Risky business: The case for reform of sales incentives schemes in banks

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About Consumers International

Established in 1960, CI is the world federation of consumer rights groups. Our goal is to ensure that consumer rights can never be ignored. With over 240 Member organisations spanning 120 countries, we serve as the only independent and authoritative global voice for consumer rights. We are a registered UK charity.

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Executive summary

Inappropriate sales incentives schemes employed by retail banks are an underappreciated and undermanaged risk to financial consumers and financial stability. This is the headline conclusion of our unique look at the continuing lack of adequate consumer protection in financial services.

Drawing on evidence from consumer organisations, trade unions, banks and regulators in G20 nations and some OECD countries, *Risky business: The case for reform of sales incentives schemes in banks*, demonstrates the pain and despair suffered by individuals who have been persuaded to buy inappropriate financial products, as well as the threat that these schemes pose to financial stability.

The scale and impact of sales incentives schemes

Inappropriate sales incentive schemes are part of a toxic banking culture that promotes high risk, short-term gains and contributed to the financial crisis in 2008.

The scale of the problem is shown by the colossal compensation bills and losses to consumers that are already measured at more than US$53 billion globally. Even this figure may only scratch the surface as consumers continue to seek redress and problems take time to emerge. The headline case studies are staggering:

- Bank of America was fined US$1.27 billion for Countrywide's aggressive, volume-led sales incentive programme for mortgages.
- The default on inappropriate mortgages sold by Washington Mutual, contributing to the largest bank failure in US history.
- In the UK, the mis-selling of Payment Protection Insurance (PPI) has led to compensation payments of £24.3 billion (US$39.3 billion) and rising.
- Risky consumer investment products in Australia have led to losses of AUS$5.7 billion (US$4.97 billion).
- Compensation to Spanish consumers for mis-sold hybrid securities stands at €2.9 billion (US$3.65 billion).
- In Hong Kong, complicated structured products backed by Lehman Brothers, resulting in HK$3.4 billion (US$438 million) in compensation and a further HK$2.2 billion (US$283 million) in losses to consumers.
- €215 million (US$270 million) in compensation for consumers of failed DSB Bank in the Netherlands.
- €2.1 billion (US$2.64 billion) cost to Banco Espirito Santo in Portugal, contributing to its failure and taxpayer bail-out.

The examples given above have come to light as a result of investigations that followed bank failings. But a major concern highlighted in this report is that many regulators simply do not know how widespread the use of inappropriate sales incentives schemes is, and therefore what level of risk they pose to consumers and the financial system.

Where regulators have investigated and taken action, the risk is shown to be significant. The UK is one of a limited number of countries to have undertaken an investigation on this issue, with the regulator noting that many of the sales incentive schemes they looked at "*were likely to drive people to mis-sell to meet targets and receive a bonus, and these risks were not being properly managed*".

The regulator went on to make a damning conclusion stating that some incentive schemes were *"… rotten to the core and made a bad problem worse."*[1]

The global nature of banking and the connection between different financial providers would suggest that practices in one jurisdiction are likely to have been replicated in others. Transparency in this area is weak with limited information available from banks on the detail of their schemes. Without proper investigations and regular monitoring, regulators are unlikely to know the extent to which inappropriate sales incentive schemes are used or their impact on consumer protection and financial stability.

Inappropriate sales incentives undermine regulatory compliance, harm consumers and create risk

Sales incentive schemes are developed by retail bank directors to encourage staff to sell more financial products. Evidence suggests that these schemes can be developed with no regard for the consumers' needs. This contributes to poor product design and leads to mis-selling and irresponsible lending.

Inappropriate sales incentives schemes create unfair pressure on retail staff, who may be trying to avoid disciplinary action and safe guard their job or who may rely on bonuses to earn a decent wage. The schemes can conflict with their duty and desire to do their best by customers.

Where inappropriate sales incentive schemes encourage the conditions for irresponsible lending, this can increase bank losses when borrowers default. The most catastrophic example being the mis-selling of mortgages to US consumers who could never afford to make repayments: widely recognised as the trigger of the financial meltdown that followed in 2008.

However, it can also lead to mis-selling of other products, creating additional risk and further losses as the misconduct and mis-selling associated is exposed. Compensation for mis-sold PPI in the UK, for example, stands at £24.3 billion (US$39.3 billion) and continues to rise.

This report shows that the money set aside by some banks to cover themselves against losses from mis-selling and misconduct, under rules on capital requirements for operational risk, was completely inadequate and severely underestimated the magnitude of the problem. This poses serious questions for those heralding a new transparent era of higher capital requirements and improved risk management and safety in the banking sector.

There is also little consideration given to potential losses from mis-selling and misconduct in the 'stress tests' banks and Ministers of finance are so keen to highlight as proof of stability in the post-crash banking system.

Our research presents a compelling argument for the reform of inappropriate sales incentives schemes being fundamental to a sustainable recovery. Reform would not only reduce risk but would also contribute to putting the need to serve the consumer before short-term returns.

So what is the solution?

The financial crisis and the dramatic increase in the number of consumers accessing financial services makes it imperative for governments to strengthen financial consumer protection.

In 2010 Consumers International (CI) campaigned to put financial consumer protection on the G20 agenda and we have contributed to the development of the G20/OECD high level principles through

[1] http://www.fsa.gov.uk/library/communication/speeches/2012/0905-mw.shtml

detailed inputs and consultation. However we are concerned that until fundamental issues, such as banking culture, are properly addressed, compliance with new regulations will be undermined. Although there has been some reform of compensation schemes for senior executives, financial and non-financial incentives schemes for retail staff have not been adequately addressed to deliver root and branch reforms.

Crisis, scandal and regulatory action taken to address the issue of inappropriate sales incentives have resulted in some encouraging practices. A few banks have begun to make positive changes to their sales incentives schemes, to tackle risks and place a greater emphasis on rewarding staff for providing customer service and meeting customer needs. We welcome this action and encourage all banks to prioritise reform of their incentives schemes.

However, transparency in sales incentives schemes is limited. This report shows many banks do not disclose anything other than cursory details of their sales incentives schemes in their annual reports. While it is positive that a number of regulators have requested details of such schemes for investigations, we found no evidence of on-going monitoring of sales incentives schemes.

Risky business: The case for reform of sales incentives schemes in banks, argues that robust financial consumer protection is a major part of good financial management. Without it, individual consumers suffer hardship: lives are ruined and dreams are shattered. Without it, our global financial system remains on red alert.

If action is not taken, banking culture will not change, the system will continue to be open to collapse; and consumers will remain the victims of short-term sales incentives stacked up to exploit, rather than serve, them.

CI is calling on the G20 to:

1. *Request urgent reviews of capital requirements for operational risk to include substantial increases to address risks and costs associated with inappropriate sales incentives schemes and the problems they cause including mis-selling.*

Remarkably, international standards for the capital held by banks to cover losses through mis-selling have not been reviewed since before the 2008 crash – a shocking dereliction in light of the billions of dollars already lost through mis-selling.

2. *We want to see accountability from the senior executives in the banks themselves.*

Despite the widespread poor practice we identified, not a single senior executive has been fined for setting up an inappropriate sales incentives scheme. Only by changing the culture at the top can we begin to shift away from short-term gain to long-term stability. Having a named director responsible for sales incentives schemes and for the regulator to take enforcement action if the executive doesn't do their job would be a positive step in this direction.

3. *Reform also needs to tackle the pressure staff face to meet sales targets, such as threats of disciplinary action, performance management or dismissal.*

Changes to financial incentives schemes alone will not be enough to improve standards. Sales targets can be equally problematic. Research with frontline bank staff conducted by CI Member Which? found that, even if financial incentives were removed, the sales-based culture can remain. This finding is echoed by evidence from trade unions.

Part 1: Introduction

Sales incentives schemes – the historical perspective

In the past, banking was a relationship-based business in which long-term success depended on serving customers and prudently managing risks. It is difficult to pinpoint a precise time when the culture of banking changed from one based on long-term customer relationships to one based on sales.

At a high level, there was an increasing focus on delivering growth in earnings per share and short-term measures of profit – combined with far higher rewards for those senior executives who could achieve these goals.[2] Banks made increasing use of securitisation and wholesale funding, which removed constraints on their growth. By allowing them to shift the risk off their balance sheet, securitisation encouraged them to relax lending standards and focus on loan growth.[3]

Banks and financial institutions merged into financial conglomerates and began to sell an increasing variety of products to their customers. This led to a drive for 'cross-selling' - to increase the number of products each customer had with the bank. There was also an increasing focus on measuring and reporting performance of individual branches and employees.

The cultural shift could also have been related to literature promoting the use of variable pay and commission-based incentives for sales staff as a way of improving organisational performance.[4] This was based on a theory of using incentives, reward schemes and variable pay as a way of encouraging frontline staff to deliver the overall objectives of the organisation. Business targets would be set at the top and filtered down through sector, regional and branch managers to frontline staff.

As the chief executive of a major UK bank explained in 1998 to the McKinsey Quarterly Report:

> *"We don't talk to them (staff) about warranted equity or economic profit; they wouldn't know what we were talking about. Instead, what we say to the staff in the branches is that we can generate income only by selling more widgets. We set what we call key sales objectives, and we say "we want you to sell these products and if you sell more, you get paid more."*[5]

In a bank, a typical sales incentives scheme might see specific sales targets set or, for each individual product, a number of 'points' given. The number of 'points' could depend on the overall profitability of the product for the bank and whether the sale of a particular product was a key business objective. Branches and individual staff would be given an overall target of the level of 'points' they would be expected to achieve.

More sophisticated schemes would divide products into 'baskets' and require staff to make a minimum number of sales across each of the 'baskets' to achieve the bonus. These sales or points targets would then be combined with other metrics, including compliance and customer service, in

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[2] For the historical perspective on the changes to the banking sector please see paragraphs 61-69 of Which? (2012) Written evidence to the Parliamentary Commission on Banking Standards, http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/writev/banking/bs29.htm
[3] Maddaloni and Peydro (2009), Bank Risk-taking, Securitization, Supervision and Low Interest Rates: Evidence from Lending Standards, http://www.fundacionbancosantander.com/media/docs/J-L-Peydro_BLS_17092009.pdf
[4] Suff and Reilly (2006), Selling rewards - Paying for performance in your sales force, Institute for Employment Studies
[5] The McKinsey Quarterly, No. 2 , Spring 1998

what is normally called a 'balanced scorecard'[6] to determine the overall level of bonus or variable pay and to measure the performance of the individual employee, branch or contact centre.

There are two broad types of sales incentives schemes:

- **Financial incentives and bonus schemes:** Thresholds and sales targets will be set and employees who meet or exceed those targets will receive a financial incentive, which could take the form of a bonus, an increase in pay or a prize. Staff who do not meet the targets would not receive a bonus or would be given a reduction in pay.
- **Performance management:** Those employees who do not meet the thresholds or targets may be subject to more intensive monitoring or coaching. If performance does not improve then employees may be subject to disciplinary action or dismissal. Performance could also be monitored and reported within the bank using league tables, with employees placed under explicit or implicit pressure to improve their ranking by selling more products.

