatives; and smaller firms, whether staff are employed or self-employed. This also includes intermediary firms where sales staff or advisers are paid a proportion of revenue earned for the firm, whether or not they also receive a basic salary.

Where an appointed representative has their own sales staff or advisers, the principal firm is responsible for managing the risks from incentive arrangements and any mis-selling. Therefore, the principal will need to have a sufficient understanding of the appointed representative's incentive arrangements.

2 By sales quality we mean whether an individual sells a product in the right way, following our rules.

Firms affected by the Retail Distribution Review (RDR) will need to consider if their incentives increase the risk of mis-selling, even where they are based on fees.

Firms with staff in sales roles further up the supply chain of products where individual incentives are linked to sales volumes, including some wholesale firms, will need to consider the relevance of this guidance.

> "firms need to improve their standards"

Our findings clearly show that firms need to improve their standards in this area.

We expect firms to:

- properly consider if their incentive schemes increase the risk of mis-selling and, if so, how;
- review whether their governance and controls are adequate;
- take action to address any inadequacies – this might involve changing their governance and/or controls, and/or changing their schemes;
- where risks cannot be mitigated, take action to change their schemes; and
- where a recurring problem is identified, investigate, take action and pay redress where consumers have suffered detriment.[3]

While this work has looked at financial incentives, we expect firms to manage the risks from sales targets and performance management, which will also influence the behaviour of sales staff. Firms should ensure that risks from incentive schemes are not transferred to these areas.

Risks to customers from incentive schemes may also arise in areas such as complaints handling, claims processing, mortgage arrears and customers retention.

## Next steps

The guidance is now final. If they have not already done so, firms should act now in accordance with our expectations. Depending on the industry response, we are still open-minded about the need to change or strengthen our rules in this area.

We have already referred one firm to our Enforcement and Financial Crime Division. We will be monitoring how firms act on this guidance, and take action against the worst offenders.

We will follow up with firms to assess what they have done in response to this work.

3 As set out in DISP 1.3.6 G.

# Section 2

# Background and findings

This section sets out in greater detail the way we carried out our thematic review, our expectations and our findings.

The FSA's overall approach to reward extends beyond the scope of this thematic review. The Remuneration Code (which implements the requirements of CRD3) aims to address the prudential and systemic risks that can arise from inappropriate remuneration policies and practices within a firm.[4]

## How do we expect firms to manage incentive schemes?

We do not currently prescribe how firms should, or should not, incentivise their staff. However, our standards for firms are clear.

Principle 3 of the FSA's Principles for Businesses states that 'a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems'. The Senior Management Arrangements, Systems and Controls sourcebook (SYSC) of the Handbook sets out organisational and systems and controls requirements for firms.

We expect firms to apply Principle 3 and SYSC when developing incentive schemes for their staff and to have a mitigation strategy in place to manage any risk of mis-selling to consumers that might occur.

The attached Annex gives examples of previous enforcement cases where financial incentives were a feature.

## What do we consider 'mis-selling'?

We use the term 'mis-selling' in this document to refer to a failure to deliver fair outcomes for consumers. These outcomes include:

- customers are treated fairly;
- customers understand the key features of the product or service and whether they are being given advice or information;
- customers are given information that is clear, fair and not misleading – information that enables them to make an informed decision before purchasing a product or service or before trading; and
- customers buying on an advised basis are recommended suitable products.

4 More information on the Remuneration Code and remuneration disclosure requirements is available on the FSA website at: www.fsa.gov.uk/Pages/About/What/International/remuneration/index.shtml

## How did we gather this information?

We conducted a review of 22 authorised firms between September 2010 and September 2011. The sample of firms covered a mixture of large and small firms from different sectors including high street banks, insurers and investment firms. For this review, we only looked at firms with in-house sales teams and we did not assess any firms with fewer than 20 sales staff.

Across these firms, we reviewed different types of sales forces selling products such as investments, pure protection, general insurance, mortgages, equity release and packaged bank accounts. Our review covered different methods of sales distribution, including telephone sales, face-to-face sales at firm branches and sales people working from their own location. We also looked at the remuneration of both front-line sales staff and their managers.

## What did we find?

The review shows that most firms have incentive schemes that can drive mis-selling and do not have effective systems and controls in place to adequately manage the risks.

We were concerned to find that 20 out of the 22 firms we assessed had features in their incentive schemes that increased the risk of mis-selling – in six cases the risks were significant.