Whether banks use either a carrot or stick approach to encourage staff to sell products, both types of sales incentives schemes present risks to consumers and to commercial operations and reputations, therefore, the risk management of both types of sales incentives schemes must be equally robust. Banks need to assess, understand and monitor the risks posed by their sales incentives schemes. They need to take action to control these risks and reform schemes to better align the interests of staff with a culture which is focused on customers and prudent risk-taking. Senior executives need to take responsibility for managing these risks and be held accountable for their performance.

Challenging on the frontline

This report is not intended to be critical of the frontline staff who work in banks. Frontline staff are not at fault for the increasing focus of senior management on sales rather than customer service.

Over the past few years, many frontline staff have been undertaking a difficult role and have seen many redundancies within their organisations. Frontline staff who did not meet sales targets would see their wages stagnate and face losing their jobs. Many frontline bank staff are on relatively modest salaries. A move away from sales incentives schemes and towards rewards for customer service and suitable advice should not lead to a drop in total remuneration. As the UK union, Affinity highlighted:

> *"The vast majority of bank staff want to do the best for their customers but can't because they are under constant pressure to hit ever-demanding targets, which increase every year. A failure to hit those targets can result in staff being subject to performance improvement plans and in some cases being dismissed for under-performance. A number of management practices we have been dealing with are based more on humiliation than on positive motivation. Extreme pressure causes desperate people to do desperate things. In that kind of environment, it is surprising that there have been so few mis-selling scandals."*[7]

Unions in Australia told us sales incentives started to creep in during the late 1990s and were being fully implemented by the early 2000s. They said that an overall volume-based target is set nationally and then translated regionally, then by branch and then to individual targets. They told us:

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[6] Ittner, Larcker, and Meyer (1997), Performance, compensation and the balanced scorecard*, The Wharton School

[7] Affinity (2012), Written evidence to the Parliamentary Commission on Banking Standards

> *"The bank says that the targets take into account economic conditions but at a time when the economy is slowing down the targets go up".*

In addition to volume outcomes there are also referral targets and other targets that staff have to meet. The union reported that one of the main consequences is that the systems have been accompanied by a bullying and humiliation culture. Staff are harassed and humiliated if they do not meet stretch targets.

Moreover, staff who do not achieve targets are placed on performance review, often for a period of three months. If they still fail to meet the target they lose their job. Importantly, more recently, a few bad practices have been exposed but interestingly not through the traditional whistle blower process. We examine this issue later in the report.

Inappropriate sales incentives schemes – a root cause of mis-selling, irresponsible lending and financial instability

Risks to consumers

Inappropriate sales incentives schemes and sales-based cultures pose a particular risk to consumers in the banking and financial services sectors. For many financial products, their quality and appropriateness for the consumer might not be apparent until many years after they have been purchased. Products are complex and the information provided may not be understandable by the consumer purchasing the product. As a result, they may struggle to accurately compare products and identify the best deal.

In these circumstances, consumers may place particular reliance on what they are told during the sales process regarding the terms, conditions and charges of the product. Many consumers will therefore rely on the advice or recommendation they are given during the sales process.[8] However inappropriate sales incentives schemes can create conflicts of interest, placing pressure on staff to recommend the product which pays the most commission or helps them meet their sales target. Mis-selling and misconduct causes an erosion of trust and confidence in banks and the banking system. This, in turn, might lead to consumers not engaging with the financial system with the consequence that they fail to take action which might improve their financial situation.

Stability risks to banks and the financial system

Sales incentives schemes also pose a particular risk in the banking sector due to their impact on financial stability. In banking, it is possible to deliver high short-term profit by increasing sales, increasing lending and taking extra risk.[9] For example, if a bank expands its sales and loans it will make higher short-term profits, regardless of whether the products are appropriate or the consumers can repay the loan. However once asset prices fall and those consumers start to default on their loans, the bank will make significant losses. Similarly a bank which designs a complex and expensive insurance product and mis-sells it for many years, will make higher short-term profits, but at the expense of substantial redress costs in the long-term. A bank which needs to raise capital and puts pressure on frontline staff to persuade its customers to take their money out of savings

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[8] Decision Technology Ltd (2010), Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective

[9] Which? (2012b), Written evidence to the Parliamentary Commission on Banking Standards on Professional Standards and Competition

accounts and buy the bank's shares, may survive in the short-term, only to find itself exposed to legal claims when consumers make losses.

Inappropriate sales incentives schemes were used to drive these behaviours in banks which put the long-term stability of individual banks and the financial system at risk. Sales incentives schemes were used to reinforce a business strategy based on the volume of sales rather than the quality of the products and their suitability for the consumer. This undermined compliance with both prudential and conduct regulation. Ultimately, it led to bank collapses, taxpayer bail-outs and austerity to pay for the failures of the banks and their impact on the economy.

Incentives schemes are behavioural levers and cultural indicators

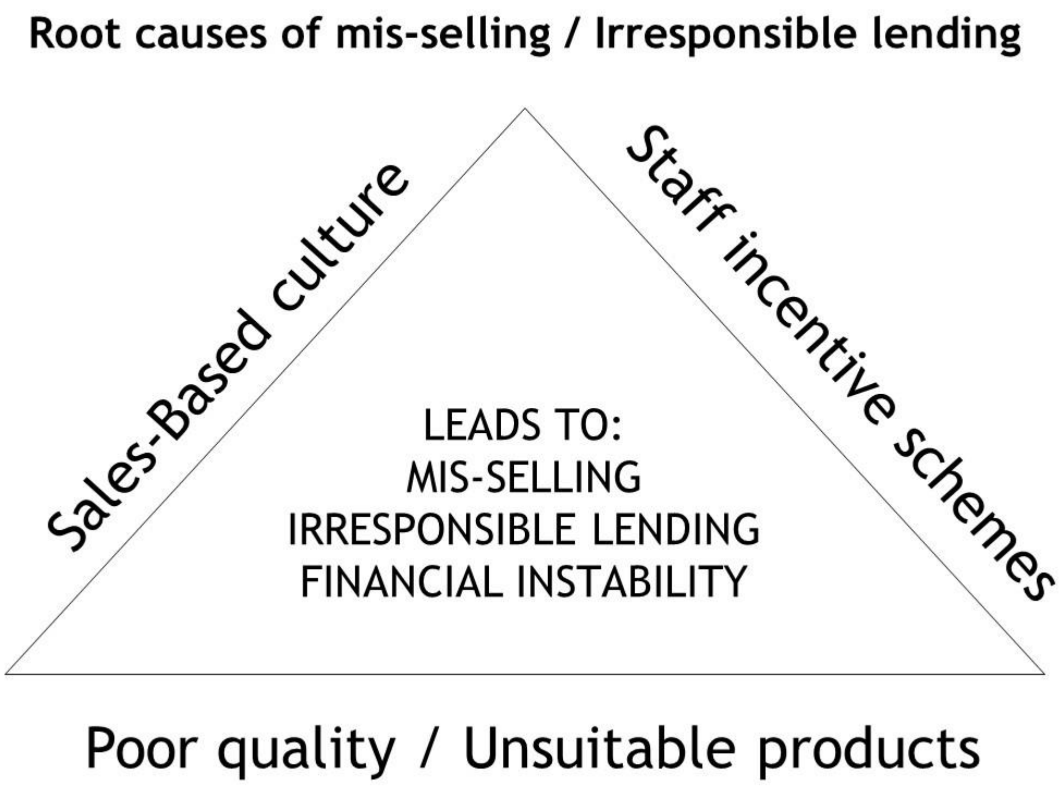
Incentive schemes for staff impact directly on their behaviour and are also an important driver of the 'culture' within a bank. They highlight to staff the objectives and measures that are most important for them to achieve on a day-to-day basis - rewarding behaviour that meets these objectives and penalising behaviour which does not.

Incentives schemes influence whether staff will act in the best interests of customers and whether they will challenge or ignore behaviour which damages these interests. Changes to incentives schemes are vital to secure a much-needed change in the behaviour and the culture of banks. Without changes to incentives schemes, no amount of 'mission statements' or 'customer charters' will change the culture of banking to be more focussed on customers and prudent risk-taking.

Sales incentives fuel a cycle of bad and risky practices

The majority of the mis-selling scandals and risks to financial stability examined in this paper share the same root causes – stemming from a focus from senior management on the maximisation of short-term profits. They started with poor quality, badly designed, unsuitable, risky or misleading products, and were fuelled by a combination of inappropriate staff sales incentives schemes and a sales-based culture within the banks.

This perpetuates a cycle of bad and risky practices, ie, if you have a poor quality or complicated product then it is likely to be more profitable for the bank. This means that it could become a focus for senior management, setting high sales targets for staff at all levels and placing excessive pressure on middle management and frontline staff to meet these targets. The culture of the bank will become focused on selling products instead of serving the customer. It also means that there is likely to be a significant amount of money available to fund sales incentives and bonus schemes for frontline staff, leading to bias towards selling the products regardless of whether they are suitable for the customer.



The foundation of poor-quality or unsuitable products and the supporting pillars of sales-based culture and sales incentives schemes lead to mis-selling, irresponsible lending and financial instability. Inappropriate sales incentives schemes can therefore cause detriment at each stage of the customer journey – from product design through to the impact on consumers and banks after the product has been sold.

Instead of designing products based on the needs of customers, there will be pressure to design complex products which will prove profitable enough to pay sufficient bonuses to frontline staff. Provision of information to consumers may rely on the supply of written documentation which is lengthy and difficult to understand. It can also lead to staff failing to emphasise the key risks and important information about the product or contradicting the written documentation.

At the 'point of sale', inappropriate sales incentives schemes lead to conflicts of interest, aggressive sales practices and bias towards selling the products needed to meet sales targets or receive incentives. In some of the cases, the product may have only been suitable for a 'target market' of a small minority of consumers but the sales incentives schemes lead to it being sold more widely and inappropriately.

Damaging effects of a short-term focus

After the product has been sold, inappropriate sales incentives schemes can mean that the focus can only be on selling customers new products rather than providing an ongoing service and building a relationship of trust. If there has been irresponsible lending then there will be increased arrears for consumers and they will also be at risk of losing their homes through foreclosure and repossession.