"20 out of the 22 firms we assessed had features in their incentive schemes that increased the risk of mis-selling"

We found that 11 out of the 20 firms were not properly addressing the increased risk of mis-selling. In four cases there were significant failings.

All 11 firms have agreed to improve their controls and/or governance – some have changed, or are in the process of changing, their incentive schemes to reduce risk. Five other firms had some shortcomings in their approach to addressing the increased risk and are taking appropriate action. One firm has been referred to our Enforcement and Financial Crime Division.

Overall we found that:

- Firms had not properly identified the risks posed by their incentive schemes to ensure effective controls were in place. Some schemes were so complex that management did not understand them.
- Sales quality generally had much less of an impact on staff incentives than the quantity sold.
- Firms relied too much on routine business quality monitoring[5] to mitigate the risks created by their incentive schemes, and this monitoring often did not focus on the riskiest areas. Also, firms were not always collecting or using appropriate management information (MI) effectively in these risky areas.
- Some sales managers earned a bonus based on the volume of sales made by the staff they supervised. This created a conflict of interest for managers who also played a significant role in checking the sales of their staff, the risks of which were not adequately managed.

5 We use the term 'business quality monitoring' to describe the firm's approach to checking the appropriateness of sales of individual products by sales staff, e.g. through using dedicated checking or quality assurance staff, and other methods like sales managers checking files or observing meetings.

- Few firms with face-to-face sales staff had fully considered the risks of poor sales conversations, including leaving out important information or pressuring customers to buy a particular product, and the specific controls that might reasonably be needed to monitor staff behaviours, including what is actually being said to customers.

- There was often inadequate governance and oversight of the design, approval and review of incentive schemes, with risks not identified, assessed or adequately mitigated. Senior management at firms often agreed to incentive schemes without sufficiently understanding the risks that could arise.

"Senior management at firms often agreed to incentive schemes without sufficiently understanding the risks that could arise"

## How firms have responded to these findings?

Since discussing our findings with the firms in the review, we have seen them take action in response to our concerns. This includes:

- changing incentive schemes so that they are not based on sales volumes;
- removing high-risk incentive features and conflicts of interest for sales managers;
- reducing the value of incentive schemes linked to sales, or capping maximum payments;
- introducing more effective links between incentive schemes and the results of business quality monitoring;
- improving controls, including additional monitoring for higher performing sales staff, and additional MI and monitoring around the features of incentive schemes that increase the risk to customers;
- improving controls to actively identify inappropriate behaviour by sales staff during face-to-face sales conversations;
- strengthening governance arrangements around the design and sign-off of incentive schemes; and
- undertaking past business sampling to identify if any systemic mis-selling has occurred because of higher risk features in incentive schemes.

# Section 3

# Guidance on incentive scheme features that increase the risk of mis-selling

Part of this review focused on whether certain features of firms' incentive schemes increased the risk of poor outcomes for consumers.

The likelihood of mis-selling increases when the value of incentives available to sales staff increases, or when incentives make up a high proportion of a remuneration package for sales staff.

"The likelihood of mis-selling increases when the value of incentives available to sales staff increases..."

Customers are likely to lose out if:

- firms reward staff through material incentive schemes based on sales volumes, fee income or similar measures;
- firms' incentive schemes include features that are harder to manage;
- management do not understand how the specific features, complexity and value of their incentive schemes could increase mis-selling; and/or
- poor quality sales or mis-selling are not adequately reflected in the eligibility for, or level of, incentive payments.

In assessing the risk arising from the features of incentive schemes, firms should consider a wide range of mis-selling risks that may arise. They should consider factors such as type of product and the method of distribution, for example, advised or non-advised, face-to-face or telephone.

Firms may need to take steps to remove features or change their incentive schemes if they are unmanageable – for example, we consider it very unlikely that a firm will be able to effectively mitigate the risks to consumers arising from a retrospective accelerator (explained later in this section).

In making changes to incentive schemes, or individual features, firms will need to identify any different risks that might arise from these changes and manage these effectively.

We have identified below examples of incentive scheme features that increase the risk of mis-selling. This is not an exhaustive list. We have set out examples under two headings: features that significantly increase the risk of mis-selling and other features that increase the risk of mis-selling.

## Examples of incentive scheme features that significantly increase the risk of mis-selling

### Disproportionate rewards for marginal sales

Reaching a certain target or a goal that triggers an increase in earnings much higher than the normal rate at which incentives accrue.