Staff may not be rewarded for highlighting or dealing fairly with customer complaints. In the UK, some banks gave frontline staff and branch managers incentives schemes which penalised them for paying redress to customers, even when the bank had made an error and the complaint was justified.[10]

Impact of inappropriate sales incentives

Pre-Purchase

- Product design processes focus on sales rather than designing products to meet the needs of consumers
- Exploitative product/ service features
- Culture and business model of the bank focuses on product sales and short-term profitability ahead of customer service

Information provision

- Reliance on disclosure of information to manage risks
- Confusing information provided to consumers
- Frontline staff do not highlight product risks to consumers or contradict written information during the sales process

Point of sale

- Conflicts of interest
- Aggressive selling practices
- Bias towards particular products rather than those most appropriate for consumer
- Staff providing a specific recommendation on to the customer to purchase a particular product
- Products sold outside of their target market
- Focus on persuading consumers to purchase ancillary products
- Lack of controls / Management Information

After Sales

- Poor complaints handling / lack of redress
- Irresponsible lending leading to increased arrears / losses for the bank
- Churning into new products
- Risks to financial stability

[10] FSA (2010), Review of complaint handling in banking groups

Part 2: Case studies of inappropriate sales incentives schemes and their damaging impact on consumer protection and financial stability

Working together with CI Member organisations we have gathered a number of case studies to illustrate the potentially damaging impact of inappropriate sales incentives schemes on consumer protection and financial stability. Inappropriate sales incentives schemes contributed to:

- The sub-prime mortgage crisis in the US by fuelling the irresponsible lending which caused significant losses to consumers, investors, the insolvency of numerous US banks and financial institutions and the worst economic collapse since the Great Depression.
- The toxic sales culture at Halifax Bank of Scotland (HBOS), the UK's fourth largest bank and the largest provider of savings and mortgage products to consumers, leading to the bank's near collapse and its £20 billion (US$32.2 billion) bail-out by the UK Government.
- Mis-selling of PPI by many of the UK's largest banks, leading to payments of £24.3 billion (US$39.3 billion) so far in compensation payments from banks.
- Mis-selling of risky investment products in Australia has caused losses of AUS $5.7 billion (US$4.97 billion) to consumers and more than AUS $300 million (US$265 million) so far in compensation payments from banks.
- Mis-selling of 'hybrid securities' to retail consumers by Spanish banks, causing instability in the Spanish banking system, government bail-outs of a number of banks, significant losses to consumers and the payment of €2.9 billion (US$3.65 billion) so far in compensation.
- Mis-selling of structured investment products backed by Lehman Brothers through a number of retail banks in Hong Kong leading to losses to consumers of around HK $2.2 billion (US$283 million) and compensation payments from the banks of around HK $3.4 billion (US$438 million).
- Mis-selling of insurance and investment products by DSB Bank in the Netherlands, leading to its eventual collapse and the payment of €215 million (US$270 million) in compensation to consumers.
- The near collapse and government bail-out of Banco Espirito Santo in Portugal due to the sale of the bank's debt and debt of connected companies to retail customers with the bank setting aside at least €2.1 billion (US$2.64 billion) to compensate consumers for potential losses.
- Banks in Mexico recommending higher-cost products instead of the low-cost basic account which they are required to make available by a law seeking to promote financial inclusion.

> ***"Consumers are an important part of the finance market: in Germany alone, their property is worth 5 trillions euro stabilizes the system, they hold 1.5 trillion euros in loans and 170 billion euros in insurances. Still their interests are not properly upheld. Bad investment recommendations, irresponsible lending, unjustified fees, veiled costs and commissions: For consumers the finance market is opaque. Consumers needs a regulator that provides for transparency and acts in their interest."***
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> **VZBV, CI Member, Germany**

United States – Sub-prime lending

In the US, inappropriate sales incentive schemes for mortgage lending helped fuel the financial crisis. Higher priced and risky sub-prime mortgages were aggressively sold to consumers with little regard to their ability to repay.

In addition, some well-qualified borrowers who should have been eligible for less-costly mortgages on better terms were also steered towards these products. Lenders offered 'limited' or 'no-doc' mortgages which did not require proof of income. These mortgages typically had low introductory or 'teaser' rates, which increased after the initial period ended. Loans which were sold as "affordable" options, soon ballooned out of reach when the rates increased.

Sellers' promises of easy refinancing when the rates increased proved false when housing values dipped below the outstanding loan amounts. Overall, there was a dramatic expansion of mortgage lending in the sub-prime sector, with the total amount lent to consumers increasing from US$35 billion in 1994 to US$600 billion in 2006.[11] When the housing market fell in 2007/08, many borrowers could not afford the new payments, were unable to refinance their loans and went into arrears.

Financial institutions had 'securitised' most of the mortgage loans and sold them along with all of their risk to other institutions and investors. Thus, the ensuing large scale defaults on the underlying loans spread instability throughout the entire financial system.

Major financial institutions collapsed and the US Government established the Troubled Asset Relief Program (TARP) to bail out the financial system. Despite this action, the financial crisis caused the most significant fall in output since the Great Depression - 8.7 million jobs were lost in the US.[12] Consumers lost their homes in unprecedented numbers, investments tanked and livelihoods were severely disrupted.

The Federal Reserve found that sales incentives payments based on a loan's terms or conditions created "incentives for loan originators to provide consumers loans with higher interest rates or other less favourable terms, such as prepayment penalties".[13] There was "substantial

In 2013,* The New York Times *reported that JP Morgan Chase's wealth management division, Chase Private Client, pressured employees to sell clients the bank's own investment products even if those products were not in the client's best interests.

JPMorgan pressured brokers to sell the bank's own products, according to current and former employees. Several advisers who resisted said they were told to change their tactics or be pushed out.

"We were not able to do the right things for our clients," a financial adviser who quit JPMorgan in April 2012. He said that an executive told the brokers on a conference call, "You are not a money manager; you are an asset gatherer."

Suzanne Craig and Jessica Silver-Greenberg, Selling the Home Brand: A Look Inside an Elite JPMorgan Unit (March 2, 2013), http://dealbook.nytimes.com/2013/03/02/selling-the-home-brand-a-look-inside-an-elite-jpmorgan-unit-2/

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[11] Bernanke (2008), Fostering Sustainable Homeownership, Speech at the National Community Reinvestment Coalition Annual Meeting, Washington, D.C.

[12] Dallas Federal Reserve (2013), How Bad Was It? The Costs and Consequences of the 2007–09 Financial Crisis

[13] Federal Reserve System (2010), 12 CFR Part 226, Regulation Z, Docket No. R-1366 Truth in Lending, page 41

evidence that [remuneration] based on loan rate or other terms is commonplace throughout the mortgage industry, as reflected in federal agency settlement orders, congressional hearings, studies, and public proceedings."[14]

Specific examples of inappropriate sales incentives schemes for mortgages include:

- Lenders paid a rebate – known as the Yield Spread Premium (YSP) to the mortgage broker or in some cases to the lender's employee. This typically varied according to the type of mortgage and the rate paid by the consumer. Loans which were higher risk or had higher interest rates for the consumer typically generated higher YSPs.

- Academic research has found that the incentives for mortgage brokers provided by lender New Century (the second largest sub-prime mortgage lender in the US) resulted in them recommending riskier loans which were more likely to default.[15] New Century filed for bankruptcy in April 2007.

- At Countrywide, once the largest mortgage lender in the US, loan processors were "financially incentivized to put volume ahead of quality, as [Countrywide] changed its compensation plan to provide bonuses based solely on loan volume. Reductions to compensation for poor loan quality were discontinued."[16]The change to the sales incentives scheme was part of a programme known as the High Speed Swim Lane or HSSL, pronounced 'Hustle'. This programme was put in place in 2007 to attempt to reverse the slowing in revenues from mortgage lending. In July 2014, a judge ordered Bank of America (which had taken over Countrywide) to pay a settlement of US$1.27 billion in connection with the 'Hustle' programme.[17]

Loan processors were "financially incentivized to put volume ahead of quality, as [Countrywide] changed its compensation plan to provide bonuses based solely on loan volume. Reductions to compensation for poor loan quality were discontinued."

- At Washington Mutual (WaMu), there was a pervasive sales culture which focused on increasing the volume of mortgage lending. The company established a sales incentives scheme for employees known as the "President's Club". This would organise all-expenses paid trips to destinations such as Hawaii or the Bahamas where loan officers would receive additional gifts. The US Senate's Permanent Subcommittee on Investigations reported that: "Only a limited number of top producing loan officers were made members of the club, and the President's Club trips were used to incentivize sales volume. Loan officers were encouraged to look up their sales rankings on the company's intranet to see if they would qualify for a trip."[18] Staff working at Washington Mutual received extra bonus payments for

[14] Ibid, page 42
[15] Berndt, Hollifield and Sandas (2009), The Role of Mortgage Brokers in the Subprime Crisis
[16] United States Attorney's Office for the Southern District of New York, Press release, October 2012
[17] Wall Street Journal, Judge Orders Bank of America to Pay $1.27 Billion in 'Hustle' Case, 30th July 2014
[18] United States Senate – Permanent Subcommittee on Investigations (2011), Wall Street and the Financial Crisis: Anatomy of a Financial Collapse, page 148

making higher risk mortgage loans and for exceeding loan targets. There were also increasing bonus payments paid to staff as their individual loan volume exceeded set targets and to increase competition between staff, further bonus payments were made to those ranked in the top 25% by loan volume. To compound these failings, the lender also made payments to quality assurance staff based on the volume of loans they processed. When it failed in 2007, WaMu was the sixth largest bank in the US. It remains the largest banking failure in US financial history. It was taken over by JPMorgan Chase and had the sale not gone through the failure would have exhausted the entire US$45 billion Federal Deposit Insurance fund. Litigation concerning responsibility for the losses is still ongoing. Practices at WaMu were part of the reason for the US Government's US$13 billion settlement with JPMorgan Chase.[19]

United Kingdom - HBOS – A "relentless" sales machine

Halifax Bank of Scotland (HBOS) was a UK bank created in 2001 from the merger of Halifax Building Society and Bank of Scotland. In the years running up to the financial crisis it grew its lending faster than its customer deposits, increasing its reliance on short-term funding from the wholesale markets. A key element of the HBOS retail bank's strategy was to grow lending in 'non-standard' mortgages such as buy-to-let and 'self-certification' loans – where borrowers did not have to provide proof of income.[20]

In 2008, due to its poor lending decisions and dependence on short-term funding, the bank was at risk of collapse and the UK Government waived normal competition law to allow a merger between Lloyds TSB and HBOS to create Lloyds Banking Group. UK taxpayers provided a £20 billion (US$32.2 billion) bail-out of the bank and are still waiting for the return of their money from the sale of the Government stake. There have also been suggestions from the competition authorities and consumer groups that the merger increased the market share of the largest banks and caused a reduction in competition in the UK banking sector.

PPI: For the most profitable of single premium products, up to 87% of the premium would be paid to the bank in commission – in one example £10,200 was paid by the consumer with the bank receiving £8,887.49 in commission.[1]

It is clear that without this bail-out, HBOS would have become insolvent and collapsed. Over the 2008-2011, HBOS made cumulative losses of £30 billion (US$48.4 billion). The UK Parliamentary Commission on Banking Standards concluded that the failure of HBOS was due to its board setting "a strategy for aggressive, asset-led growth across divisions over a sustained period."

A key driver of this push for growth (regardless of risk) was the culture of the bank and the incentives it set for its staff, both through its financial sales incentives scheme and the approach the bank took to using sales targets in its performance management assessments of staff. The bank highlighted its "sales-based culture" as a virtue, with senior management discussing how they "microscopically manage sales detail day in, day out, and incentivise our colleagues to deliver sales

[19] Department of Justice (2013), Justice Department, Federal and State Partners Secure Record $13 billion Global Settlement with JPMorgan, November 19th http://www.justice.gov/opa/pr/2013/November/13-ag-1237.html

[20] Parliamentary Commission on Banking Standards (2013), 'An accident waiting to happen': The failure of HBOS, Para 44

volume." The bank executives explained how they "motivated, rewarded and incentivised colleagues to deliver this exceptional volume growth", and explained what sales processes they were "putting in place to ensure that this remains a long-term trend". Andy Hornby, the then chief executive of the retail division of the bank said that with regards to retail staff in branches the "actual targeting is volume based for the simple reason that colleagues can understand volume" and that "for an average branch they have 12 or 13 sales targets in order to make sure that we do get the optimising shareholder value mix."[21]

HBOS senior management also described how the bank had:

> "…a religion, and our bible is 'Sales Eye'. Every day, by 8 am, every colleague can see their individual sales, the branch's or call centre team's sales for the previous day and, if they want, the sales of our other branches in the area and the region. This helps every branch plan and re plan their sales effort on a daily basis. That philosophy runs right through the business with [senior management] chairing a weekly sales meeting for all products and channel heads in the centre."