An example is a 'retrospective accelerator' where passing a target increases the level of incentive earned for all sales over a period, rather than just those above the target.

*Example of a retrospective accelerator – bonuses multiplied up to eight times*

One firm's sales staff could see their bonuses multiplied by up to eight times for cross-selling protection products. This resulted in a strong incentive for staff to sell protection products to consumers, regardless of their needs, to reach a certain number of sales and dramatically increase their bonus, backdated for the whole month.

This incentive scheme was likely to drive sales staff to mis-sell, for example misleading consumers by exaggerating the benefits of a product while playing down the limitations.

Other examples include schemes where high performance can trigger significant additional incentives, both monetary and non-monetary (such as foreign travel).

*Example of disproportionate rewards – 'first past the post' competition bonus*

One firm operated a 'Super Bonus' scheme competition which was run on a 'first past the post' basis for reaching a sales target or threshold. The first 21 people to reach this target earned up to £10,000. This created a strong motivation to reach the 'Super Bonus' target as soon as possible, increasing the risk of mis-selling.

*Example of disproportionate rewards – enhancing annual bonus*

One firm had an incentive scheme where advisers were paid commission on products sold over the course of the year. If they reached a series of targets, they could lock in an enhanced commission of up to 35% for the whole of the next year. This created a heightened risk from a series of 'cliff edge points' at the end of the year, to exceed the target and secure enhanced commission for the following year.

### Accelerators (or stepped payments)

A higher rate of incentive is earned with higher volumes of sales – where the higher rate only applies to sales over a target. This form of incentive creates increased risk as staff try to maximise their sales before the end of the incentive period.

*Example of an accelerator*

A monthly bonus is based on a set payment for each product sold up to 100% of a target and the payment per product is increased for the rest of the month if the target is reached before month-end.

### Inappropriate incentive bias between products

There is an inappropriately larger incentive for one product compared with another, whether the products are substitutable or not. Where the incentive is different for substitutable products, there is an even higher risk that sales staff will sell the higher earning product.[6]

*Example of incentive bias between products*

A firm excessively incentivised one product type over another, where that product was more profitable. The high difference in value meant that staff could only earn a significant bonus by selling the more highly incentivised products. The firm claimed to offer holistic advice, but there was a clear risk that advisers would sell one product over another because there was no prospect of earning large bonuses from selling the other product range. The firm did not seem to have considered the risk to customers.

### Variable 'salaries'

Incentive schemes may vary basic pay (up or down) based on performance against sales targets in a set period. This could include a substantial reduction if sales staff do not continue to meet their sales targets. A reduction in basic pay may have a significant impact on an individual's ability to meet financial commitments and may reduce other employee benefits linked to pay.

6 For different product types there may be good reasons for differential rates of incentive, for example to allow for differences in typical premium levels and/or the time required to make the sale. However, there is a risk that inappropriate differences in incentives between different product types will lead to adviser product bias, in particular where firms are offering holistic financial advice to customers.

### *Example of variable salaries*

A firm reviewed staff salaries every quarter, and moved staff between salary bands depending on how much they sold. The highest salary band earned more than three times the lower salary band so there was a strong incentive to achieve the sales targets required to get the higher basic salary. Staff may also have put themselves under pressure to sell enough to stay in the higher salary bands once they got there, increasing the risk of mis-selling further.

Staff could move through salary levels quickly. One top performer described coming in at grade 1 and rapidly moving to grade 5, which meant his annual salary increased by more than £25,000. He then exceeded sales targets in the next 18 months, adding another £20,000 to his salary.

We were concerned that the variable salaries significantly increased the risk of mis-selling at this firm. In a review of advisers who were close to dropping a salary band, several made a lot of sales at the end of the quarter, including to family members, and these sales did not always follow proper procedures. In particular, one adviser cut corners to rush through six sales in the last few days of a quarter to avoid his pay being reduced.

### Inappropriate requirements to determine if incentives are paid

For example, incentive payments are accrued but will not be paid unless a minimum target is met for each of several different product types, which potentially leads to sales to meet quotas rather than meeting customer needs.

### *Example of inappropriate requirements*

From our thematic work on payment protection insurance (PPI), we saw one firm where sales staff could earn an incentive of up to 100% of their basic salary for sales of loans and PPI. However, no bonus would be paid unless staff sold PPI to at least 50% of all customers. This incentive increased the risk of sales staff mis-selling PPI.