Concerns about the sales culture at HBOS and the lack of controls over the risk this posed to the bank were raised by whistle blower Paul Moore, former head of regulatory risk. He highlighted a significant imbalance between the sales culture and the controls in place in the retail bank. This created the risk that customers were: "mis-sold/oversold credit of all types—credit cards, personal loans, excessive mortgages, creditor insurance, investment products such as Corporate Bond Funds which are not necessarily suitable to their needs or affordable."

As emblematic of the sales culture which existed within HBOS, he highlighted a case where a manager had introduced a "cash or cabbage" day, where staff would be given cash bonuses for meeting weekly sales targets, but publicly handed a cabbage if they failed.[22] Mr Moore acted as a whistle blower, disclosing his concerns internally within HBOS and then to the regulator, the Financial Services Authority (FSA). His concerns were not acted upon by the bank and Mr Moore was removed from his position. The FSA did not investigate his concerns and instead relied on a report from KPMG, the auditor of HBOS, which dismissed Mr Moore's concerns.[23]

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The UK regulator is still conducting an inquiry into the collapse of HBOS and has yet to publish its report. However, enforcement action has found that in the corporate division "staff were incentivised to focus on revenue rather than risk, which increased the appetite to facilitate customers, increase lending and take on greater risk."[24]

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[21] HBOS (2003), Retail Investors' Seminar, Transcript, 16th December 2003

[22] BBC (2009), The Choice, BBC Radio 4; also see The Guardian, 'Cabbage lands bank in the soup', 17th August 2005

[23] Dewing and Russel (2011), Whistleblowing on 'fraud' – audit, governance, risk and regulation at HBOS, Norwich Business School

[24] FSA (2012), Final Notice: Bank of Scotland plc, Reference Number:169628

United Kingdom – Payment Protection Insurance

> ***Regulators have said that: "Incentive schemes on PPI were rotten to the core and made a bad problem worse."***

In the UK, PPI was sold on the basis that it protects a borrower's ability to maintain loan repayments should they be unable to keep up their repayments due to accident, sickness, or unemployment. PPI was generally sold alongside the credit, with the same bank typically arranging both the credit product and the insurance. There were significant problems in the market for PPI, with it being widely mis-sold to consumers who would never have been able to claim on it. Banks automatically included PPI when consumers requested a quote for a personal loan. They provided misleading information at the 'point-of-sale', and put pressure on consumers to purchase the insurance. In some cases, consumers were misled that purchasing PPI would increase their chances of obtaining credit. The product was complex and the information provided failed to highlight the key exclusions or to explain the total price of the insurance to consumers. For certain types of PPI, a lump sum covering the cost of the insurance was added to the amount the consumer borrows, so they end up paying interest on both the insurance premium and the loan. This meant that to pay for the PPI premium, a consumer could end up borrowing substantially more than they intended.

PPI was also a very expensive product for the consumer, but very profitable for the banks which sold it. Just 16% of premiums between 2002 and 2006 were paid out to consumers in successful claims. This meant that very high commissions were available to retail banks for distributing PPI. Average commission rates were between 50% and 80% of premiums. For the most profitable of single premium products, up to 87% of the premium would be paid to the bank in commission – in one example £10,200 (US$16,422) was paid by the consumer with the bank receiving £8,887.49 (US$14,311) in commission.[25] These factors meant that PPI represented a significant percentage of retail banking profits. For Lloyds TSB, PPI net income (after claims and expenses) accounted for an average of more than a third of retail banking and general insurance pre-tax profits in 2004, 2005 and 2006. Overall, banks sold £44 billion (US$70.9 billion) of PPI policies since 1996. Taking into account the additional interest paid on the PPI, it is estimated that consumers paid over £50 billion (US$80.6 billion) for PPI.[26]

Despite a series of warnings from consumer groups and some regulatory action, PPI was mis-sold for many years. Finally, in 2011, the banking industry lost a legal challenge against the UK regulator. Consumers made a growing number of complaints about PPI, but many banks demonstrated poor standards of complaints handling, delaying or unfairly rejecting legitimate complaints. High uphold rates at the Financial Ombudsman (the UK Alternative Dispute Resolution scheme) persisted for several years after the problems were first highlighted by consumer groups. There were also delays in contacting consumers who may have been mis-sold PPI. UK banks have so far set aside around £24.3 billion (US$39.3 billion) to pay redress to consumers.

Inappropriate remuneration and sales incentive schemes were an important root cause of PPI mis-selling – frontline staff were given strong incentives to sell the product, regardless of whether it was appropriate for the customer. Regulators have said that "Incentive schemes on PPI were rotten to

[25] Harrison & Anor v Black Horse Ltd (2011), EWCA Civ 1128, 12th October 2011 http://www.bailii.org/ew/cases/EWCA/Civ/2011/1128.html

[26] Which? (2012c), Written evidence to the Parliamentary Commission on Banking Standards Mis-selling anel

the core and made a bad problem worse."[27] The former Chief Ombudsman in the UK told a parliamentary inquiry that PPI "was not always priced appropriately, nor was it always sold to the right people…some banks were incentivising their staff to sell it to over 50% of people who took out loans, which I would argue cannot possibly have been the right proportion."

Poor practice regarding the remuneration and sales incentives schemes for PPI, which contributed to mis-selling included:

- Advisers at Alliance and Leicester received six times as much bonus for selling a loan with PPI as for selling a loan without PPI. If they did not sell PPI with more than 50% of loans then they would see a quarter of the value cut off their bonus.[28]
- HFC bank set sales targets of selling PPI with 80% of loans and frontline advisers were eligible for bonuses if they reached this target.[29]
- In Liverpool Victoria Banking Services, targets of 50% PPI penetration were set for each member of staff for the award of these bonuses. Individuals failing to meet this target were not awarded any bonuses and were described as having 'a training need.' Furthermore, there was no clawback of the bonus if the customer subsequently cancelled the policy.
- HBOS had a policy in the personal loans market to "drive profitability through [Payment Protection] insurance cross-sales" with take-up rates reported to be greater than 50%.[30]
- Firstplus (part of Barclaycard) Customer Account Managers were measured on achievement of targets based on transaction volume and PPI penetration. The average payment to an employee for a PPI sale was £100 (US$161). There was a cap on the incentive related to penetration rates set at 85%. Clawback provisions only deducted the incentive if a PPI policy was cancelled during the 30 day "cooling off" period.[31]
- RBS awarded its frontline staff "double bonus points" when they sold a loan with PPI. The number of bonus points awarded also increased as the size of the loan increased. So, frontline staff could earn higher points for persuading customers to borrow more and to take out PPI. Gordon Pell, former chief executive of RBS retail said that he did not sign off the RBS staff incentive scheme and was not aware that there were double points for PPI sales.

Australia – Mis-selling of risky investment products to retail consumers

In Australia, a number of cases of mis-selling of investment products have been linked to inappropriate remuneration and commission schemes. CI Member *CHOICE* reported the case of multiple financial planners in the Commonwealth Bank (CBA) investing clients' money in high risk investment products when medium or low risk products were in their best interests. In some cases, low risk investments were requested but documents were forged to move clients to high risk (and high commission) products. In other cases, clients were 'churned' into new products simply to meet sales targets. Evidence to an inquiry by a Committee of the Australian Senate from a whistle blower within Commonwealth Bank suggested that the culture was driven by "sales and a metricated short

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[27] Wheatley (2012), The incentivisation of sales staff – are consumers getting a fair deal?, 5 September 2012 http://www.fsa.gov.uk/library/communication/speeches/2012/0905-mw.shtml
[28] FSA (2008), Final Notice: Alliance and Leicester, 6th October 2008
[29] FSA (2008b), Final Notice: HFC Bank, 16th January 2008
[30] HBOS (2003), Retail Investors' Seminar, Transcript, 16th December 2003
[31] Barclays (2012), Written evidence to the Parliamentary Commission on Banking Standards Mis-selling Panel

term remuneration/bonus structure at all levels" and "where ethics and propriety at best" took a back seat.[32]

Despite the risk of mis-selling posed by the commission-based sales incentives scheme, it was apparent that the bank was unwilling to take action against advisers giving non-compliant advice. The Australian Securities and Investment Commission (ASIC) noted that of the 38 advisers rated 'critical' by the bank's compliance unit only 12 were removed from their posts and that there appeared to be some correlation between the amount of revenue earned and a decision not to revoke an adviser's authorisation. The Senate Economic References Committee concluded that the bank was "willing to turn a blind eye to non-compliant advisers, so long as they were earning significant revenue for the company".

CHOICE provided the following case study of the impact on an individual consumer:

> Victims of fraud, Commonwealth Bank of Australia: "Robyn and I invested AUS$260,000 (US$229,537) with CFPL in an Allocated Pension in May 2007. By March 2009 this capital investment had devalued to $92,399 (US$81,573). We cashed out in August 2010 with a residual balance of around $141,000 (US$124,458). Between 2007 and the present time we have been subjected to unmitigated deception, obstruction and fraud as CBA has attempted to cover up the illegal activities of… CBA's financial planner who organised this investment."

When the regulator, ASIC, ultimately acted on these cases, seven financial planners were banned from practicing for several years. The Commonwealth Bank signed an enforceable undertaking which, required better internal compliance systems and established a compensation fund which has returned $50 million (US$44 million) to consumers. After an extensive Senate Inquiry, it emerged that the initial compensation process was extremely inadequate, failing to capture a number of affected customers. After public pressure, the Commonwealth Bank recently announced a new scheme enabling customers who received advice between 2003 and 2012 to have it reviewed. The bank has not revealed how much this compensation scheme might cost.[33]

Other cases of mis-selling in Australia caused by inappropriate sales incentives schemes have included:

- Opes Prime was a firm which offered a way for consumers to invest in the stock market using borrowed money from a bank. It was suggested that the sales staff either did not understand the product "and so were unable to disclose the higher risk nature of the product – or they were fully cognisant of the higher risks but obscured them rather than jeopardise their sales commission."[34] ANZ bank provided this financing, but had a relationship with Opes Prime rather than its individual customers. The company was put into liquidation in 2008 and ANZ bank seized the shares and sold them to recover money owed to

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[32] Australian Senate Economics Reference Committee (2014), Performance of the Australian Securities and Investment Commission, Chapter 8 – Commonwealth Financial Planning Ltd: What went wrong at CFPL and Why?

[33] Commonwealth Bank (2014), Statement to our customers from Ian Narev, CEO of the Commonwealth Bank, 3rd July 2014

[34] Australian Parliamentary Joint Committee on Corporations and Financial Services (2009), Financial Products and Services in Australia, Chapter 4 – The collapse of Opes Prime

it by Opes Prime. Customers found that they no longer had any entitlement to the shares which they had borrowed against. Subsequently, ANZ and Merrill Lynch contributed AUS$250 million (US$221 million) to a scheme or arrangement which was intended to compensate creditors, including Opes Prime customers. However, the creditors only received 37% of their losses through the scheme.

- Macquarie Bank is being required to contact 160,000 customers about the poor advice given by its financial advice division – Macquarie Private Wealth. It is not yet clear what the extent of compensation payments might be.
- Storm Financial sold investment products to consumers who were encouraged to borrow against their homes to invest in the stock market. In some cases the customers were also encouraged to take out additional 'margin loans' to further increase the size of their investments. Customers were all given the same advice, regardless of their particular circumstances and attitude to risk. When stock markets fell, Storm Financial collapsed and 14,000 customers suffered losses totally $830 million (US$732 million). There were a number of commission-based sales incentives schemes for Storm advisers including upfront commissions and payments based on sales volumes, which encouraged staff to recommend borrowing to invest in the stock market. It has also been suggested that sales targets in Commonwealth Bank encouraged the bank to lend to clients of Storm to purchase these investments.[35]

Spain – Hybrid securities/Preference shares

In Spain, the sale of 'Preferred shares' (Participaciones Preferentes) and subordinated debt have created significant losses for consumers and caused instability in the Spanish banking system. These complex products (also known as hybrid securities) offered an income in the form of an annual payment. Whilst they were sold to consumers as substitutes for simple deposits, the income paid by these hybrid securities was variable and the consumers were at risk of losing their capital if the bank which issued and sold the product should run short of capital and default. There was no guarantee that consumers would be able to sell these securities if they needed access to their money. Whilst these products had been sold in Spain for a number of years, the amount sold to retail customers increased after the financial crisis. Banks in Spain needed to raise money to increase their level of capital following substantial losses made in the property market. Some banks found that an easy way to raise this money was to sell these hybrid securities to their retail customers.[36] Many did not inform consumers of the risks of the product, gave them misleading information or told them that the securities were no more risky than ordinary bank deposits.

> ***Emiliano, 73, Spain***
> ***I asked: "What do you mean, that the money has disappeared?"***
>
> **OCU, CI Member, Spain**

As the financial situation of these savings banks deteriorated consumers found that they were facing significant losses of their capital. The preferred shares were converted into ordinary shares when the savings banks were recapitalised. CI Member, consumer group Organización de Consumidores y Usuarios (*OCU)* reported that 80% of the consumers affected were older than 65. *OCU* have also

[35] Industry Super Australia (2014), Submission on Exposure Draft: Corporations Amendment (Streamlining of Future of Financial Advice) Bill
[36] Zunzunegui (2013), Distribution of Preferred Shares Among Retail Clients

highlighted cases such as 'Preferred shares' being sold to consumers such as Emiliano, a blind 73-year-old who was told that the product was "guaranteed".[37] Poor practice has included banks:

- Providing misleading information about the riskiness of the product
- Aggressively selling these products to their existing retail customers
- Claiming that these products are "guaranteed" or were similar to "safe" banking deposits
- Providing unsuitable advice to purchase these products

The losses led to widespread complaints from consumers, the establishment of an arbitration scheme and enforcement action by the regulator.

- In February 2014, Santander was fined $16.9 million (US$14.9 million) for inappropriately selling bonds to its customers which converted to ordinary shares sales.[38]
- In June 2014, the government established Fund for the Orderly Restructuring of the Banking Sector (FROB) which reported that claims totalling at least €2.9 billion (US$3.65 billion) would be paid by the three banks in which the FROB owns a stake.[39]

The fact that these hybrid securities were inappropriately sold to customers has also complicated the orderly resolution of failing Spanish banks and resulted in the Spanish Government having to increase its bail-out of the sector. The concept of these hybrid securities was that they would be used to absorb losses if the bank got into financial difficulties. However, if they have been inappropriately sold to retail customers then the bank could be subject to litigation and legal claims arising from breaches of regulation and the law.

The risk of sales incentives schemes leading to further inappropriate sales of these products is heightened as banks across Europe will need to meet new higher capital requirements and to issue increased volumes of hybrid securities, with the intention that this will reduce the probability that governments will need to bail them out. This objective will not be achieved if inappropriate sales incentives schemes cause banks to conceal the risks of these products and sell them to their existing customers.

Emiliano is 73 years old. In 2011 he was contacted by CajaMadrid (today Bankia) to invest his lifelong savings in preferred shares. He was told that a 7% interest rate was guaranteed and if he needed his money – as he was planning to move to a retirement home – it could be in his account the next day. He had been a customer of that bank for 48 years and was told that this was a special product for customers like him. When he needed his money he was told that the bank had not made any profit and therefore there was no interest, when he simply asked for his money back he was told that this was difficult. Bankia was bailed out by the Spanish Government. Emiliano and his wife Begoña, both blind with no children, cannot join a senior home anymore as they had planned to do.

OCU, CI Member, Spain

Watch him tell his story: http://www.youtube.com/watch?v=sFNneZLoz8E&list=PLDE9E37227C587709

[37] OCU (2013), The preferred shares drama, video
[38] Reuters (2014), Spain fines Santander over convertible bond sale
[39] FROB (2014), Testimony by the chairman of the governing committee of the FROB before the parliamentary committee on economic affairs and competitiveness

It was reported that banking staff were instructed to pressurise customers to buy these hybrid securities.[40] A former chairman of the CNMV (the Spanish stock market regulator) has said that "The branch networks work like armies that get instructions on the quota of the product they need to sell."[41]

Sales incentives schemes were used to encourage banking staff to sell these riskier hybrid products instead of normal savings accounts. The European Federation of Financial Services Users highlighted that "According to the Commission for Investigation created by the Regional Parliament of Valencia upon the failure of the regional savings bank CAM (Caja de Ahorros del Mediterraneo), Mr Hernández Olivares, member of CAM's Commission for Control, declared to the Commission that branch directors had to comply with the quantitative objectives [for the sale of these products] established by the management and, if such objectives were not reached, had to provide explanations to the management."[42]

Hong Kong - Lehman mini-bonds/structured products

In Hong Kong, consumers suffered significant losses from investing in structured investment products backed by the investment bank – Lehman Brothers. The return paid by these structured products was linked to a basket of shares, a stock market index or the creditworthiness of a number of publicly-listed corporations. However, the return and the consumer's original investment depended on the ability of Lehman Brothers to make the payments due under the structured product. In total, HK$20.23 billion (US$2.6 billion) worth of Lehman Brothers structured products were sold to more than 43,700 consumers through retail banks. When Lehman Brothers collapsed in October 2008, the holders of these structured products and mini-bonds suffered significant losses.

Information disclosed to consumers regarding the products was lengthy and complicated, with prospectuses stretching to more than 200 pages. Banks claimed that their sales processes only provided "information" to consumers about the products and not regulated investment "advice" that the product was suitable for their circumstances.

However, the sub-committee of the Hong Kong Legislative Council appointed to study the issues arising from the sale of these products noted that from "the perspective of some customers, the line between the two was far from clear, as it was often the case that they had been introduced to such products by the bank staff who also persuaded them to subscribe for these products for higher returns."[43] It was also alleged that staff encouraged consumers to invest their normal bank deposits into structured products by offering gifts such as "free shopping coupons".[44]

Inappropriate sales incentives schemes contributed to the mis-selling of these products. Remuneration of frontline staff within the banks selling Lehman Brothers structured products was:

> "…linked to the sales staff's overall performance, the total revenue earned by the staff for the bank from sale of different products (usually calculated on a quarterly basis), and/or the product-level incentives."

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[40] WSWS (2013), Hundreds of thousands of defrauded small savers face loss of life savings in Spain

[41] Bloomberg (2012), Spain bank bailout means forcing losses on cooks, pensioners, 12 July 2012

[42] EuroFinuse (2012), Response to the ESMA Consultation Paper on Guidelines on Remuneration Policies and Practices

[43] Hong Kong Legislative Council (2012), Report of the Subcommittee to Study Issues Arising from Lehman Brothers-related Mini-bonds and Structured Financial Products, page 179

[44] Godwin (2010), The Lehman Bonds Mini-crisis in Hong Kong: Lessons for Plain Language Risk Disclosure

One member of staff reported that the incentives he received from the sale of financial and investment products in a quarter could be five or six times his monthly basic pay. The banks maintained that the payments under the incentives schemes were subject to satisfactory "compliance" with regulatory requirements. However, it was observed that determining compliance relied too much on "reviewing documents" to check whether all the necessary steps of the sales process had been duly completed.

In terms of the appraisal of staff, the investigation found that: "Sales achievement was a very important aspect in the evaluation of the performance of sales staff." The Sub-committee concluded that: "in some cases sales staff might have sought to achieve sales at the expense of observing a proper standard of conduct."[45]

Following negotiations, the 16 banks agreed to re-purchase the mini-bonds from customers and to make additional payments depending on the amounts recovered from the Lehman Brothers bankruptcy. Depending on the precise issue of the mini-bonds the customer invested in, the losses ranged from 15% to 3.5% of their investment. Royal Bank of Scotland and Citibank entered into agreements with the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) to repurchase the products from investors. The Bank of China reported that investors in the Lehman Brothers mini-bonds it sold would suffer aggregate losses of HK$640 million (US$82.5 million), with the bank itself suffering a further loss of HK$1 billion (US$129 million) due to its costs and the agreement to make payments to investors.[46] Assuming that these percentages represent typical losses to the banks and investors then total losses would be in the region of HK$3.4 billion (US$438 million) for banks and HK$2.3 billion (US$297 million) for investors.

In Italy, Santander Unifin offered a loan to an employee: ***"The bank gave me the sum of €13,820 to be paid in 96 payments which they took directly from my wage, for a final amount of €23,712, interest included. To receive the loan I had to subscribe to a credit insurance policy that cost me €1,700. I paid 54 out of 96 payments when I lost my job. Santander wants me to pay a further €10,000 because the insurance is not paying for it. Why have I been obliged to buy that insurance if they won't pay now? The policy is just a further robbery on needy people!" –***

Altroconsumo,
CI Member, Italy

The Netherlands - DSB Bank –insurance and investment products sold alongside mortgages

DSB (Dirk Scheringa Beheer) Bank was based in the Netherlands and specialised in mortgages, insurance, personal loans and savings accounts. The DSB Bank business model was to sell mortgage and consumer loans at low interest rates in combination with life and disability insurance. To pay for this insurance the amount of the premium was added to the loan in a single upfront lump-sum.

The bank also sold investment products alongside the loans with a proportion of the customer's monthly payment invested in the stock market in the hope that the growth of the investment would be sufficient to repay the loan. DSB's profits relied heavily on the commissions and premiums gained from selling the insurance and investment products. There were no proper systems for recording, responding to or investigating complaints and no analysis to determine the root causes of the issues

[45] Hong Kong Legislative Council (2012), pages 122-23
[46] Bank of China Hong Kong (2011), Final resolution proposal in respect of relevant mini-bonds

raised. This led the bank to fail to make proper provisions for the payment of compensation to customers.