### 100% variable pay/commission only

Where firms remunerate staff or advisers purely by variable pay (such as sales commission with no basic salary or a proportion of the revenue earned for the firm). This significantly increases the risk of mis-selling because staff need to make a minimum level of sales each month to be able to meet their financial commitments.

### Inappropriate levels of incentives for sales of additional products

Where sales staff receive an inappropriate level of incentives for cross-selling additional products or selling product ‘add-ons’, compared to the incentive for only selling the primary product.[7] There may be a greater opportunity to increase the sales of additional products and add-ons through inappropriate sales conversations than is the case for primary product sales. For example, sales staff may not make it clear to customers that the additional product is optional and a separate product.[8] This type of mis-selling occurred many times in relation to PPI.

“There may be a greater opportunity to increase the sales of additional products and add-ons through inappropriate sales conversations”

## Other incentive scheme features that increase the risk of mis-selling

### Thresholds

Once staff achieve a certain ‘threshold’ (a minimum level of sales), they get bonuses on each sale above the threshold. The threshold might be 50 sales a month or 100 sales a quarter, for example.

There is a risk that staff will want to sell as much as possible after they have met such a threshold and before the end of the month/quarter, as sales may be worth more than those in the next period. This may be exacerbated where deficits from previous periods need to be met in addition to the current threshold.

### Incentives linked to the level or type of premium, investment amount or length of term

There is the risk that sales staff seeking to maximise income will persuade customers to invest more than is appropriate or take out more insurance cover than they need, or select a product term that is longer than required. This can also include differences in incentive levels where there is a product with a choice between regular or single premiums.

### Competitions/promotions

Campaigns or competitions designed to increase sales volumes, or based on similar measures, where staff can earn additional payments or win prizes. These can be product-specific or simply based on general sales volume. With product-specific promotions, there is a risk of product bias leading to mis-selling.

## Incentive scheme features that might reduce the risk of mis-selling

We have identified below examples of scheme features that might help to reduce the risks of mis-selling created by incentive schemes. These features may reduce risk but do not eliminate it, and the remaining risk will still need to be managed. We also include examples that show these features are not always implemented effectively. This is not an exhaustive list.

7 By ‘add-ons’ we mean secondary products or additional product features sold alongside another product but not independently. In the FSA Retail Conduct Risk Outlook 2012, we highlighted an issue with firms selling add-on general insurance products, where the consumer is focused on the primary sale and may not understand the overall cost and value of the add-on to them. www.fsa.gov.uk/static/pubs/other/rcro12.pdf

8 For example, see our open letter on common point of sale failings for PPI sales: www.fsa.gov.uk/pubs/other/trade_associations_ppi.pdf

## Emphasising quality

Bonus and incentive schemes need to reward quality or good compliance (selling the right way) with a sufficient deterrent to penalise poor behaviour or mis-selling. Quality measures should reflect the fair treatment of customers and not just customer satisfaction.

Deterrents will not work if the rewards for how much is sold are set at a much higher level.

### Good practice

***Taking action on poor quality***

**A firm took strong action when they found that the quality of sales was poor. Depending on the seriousness of the breach, this meant the sales person could be removed from the incentive scheme immediately.**

**Lesser failures led to deductions in bonus payments, depending on how serious and frequent the problem was.**

### Poor practice

***Sanctions not applied***

**Sanctions in the bonus scheme were not applied despite problems occurring. For example, staff remained part of the bonus scheme even when the quality standards were not met.**

***Quality failures not having a material impact***

**One firm had both a monthly and quarterly bonus scheme for sales staff, with the monthly scheme providing the majority of the bonus available. Where the firm's file checking identified failures (such as giving poor advice that needed corrective action), sales staff were penalised by losing only their quarterly bonus.**

**However, they were still eligible to receive the more significant monthly bonuses, which in some cases were more than £7,000 over the course of three months. Since staff could still earn significant bonuses while giving poor quality advice, this scheme was unlikely to have the right impact on staff behaviour.**

***Flawed 'quality gateway'***

**A firm had an incentive scheme with a 'quality gateway' that was meant to stop staff receiving bonuses if certain sales quality standards were not met. It was based on a points system driven by the firm's monitoring of advice quality, upheld complaints, product lapses, the mix of products sold and other measures.**

**The firm had presented this as a positive example of how their incentive scheme was linked to sales quality. However, this was not an effective control because staff could have any number of sales failed for incorrect advice and still qualify for a bonus payment, if the other categories the firm measured met the standards.**

## Poor practice

***Doubling bonus even if mis-selling***

**One firm doubled the monthly bonus of staff who met a high standard of compliance with sales processes as long there was only one mistake. Administrative errors (e.g. getting a customer's name wrong) were treated the same as mis-selling (e.g. withholding key product information). Sales staff could therefore still have their bonus doubled even if they had mis-sold.**

### Claw back

Many firms have claw back arrangements where incentive payments already received by sales staff have to be repaid or offset against future incentives if, for example, products are subsequently cancelled. To be really effective, firms need to carefully monitor the levels of claw back and why customers are cancelling sales.

*Unexplained high level of claw back*

At one firm, a number of sales staff had high levels of claw back in relation to the bonuses earned, for example, one person earned a bonus of £40,000 after claw back totalling £19,000. The firm was unable to satisfy the FSA that it had an effective approach to monitoring the levels of claw back for individual sales staff, in particular the root causes of the underlying reasons for the cancellation of policies.

### Capped or decreasing incentives

For example, setting a cap or reducing bonuses when sales volumes approach a certain level, so that sales staff are not tempted to rush lots of sales through before the end of a target period. Firms might also choose to limit variable incentive earnings to a lower proportion of basic salary.

### Deferral of incentive payments

Firms might award bonuses on a monthly or quarterly basis, but defer part of the payment until the end of the year or longer. Qualification for payment of the deferred element could then be linked to ongoing sales quality results or other measures, like cancelation rates or the number of complaints received.

### Rolling target thresholds

Where a firm has a threshold based on a minimum number of sales before incentive payments begin to accrue, this might be based on a 'rolling' average of the sales made. For example, a threshold in a quarterly bonus scheme based on a minimum volume of sales averaged over a 12-month rolling period.

### Balanced scorecards

For example, a firm might have an incentive scheme where a bonus is not just based on sales volumes but will include other measures that determine how much bonus is awarded. An example of the measures in a balanced scorecard approach might include; sales results or financial contribution; sales quality results; customer satisfaction; and other key performance indicators (such as cancelation rates, upheld complaints and the mix of products sold).

However, a balanced scorecard approach would be less effective if the element relating to sales results or financial contribution was the most dominant factor in how the incentive is calculated. The effectiveness will also depend on the importance given to other measures and whether they drive appropriate behaviours, which reflect the fair treatment of customers.

## Smaller firms

The guidance in this section applies to smaller firms where they have features in their remuneration practices that increase the risk of mis-selling.

Examples of higher risk features in incentive schemes at smaller firms include:

- **Variable pay –** many small firm mortgage and investment intermediaries pay advisers purely based on the revenue they earn. This is a form of 100% variable pay, so these firms should be aware of the increased risk of mis-selling and have adequate controls to mitigate the risk. Advisers can also receive additional bonuses for exceeding a revenue threshold, which acts like an accelerator on their earnings.

- **Reducing costs –** advisers can have costs relating to compliance deducted from sales revenue, and these costs might be reduced for future business if the adviser's revenue passes a certain threshold. This can create a disproportionate reward for marginal sales if advisers are trying to reach the threshold towards the end of any qualifying period, as the reduced compliance costs effectively increase future earnings.

# Section 4

# Guidance on managing the risks and governance of incentive schemes

Customers can lose out if firms do not have effective governance arrangements and controls to identify and manage the increased risk of mis-selling from features of their incentive schemes.

Effective controls and governance may include:

- robust risk-based business quality monitoring and adequate controls to mitigate the risk of inappropriate behaviour during sales conversations;
- MI to identify, and act upon, trends or patterns in individual sales staff activity that could indicate an increased risk of mis-selling as a result of features in the incentive scheme. Using this MI to inform the approach to monitoring sale staff incentive risks;
- proper management of sales managers' conflicts of interest;
- effective oversight of incentive schemes by appropriate senior management, including approval of the incentive schemes; and
- an effective risk identification and mitigation process, including regular reviews of incentive schemes and the effectiveness of controls, taking into account customers' interests.

The following section sets out what controls and governance arrangements we expect firms to have in place to identify and mitigate the increased risk to consumers from features within incentive schemes.