Growing customer complaints and the credit crunch reducing its ability to borrow led to a run on DSB and the bank was declared insolvent on 19 October 2009. The bank is still being managed through the bankruptcy process so the total losses for creditors of the bank will not be known for several years. A compensation scheme was established to pay customers part of the losses they had suffered from the breaches of regulation when selling the insurance and investment products and is expected to pay out €215 million (US$270 million).[47]

A report into the collapse found that DSB Bank's strategy was a "sales-driven" business model. The percentage of other products sold alongside the loans (the cross-selling percentage) was reported "weekly"[48] to management. The structure of sales incentives schemes for staff were designed by management to support the cross-selling model and contributed to the mis-selling of these products and ultimately the collapse of the bank:

> "…a substantial portion of [staff] pay (an average of 40%) was variable remuneration, to drive and incentivise cross-selling to achieve targets in terms of numbers and revenue. Offices could also earn bonuses by achieving set targets. Office staff were given 'performance snacks' to encourage them to reach targets. It was not until early 2008 that variable remuneration was also made partially dependent on the quality of the production, such as the quality of the customer profile."[49]

Portugal – Banco Espirito Santo

Portugal's second largest bank, Banco Espirito Santo, sold its own bonds and bonds issued by companies linked to the bank to its retail clients. It sold Banco Espirito Santo bonds through "Special Purpose Entities" (SPEs) to its own retail customers. It also sold debt issued by companies linked to the bank including Espirito Santo International, Rio Forte and Espirito Santo Financial Group. In total the bank had to set aside €2.1 billion (US$2.64 billion) to repay retail and institutional clients who had bought this debt. It also noted that short-term bonds issued by the bank have also been placed with retail clients and in the possible, but unlikely, event that it had to purchase all these bonds, losses as of June 30th 2014 would be €505 million (US$638 million).

The bank has received a €4.9 billion (US$6.2 billion) bail-out from the Portuguese central bank. In light of these losses, the Board of Directors had "decided to revise the entire process of sale of own debt instruments to retail clients".

The Wall Street Journal reported[50] that: "Bank branch managers told retail customers that the products were as safe as deposits but with better returns" and that "Portuguese regulators believe the vehicles were designed to appeal to retail customers. 'Aforro' and 'poupanca' mean 'savings' in Portuguese. 'Top Renda' means 'Top Income'. It also cited sources saying that the sales of these products were an attempt to prop-up the bank and other Espirito Santo group companies.

[47] Houthoff Buruma (2014), Insolvency Report no. 21 by the Administrators of DSB Bank N.V.
[48] Houthoff Buruma (2012), Report on investigation of the causes of the bankruptcy of DSB Bank N.V. Para 10.4.2
[49] Ibid, Para 10.4.2
[50] Wall Street Journal (2014), Credit Suisse caught up in Espirito Santo mess, 19th August 2014

Mexico - Micro-finance problems

In Mexico, inappropriate sales incentive schemes have been identified by research conducted by the World Bank as a possible barrier to financial inclusion. In 2007, the Mexican government introduced the Law on Credit Institutions which requires that all deposit-taking institutions offer a "basic account" without account opening, deposits, withdrawals, balance enquiry, or debit card fees. This was intended to promote financial inclusion, improve access to the financial system and contribute to alleviating poverty.

A World Bank mystery shopping study on bank selling practices for credit and savings products found that "staff voluntarily provided little information about avoidable fees, especially to auditors trained to reveal little knowledge about the market" and clients were "almost never offered the cheapest product, most likely because staff [were] incentivized to offer more expensive products that are thus more profitable to the institution". Despite the new law, staff offered the basic account in only two out of 54 visits conducted.[51]

France – Floatation of Natixis bank

In October 2006 as part of the initial public offering of Natixis, the investment banking and asset management arm of the French bank Banque Populaires-Caisses d'Epargne (BPCE), shares were sold to retail customers of BPCE for €19.55 (US$24.72) each.

Shares of Natixis were marketed and sold by BPCE employees to their customers, with some telling them that it was a safe investment. There was a "promotional drive" to sell Natixis shares through the branches of Banque Populaire and Caisse d'Epargne.[52] Moreover, purchases were engaged by BPCE under the name of their clients, but without their consent. Sometimes, BPCE employees swapped funds to secure financial products (such as "Livret A" – a tax advantaged cash savings account) for Natixis stocks. Eventually, 2.6 million people bought Natixis shares, including 5% of all BPCE clients.

As a result, Natixis' stock lost more than 95% of its value over the course of a few months: it became worth less than €1 (US$1.3) in March 2009, and are now only worth €5 (US$6.32). Legal action concerning mis-selling and poor advice is ongoing.

In Italy, many consumers were told that in order to take out a loan they would first need to subscribe to an insurance policy with the same bank. One customer of Banca Popolare di Bari needed a mortgage for a new flat:

"It was a small mortgage compared to the cost of the flat, most of which I had already paid. I have good revenues but the bank employee was not interested at all in my personal financial situation. He shut me up and said that if I wanted the mortgage I had to subscribe to their mortgage life insurance product that cost more than €12,000." **- Evidence Altroconsumo, CI Member, Italy**

More mystery shopping from Italy: https://www.youtube.com/watch?v=efwzy8moWjc

[51] World Bank (2014), Financial (Dis-) Information – Evidence from an audit study in Mexico
[52] Ali-baba (2009), UPDATE 3-State-backed BPCE underwrites Natixis toxic assets, 26th August 2009

Part 3: Risks to financial stability from inappropriate sales incentives schemes

These case studies demonstrate that inappropriate sales incentives schemes have caused significant detriment to millions of consumers and instability in the financial system.

The impact of inappropriate sales incentives schemes:

- Irresponsible lending leading to:
    - Booms and busts in housing markets
    - Consumer detriment from mortgage/loan arrears and loss of homes from foreclosure/repossession
    - Losses to banks and investors
- Inappropriate products and unsuitable advice leading to losses to consumers and banks
- Collapse of banks and other financial institutions and difficulties in securing an orderly resolution of failing banks
- Taxpayer support and bail-outs which distort competition and lead to losses for taxpayers
- Economic volatility and job losses caused by the collapse of banks and a move from feast to famine in the availability of lending
- Erosion of trust and confidence in banks and the banking system

The compounding effect

Losses to the banks from misconduct and mis-selling caused by inappropriate sales incentives can compound the losses caused by irresponsible lending. These issues can also be correlated: inappropriate sales incentives schemes for mortgage lending could contribute to an eventual decline in the housing market. This will lead to losses to banks as consumers default on their mortgages. There is also likely to be greater consumer detriment (and associated complaints) in the aftermath of a decline in the housing market. Uncovering of poor practice could result in regulatory fines for the banks and the payment of compensation to consumers. Losses to consumers and banks from inappropriate investment advice will also be more likely to be exposed in the aftermath of a fall in the stock market.

Delayed exposure and resolution

Misconduct caused by inappropriate sales incentives can take several years to emerge, investigate and be resolved. There are several reasons for this:

- Financial products and services are long-term contracts, and it may take time before it becomes clear that they have been sold inappropriately
- It may take time for misconduct to be uncovered within the banks and there may be delays in notifying the problem to the regulator
- The regulator will take time to investigate the misconduct and take enforcement action
- Banks may not contact or delay contacting consumers who might have been affected by the misconduct
- The initial redress schemes agreed between the banks and the regulator may prove to be inadequate or banks may receive more complaints than they expect
- Banks may delay or frustrate legitimate complaints with the result that consumers may need to access an Alternative Dispute Resolution (ADR) scheme or take legal action to obtain redress

- Legal action can take several years to be resolved, with the industry possessing substantially greater resources than consumers which enable banks to appeal any verdict to a higher authority

The implication of these issues is that the provisions can impact negatively on banks just when consumers need them to recover and support the economy through lending. These provisions can also be substantial and can appear in a short space of time as the misconduct is uncovered, coming as a surprise to the bank's management and the market. They can also appear or increase suddenly following a change in management and a willingness to reveal the bad news as quickly as possible. Credit Suisse has estimated that the total provisions for European banks from litigation will now reach US$104 billion compared to their previous estimate of US$58 billion at the start of 2013.[53]

Sales incentives schemes and operational risk

Banks are required to set aside capital to cover losses from what is referred to as "operational risk" (see box text at the end of this section for details of the different methods banks can use to calculate operational risk capital). This capital pays for, among other things, the costs associated with bad practices, fines, compensation, legal fees, etc. incurred as a result of inappropriate sales incentives schemes. However the scale of these costs in recent years has meant that the losses suffered by some major banks has significantly exceeded the amounts set aside for all operational risk. In several cases these inadequate levels of capital and other operational risk events have contributed to the failure of a bank (or its failure in the absence of a taxpayer bail-out).

The Basel Committee on Banking Supervision is responsible for setting the capital requirements for 'operational risk' and would need to take action to recommend a substantial increase in the amount of capital held.

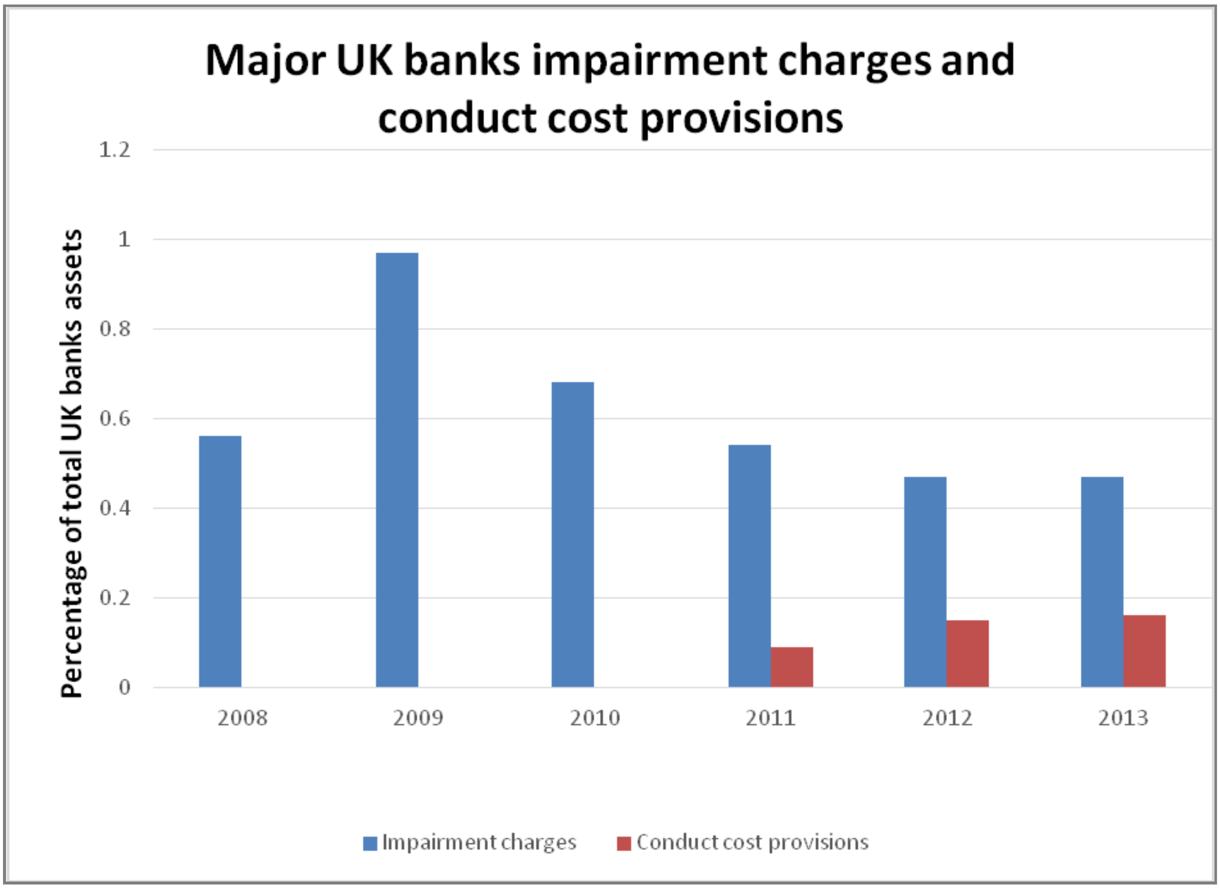
Once misconduct has been uncovered, banks may report specific provisions which will estimate the extent of their losses. Whilst there are significant international and national standards concerning how banks should calculate and report on credit impairments (losses from loans)[54], there are no detailed standards or regulatory guidance on how they should report losses and potential provisions from misconduct and nor do they need to provide transparency around how those provisions are calculated. This can make it difficult to determine whether, once the misconduct has been uncovered, banks have set aside enough money to cover the losses.