## Management information (MI)

We expect firms to collect sufficient information to be able to properly manage risks with their incentive schemes. Firms should make sure that they have the right information to help monitor what is being sold and identify individual sales staff who are higher risk.

This information may include:

- which sales staff are achieving high sales volumes and what products they are selling;

**"Firms should make sure that they have the right information to help monitor what is being sold and identify individual sales staff who are higher risk"**

- patterns of an individual's sales activity around incentive scheme features that indicate increased risk; and
- the effect of product promotions or sales campaigns.

Firms should then act on the results accordingly, including taking areas of increased risk into account in business quality monitoring.

### Good practice

***Using information effectively***

**A firm used a wide range of information to monitor the sales patterns of individual sales staff, analysing trends and causes, with particular attention paid to those staff selling the most products and other staff who may have been at a higher risk of mis-selling.**

### Poor practice

***Monitoring individual sales patterns***

**MI did not take account of the specific features in a firm's incentive scheme and did not identify trends or spikes in the sales patterns of individual staff that may be a sign of mis-selling. For example, sales patterns before and after a target has, or has not, been met.**

***Not reviewing a wide enough range of appropriate MI***

**A firm failed to use MI down to the level of individual sales staff, which could assist in identifying potential inappropriate selling, for example penetration rates for cross-selling or variations in the mix of products sold. Other firms selling insurance products did not review claim repudiation rates, and the reasons for rejected claims at the level of individual sales staff.**

## Business quality monitoring

Where incentive schemes increase the risk of mis-selling, we expect firms to take account of these increased risks in their approach to monitoring and when identifying sales cases for checking. Well-designed business quality monitoring (including call monitoring for telephone sales), carried out by competent staff, can be an effective control. However, this is unlikely to be sufficient on its own because firms are likely to need a range of controls depending on the incentive scheme in place and the type of product or distribution method.

Staff undertaking business quality monitoring should be sufficiently independent of the sales function to avoid inappropriate influence by sales staff or managers. Firms should take appropriate action where issues are identified, for example, reviewing individual sales, re-training and undertaking follow-up monitoring to ensure issues are not recurring. Firms should also check if the issues identified indicate trends of mis-selling.

## Good practice

***Targeting additional monitoring***

**The MI used by a firm to identify the sales patterns of individual sales staff activity influenced where additional monitoring was targeted. For example, where there were trends or spikes that indicated an increased risk of mis-selling.**

## Poor practice

***Monitoring***

- **Monitoring was not consistent with the sales and bonus strategies. For example, it focused on the more risky products but did not review enough of the products with the highest sales, or the products where there were large bonuses for selling.**
- **Monitoring was based on checking that sales were carried out according to the firm's sales guidelines and the information gathered, rather than identifying where there had been poor customer outcomes.**
- **No extra monitoring was carried out on sales staff achieving high sales volumes, or other staff whose sales patterns indicated increased risk, or who may have been under pressure to sell, for example, due to fear of disciplinary action.**
- **No extra monitoring was carried out on individuals who had higher than normal rates of cross-selling different products where they could earn extra bonuses for this, or on sales of products that earned much higher bonuses.**
- **Monitoring was based on narrow checklists that gave the same weight to minor administrative errors as they did to mistakes in the sales process that meant customers were likely to lose out.**

## Sales managers' conflicts of interest

Sales managers can have conflicts of interest where they are responsible for supervising staff and also earn incentive payments based on the volume of sales made by those staff, especially if they play a significant role in the business quality monitoring of their own sales staff. Firms should reduce or manage these conflicts of interest.

## Good practice

***Independent checking***

**One firm carried out independent quality checking of the supervision assessments and/or business quality monitoring undertaken by sales managers.**

## Controls for inappropriate behaviour by sales staff

Inappropriate staff behaviour during sales conversations, motivated by financial gain, is unlikely to be identified by firms undertaking reviews of written sales records or from training and competence schemes.

*Examples of inappropriate behaviour that might increase the risk of customers losing out*

- Not properly explaining or omitting key information, such as the limitations or eligibility for a product, where applicable, or misleading a customer regarding the level of any risks or product charges;
- Pressuring customers to purchase a product, persuading a client to trade unnecessarily or failing to make it clear that an additional product is separate and optional (where that is the case);
- Making personal recommendations when following a non-advised sales process; and
- Misleading a customer about how sales staff are incentivised for individual product sales.