An example from the UK: how the cost of misconduct exceeded operational risk capital

The chart below shows that the provisions UK banks set aside to pay for their misconduct steadily increased in 2011 to a peak in 2013. Banks were slow to recognise that they needed to set aside realistic provisions to pay for the cost of mis-selling and misconduct and to understand the amounts necessary. By contrast, provisions against losses on loans peaked in 2009 immediately after the financial crisis before declining again. The banks' failure to properly record and assess conduct provisions prolongs their financial issues and hinders their ability to support the economy by lending to consumers and business. Consumers suffer delays in having their complaints dealt with and receiving redress. It also hinders investors from making informed decisions about the financial position of the banks.

[53] Credit Suisse (2014), European banks: Litigation – more risk, less return

[54] International Financial Reporting Standard 7 (Financial Instruments); In the UK, PRA Handbook sections include Senior Management Arrangements, Systems and Controls (SYSC) & Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU)



Underestimated impact and provisions for misconduct and risk

It is also clear that, in some cases, the losses stemming from misconduct caused by inappropriate sales incentives schemes and the need to pay compensation can be more significant than those caused by normal lending to retail customers. In total, so far, UK banks have set aside around £24.3 billion (US$39.3 billion) to compensate consumers for mis-sold Payment Protection Insurance. That is more than twice as much as their total losses on UK mortgage lending since 2008.[55]

UK payment protection insurance mis-selling

For the largest UK banks, paying redress to customers affected by the PPI scandal represented a significant proportion of their overall capital and significantly exceeded the amounts they had set aside to cover "operational risk". The charts below show the impact of PPI redress provisions on the five major UK bank's capital and role of 'operational risk' provisions in a substantial capital shortfall at the Co-operative Bank.

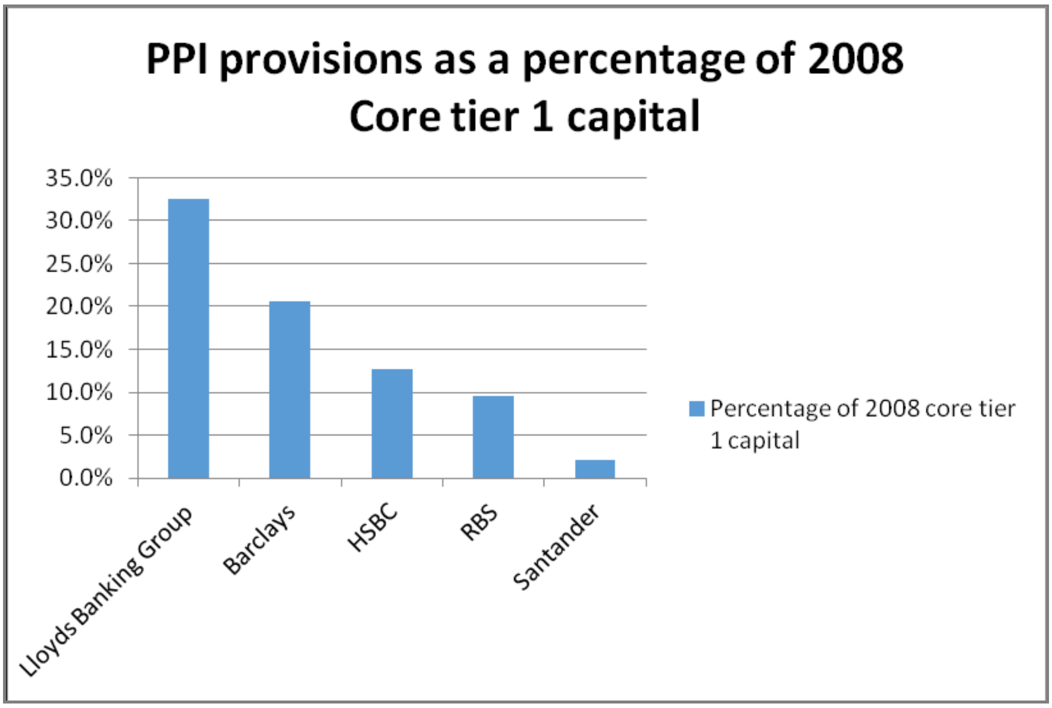
The chart below illustrates that for four of the major UK banking groups, the amount of PPI provisions has exceeded the amount of operational risk capital. In the case of Lloyds Banking Group, the amount of PPI provisions has been more than five times the amount of operational risk capital. It should be noted that the capital set aside for operational risk is expected to cover a wide range of events.

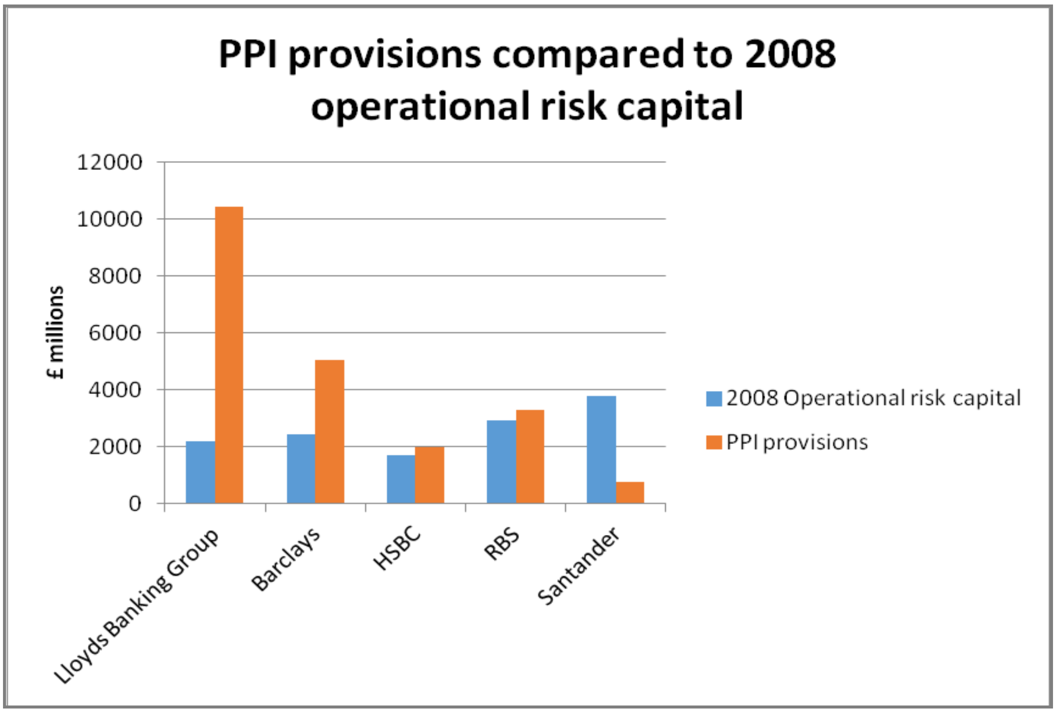
That the capital requirements were exceeded by the cost of redress from mis-selling of a single product demonstrates that the methods of calculating operational risk capital need improvement.

[55] Bank of England (2014), Financial Stability Report, Issue No. 135, page 15

Widespread misconduct increases operational risk costs

In addition to PPI mis-selling, the major UK banks also face provisions and litigation costs from the mis-selling of interest-rate swaps to small business and the mis-selling of investment products, card protection and ID theft insurance to consumers. They have also incurred and will incur further provisions relating to regulatory settlements or class action lawsuits in relation to manipulation of LIBOR, interest-rate, commodity and foreign-exchange markets; US mortgage litigation and anti-money laundering sanctions; litigation from providing misleading financial statements and bank specific issues such as misleading customers about the terms of their mortgages, dealing with Bernie Madoff and not disclosing 'advisory payments' for raising money during the financial crisis.

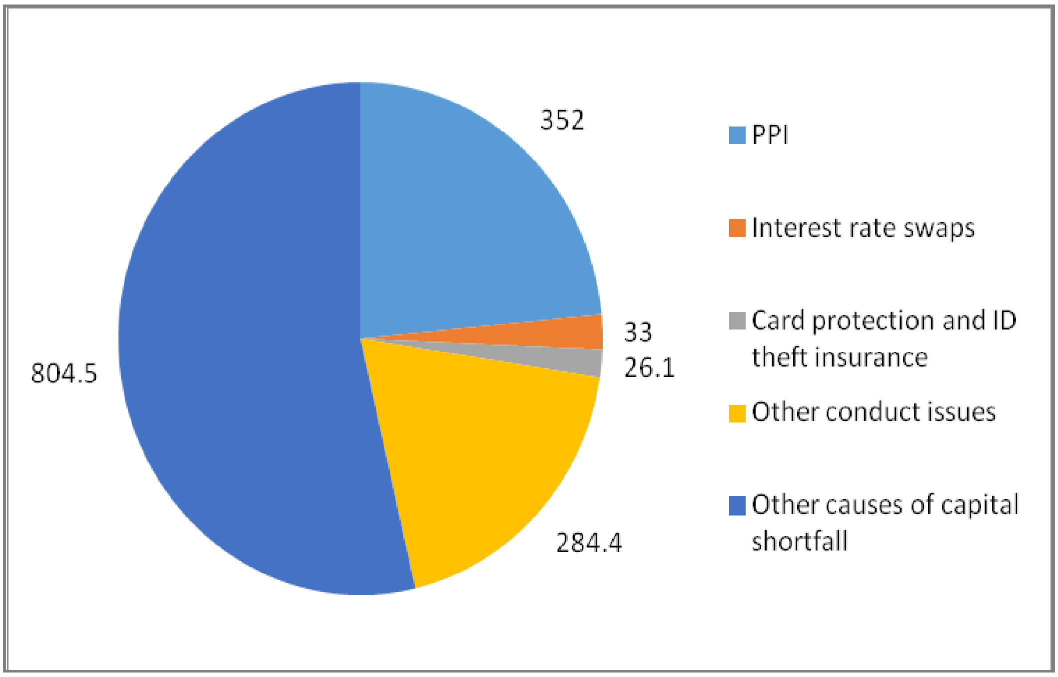




The Co-operative Bank capital shortfall: Total provisions for misconduct and customer issues almost five and a half times capital for operational risk

Following a review of its capital position in 2013, the Co-operative Bank identified that it had a capital shortfall of £1.5 billion (US$2.4 billion).[56] Conduct risk issues accounted for ~46% of its £1.5 billion (US$2.4 billion) capital shortfall, which almost caused the bank to collapse.[57] These issues included the mis-selling of PPI, interest rate swaps and card protection/ID theft insurance to its customers. Instead of increasing the amount of capital it was holding against 'operational risk', the Co-operative Bank reduced it from £128.6 million (US$207 million) in 2009 to £115.3 million (US$185 million) in 2012.[58] Total provisions for conduct risk and customer issues were almost five and a half times the capital set aside.