### Poor practice

***Example of an adviser blatantly misleading customers***

**One firm gave a bonus to sales staff based on the amount the customer paid for the product. We listened to a call where sales staff colluded to intentionally overcharge a customer to help meet a sales target. During the conversation that took place before they called the customer, the sales person said:**

*"This is going to make my target… I'll end up with about a thousand pounds… We need to ring [the customer], I will do all the talking [and] you confirm the price."*

We expect firms to consider what inappropriate behaviour might occur as a result of their incentive schemes and to assess actively the behaviour of their sales staff during sales conversations, including what is actually being said to customers. To be effective, the approach taken should test customer outcomes rather than just customer satisfaction. Firms should also take account of the type of products being sold and the method of distribution.

Although it might be harder to monitor face-to-face sales conversations, firms can identify inappropriate behaviours by controls such as: mystery shopping; contacting a sample of customers shortly after completing a sale; recording face-to-face sales conversations for later review; or additional scrutiny of high-performing sales staff or those with unusual sales trends. Such monitoring can also act as a deterrent for inappropriate behaviours.

"We expect firms to consider what inappropriate behaviour might occur as a result of their incentive schemes"

Firms should consider if they can effectively mitigate the risks posed by higher risk or material incentive schemes for staff in face-to-face sales roles, where monitoring is more difficult. If they are not able to do this, they should reduce the risks in their incentive scheme.

## Good practice

### *Monitoring calls*

**At one firm monitoring recorded telephone calls helped to identify inappropriate behaviours and acted as a deterrent to sales staff, as well as checking the firm's sales guidelines were being followed and that sales were compliant. Calls were also assessed to check that sales staff provided information in a way that was clear, fair and not misleading, and to check that customers were not put under undue pressure to buy.**

### *Audio visual mystery shopping*

**One firm undertakes mystery shopping covering a face-to-face sales team. This includes an audio visual record of the sales conversation, which is reviewed by independent staff in the firm's quality monitoring team.**

**As well as testing customer service and compliance with the firms' sales process, the mystery shopping identifies whether there is any inappropriate behaviour, for example pressure selling or providing misleading or incorrect information. The monitoring staff also check for any discrepancies between the information gathered during the sales conversation and the information recorded in the file to justify that the sale was appropriate.**

### *Seeking customer feedback*

**One firm uses a programme of outbound calls to customers for its face-to-face sales teams, in addition to reviews carried out by sales managers. The calls are undertaken by a separate team and call scripts are used to check that the key features of the product and any relevant exclusions were properly explained. The outbound calls are also monitored and sampled for quality control and consistency.**

## Poor practice

### *Flawed approach to seeking customer feedback*

**One firm relied on contacting customers after the sale for feedback, but collected irrelevant evidence, because the main focus was on customer satisfaction. They relied on 'yes/no' questions, for example asking the customer if the key features or limitations of a product were explained to them, rather than testing if the correct information was provided clearly.**

### *Over reliance on training and competence*

**A firm relied on observations of sales conversations carried out as part of training and competency arrangements to assess sales staff for inappropriate behaviour. This type of monitoring can be useful for checking competence, but it is unlikely to spot mis-selling or inappropriate behaviour motivated by financial gain as staff know they are being assessed.**

## Governance arrangements

Senior management should ensure that firms identify and assess the specific features of their incentive schemes that might increase the risk of mis-selling and ensure controls are in place to adequately mitigate the increased risks.

Senior management should approve incentive schemes with input from risk management and compliance functions into the design and review of incentive policies. Senior management should ensure they consider how incentive scheme features can lead to poor customer outcomes.

There should be frequent and effective reviews of incentive schemes, with sufficient attention given to risks to the fair treatment of customers. Management information should be collected and used by senior management to assess if risks are crystallising and if controls are effective in mitigating the risks.

### Good practice

***Customer interests***

**A firm made a senior manager formally accountable for representing customers' interests in the design and review of incentive schemes.**

### Poor practice

***Not understanding the risks***

**Senior managers responsible for incentive schemes did not understand the risks to customers created by the features of their incentive schemes or relied on other staff who did not understand the risks.**

***Regular reviews***

**A firm failed to carry out regular reviews of the effectiveness of controls in mitigating the risks arising from the incentive schemes.**

## Smaller firms

Smaller firms need to consider how the guidance in this section will apply to them. The following points may help.

- **Management information** (**MI**) **–** the information needed is likely to vary depending on the nature, scale and complexity of the firm's business.
- **Business quality monitoring –** in smaller intermediary firms, monitoring of the business is often carried out by the principals or senior advisers and it may not be proportionate for such firms to have a separate independent monitoring function.
- **Sales managers' conflicts of interest –** the guidance relating to sales managers' conflicts of interest applies to smaller firms where this role, or a similar role, exists.

- **Controls for inappropriate behaviour by sales staff –** while we generally expect firms to use a range of controls to assess behaviours, for small firms some of the examples mentioned above would cost too much, for example, independent mystery shopping. Smaller firms should consider how they can obtain and use customer feedback to assess what is said to customers during sales conversations.

- **Governance –** the principles underlying the guidance on governance are generally relevant to all firms. We expect the principals of smaller firms to be aware of the risks arising from the way in which their sales or advisory staff are paid, to identify these risks and to mitigate them. The degree of formality required for governance arrangements will depend on the nature, scale and complexity of the firm's business.

# Conclusions and next steps

This paper marks the start of a programme of work to reduce the risks to consumers from poorly managed incentive schemes, which will be taken forward by the Financial Conduct Authority (FCA).

During the review we found that most firms have incentive schemes that can drive mis-selling, but do not have effective systems and controls to adequately manage the risks.

Depending on the industry response, we are still open-minded about the need to change or strengthen our rules in this area. In the meantime, we will continue to take action against firms that do not meet our requirements and we plan to strengthen the way we supervise firms' incentive schemes.

We will follow up with firms to assess what they have done in response to this work.

# Annex: Examples of previous enforcement cases

Issues with reward arrangements have featured in a number of enforcement cases, including the following examples:

### Square Mile Securities Limited (January 2008)[9]

'Square Mile operated a remuneration system that was based on achieving expected sales figures (and therefore rewarded volume selling) and which paid higher commission in respect of selling riskier securities in a high pressure environment without adequate controls.'

### Liverpool Victoria Banking Services Limited (July 2008)[10]

'The risk of pressure selling was further increased by the financial incentive schemes LVBS operated … The amount a sales person could make from incentives was substantial – up to two-thirds of their base salary. Telephone sales team leaders were also incentivised throughout the relevant period on the basis of the PPI sales of their teams, which created a potential conflict of interest with the supervision of their sales staff …'

### Alliance & Leicester plc (October 2008)[11]

'The risk arising from these inappropriate sales techniques was further increased by the bonus scheme operated by A&L. A&L advisers and team managers were eligible for potentially significant bonuses which were based on the number of PPI policies sold, the value of those sales and the amount by which those sales exceeded target rates. Advisers also received a much larger incentive to sell PPI than on the associated loan.'

'… A&L's remuneration structure increased the risk that advisers might make unsuitable sales of PPI to achieve those bonuses. This increased the importance of having robust systems and controls in place to ensure suitable and compliant PPI sales, …'

### AWD Chase de Vere Wealth Management Limited (November 2008)[12]

'The firm had inadequate controls and inappropriate incentives to ensure that the advisers gave suitable advice and processed their sales in an appropriate manner.'

'Advisers were remunerated on the volume of the business they generated. Sales managers were remunerated on the productivity of their advisers and also received commission from their own sales. Compliance factors did not affect the remuneration of sales managers or their advisers.'

9 www.fsa.gov.uk/static/pubs/final/square_mile.pdf
10 www.fsa.gov.uk/static/pubs/final/liverpool_victoria.pdf
11 www.fsa.gov.uk/static/pubs/final/alliance_leicester.pdf
12 www.fsa.gov.uk/static/pubs/final/awd.pdf

### Falcon Securities (UK) Limited (January 2010)[13]

'MPS [an appointed representative of Falcon] failed to ensure that the reward and remuneration systems operated effectively and to act on indications of non-compliance on a timely basis.'

'Falcon failed to implement strong countervailing controls, including disciplinary measures, to mitigate the risk that MPS's commission structure and pressurised environment could detrimentally effect how its clients were treated.'

### Combined Insurance Company of America (CICA) (Nov 2011)[14]

'Remuneration and reward framework: CICA paid its sales agents on a commission-only basis. Its reward framework focused on sales volumes with insufficient consideration of quality. CICA failed to put in place effective controls to manage the risk of poor customer outcomes.'

13 www.fsa.gov.uk/static/pubs/final/falcon.pdf

14 www.fsa.gov.uk/static/FsaWeb/Shared/Documents/pubs/final/cica.pdf