Causes of the £1.5 billion capital shortfall at the Co-operative bank



[56] Co-operative Group (2013), Update on The Co-operative Bank's capital position and plan to meet The Co-operative Bank's capital requirements http://www.co-operative.coop/corporate/press/press-releases/headline-news/Update-on-capital-position/
[57] Co-operative Bank (2013), Annual Report and Accounts http://www.co-operativebank.co.uk/assets/pdf/bank/investorrelations/financialresults/bank-r-and-a.pdf
[58] Co-operative Bank (2010) and (2012), Pillar 3 disclosures http://www.co-operativebank.co.uk/assets/pdf/bank/investorrelations/financialresults/pillar-3-disclosure-2012.pdf http://www.co-operativebank.co.uk/assets/pdf/bank/investorrelations/financialresults/pillar-3-disclosure-2010.pdf

Operational risk capital

The Basel capital adequacy framework requires banks to set aside capital against what is called 'operational risk' – which is defined as the "risk of loss resulting from inadequate or failed internal processes, people and systems or from external events." This should include capital set aside to cover issues such as the mis-selling of products or non-compliance with regulatory requirements. However, it should also include capital to cover potential losses from issues such as business disruption, technology systems/cyber security, financial crime and employment/health and safety policies.

Banks are allowed to use one of three approaches to estimate the amount of capital they need to set aside for 'operational risk'. These are:

- **Basic indicator approach**: This requires the bank to set aside capital for operational risk as a fixed percentage of an average of three years of relevant income.
- **Standardised approach**: This requires banks to divide their business into a number of different categories and then sets capital requirements as a percentage of an average of three years of relevant income for each category of banking business. These indicators range from 12% to 18%, depending on the category, with retail banking attracting the lowest weight of 12%.
- **Advanced Management Approach (AMA)**: This allows banks to use their own internal models to estimate the amount of capital they need to set aside for operational risk. The models will estimate the potential frequency and severity of operational risk losses to determine the capital required. Models should use internal data, external data and factors reflecting the business environment and internal control systems. Based on this modelling the bank is expected to set aside sufficient capital for operational risk at a 99.9% confidence interval. This means that the bank should only suffer losses worse than this 0.01% of the time.

Each of these approaches has its drawbacks. The basic indicator and standardised approaches use a mechanistic method of setting capital. Whilst simplistic, they are not sensitive to changes in the external environment and not forward looking. By setting capital as a percentage of the bank's income they reduce capital following a reduction in income – which might coincide with declining revenue at the bank due to an economic downturn or business specific issue – both of which could increase the probability and impact of losses from operational risk.

The AMA approach is more complex and could be more sensitive to emerging risks. However, it relies on internal data which might be limited, incomplete or difficult for banks to model accurately. Also, by using internal and external data it could be pro-cyclical – reducing capital requirements at the very time when risks are greatest. Models could assume that a low level of losses both internally and externally reflects a low level of risk, whereas risks could actually be building up or concealed by management practice or benign economic conditions. There is also the criticism of the modelling techniques used and that they fail to account for rare, but extreme events which are difficult to model. It is those rare or extreme operational risk events which cause the greatest impact on financial stability.

Tools to assess operational risk to ensure a stable financial system

Stress-testing of banks

A bank stress test is a detailed examination of the financial state of individual banks and the banking system following a number of defined scenarios.[59] The main purpose of a stress test is to provide a forward-looking assessment of the financial health of individual banks and the banking system. It measures the amount of capital help by banks the possible extent of losses they could incur and how much capital they would be left with after experiencing those losses. Using stress tests is an important way of assessing whether banks need to raise additional capital. Regulatory authorities can respond to these stress tests by ordering banks to raise additional capital, restrict dividends or reducing risk exposures or business lines. A key principle of stress tests is that the results of them and the underlying analysis should be made public.[60] This transparency is supposed to enhance market discipline, support the credibility of the stress tests, incentivise banks to engage with the exercise and for them to manage the risks in their business.

Before starting a stress test, the regulator could require the banks to conduct what are known as 'asset quality reviews'. These act as the starting point for the stress tests by checking that the banks current capital position is presented accurately.

Treatment of conduct costs and risks from inappropriate sales incentives schemes

If bank stress tests and asset quality reviews exclude 'operational risk' then they will exclude an important risk to the stability of banks and the financial system. By not including operational risk and the possible losses caused by inappropriate sales incentives schemes, stress tests will not provide a comprehensive picture of the health of the banking system or individual banks. CI believes that there is significant room for improvement in how stress tests and asset quality reviews should examine misconduct and operational risk issues.

An important purpose of a stress test is for banks to provide transparency about their current financial position. CI argues that this should include full details of all pending litigation, regulatory issues and possible customer redress as well as full details of how these have been calculated. The stress test should also include applying reasonable judgment to the range of possible operational risk losses, and that this should take into account that they are likely to be more severe in a 'stressed' economic scenario.

To judge whether the capital provided by the bank will be capable of absorbing losses, regulators would also need to investigate whether any of the capital instruments have been sold to retail customers. Regulators would need to pay particular attention to whether any sales incentives scheme encouraged frontline staff to sell these products.

[59] Bank of England (2013), A framework for stress testing the UK banking system, A discussion paper http://www.bankofengland.co.uk/financialstability/fsc/Documents/discussionpaper1013.pdf
[60] Ibid, Page 32

Approach by national regulators to stress tests

Europe

The only reference to mis-selling issues in the European Central Bank's 285-page manual for the conduct of the asset quality review is displayed below. It is not clear what this 'high-level' check involves or the extent to which supervisors have challenged the bank's assumptions when estimating future costs.

"Future costs relating to litigation are extremely material for many banks and can have a significant bearing on available capital. A high-level check on the processes the bank has in place to size litigation reserves will be carried out to ensure suitability of bank treatment of such costs including:

• Bank policy for sizing litigation provisions (including example cases and associated drivers used for sizing provisions)

• Frequency of review of reported provisions related to litigation costs[61]

The European Banking Authority (EBA) requires banks to conduct stress tests against the following common set of risks: credit risk; market risk; sovereign risk; securitisation; and cost of funding.[62]

UK - The Bank of England

The Bank of England expects banks to provide the 'most-likely' estimate of probability weighted costs. Banks should provide data to the Bank of England (BoE) regarding how these costs have been calculated. It is not clear whether this data will be published by the BoE. It is also not clear how the BoE will use this information or whether it applies additional prudence to the firm's calculation of operational risk costs during the stress scenario.

> "Firms are expected to include all operational risk projections including conduct costs within the baseline projections. For conduct costs that can be quantified, firms should provide supporting material alongside the projection. This material should explain how firms arrived at the cost projections. For example, for customer conduct issues, firms should provide total contract volumes and values. Some conduct costs cannot be quantified easily, such as possible exposure to regulatory fines and penalties for issues where there are few precedents. For such risks, the firms should interpret the 'most likely' estimate as a probability-weighted expected cost, rather than what the firms may be required to provision under accounting rules.
>
> "Firms should also provide quantitative and qualitative information about the extent of their business in that area. For costs that can be quantified, any excess conduct cost estimate over what has been already captured by accounting provisions should be taken into account in the firm's projections. For other costs that cannot be as easily quantified, the impact of these will form part of the PRA's qualitative assessment. In most cases, it is not expected that estimates of conduct costs will vary significantly between the baseline and stress scenarios. However there may be some variation in cases where redress is related to market prices."[63]

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[61] European Central Bank (2014), Asset Quality Review, Phase 2 Manual
[62] European Banking Authority (2014), Methodological note EU-wide stress test 2014, page 11
[63] Bank of England (2014), Stress testing the UK banking system: guidance for participating firms

US - The Federal Reserve

The Dodd-Frank act requires the Federal Reserve to conduct an annual stress test of the largest banks. It uses both “adverse” and “severely adverse” scenarios. The results of the 2014 stress test indicate that in the adverse and severely adverse scenarios there are US$151 billion and US$130 billion respectively of losses related to operational-risk events and mortgage repurchases, and expenses related to disposition of owned real estate.

The methodology explains that “Operational-risk loss estimates include historically-based loss estimates, based on the average of three approaches, and estimates of potential costs from unfavourable litigation outcomes, which reflect elevated litigation risk and the associated increase in legal reserves observed in recent years.”

Stress tests have to be sufficiently robust to make a realistic assessment of, and ensure proper provisions for, the medium to long term operational risks posed by misconduct relating to inappropriate sales incentives and other issues. Inadequate operational risk capital in the cases mentioned here must act as a lesson to regulators to secure a more stable financial system.

Part 4: Checklist of the high-risk features of sales incentive schemes and the lack of controls and governance which pose risks to consumer protection and financial stability

Based on our research from CI Members, we categorise the types of sales incentives and remuneration schemes which pose high risks to consumer protection and financial stability. These are divided into three categories:

1) High-risk features created by the structure of sales incentives schemes
2) High-risk features created by the lack of monitoring, management information and other controls
3) High-risk features which can remain even after sales incentives schemes have been reduced or reformed

Risks created by the structure of sales incentives schemes

1. ***Product targets and incentives which lead to bias***: Incentives or targets which encourage staff to steer consumers towards specific products rather than that which might be better value or more appropriate for the customer. These can create bias in the recommendations of staff and result in products being sold outside of their target market.
    - Schemes which offer staff a higher commission for selling an investment product where the consumer's capital is at risk compared to a simple savings account.
    - In a UK bank, a member of staff would need to sell consumers 25 of the 'basic bank accounts', an account with no fees designed to promote financial inclusion, to match the incentive they would get from one 'packaged account' which had a monthly fee and offered the consumer a series of insurance products alongside the bank account.[64]
    - In India, commission payments for 'whole of life' insurance (a combination of insurance and an investment) are significantly greater than the alternative of purchasing term insurance and a savings account. Research found that despite the large economic losses associated with investing in whole [of life] insurance compared to alternative products "agents overwhelmingly encourage the purchase of whole [of life] insurance. This is likely due to the larger commissions offered to agents for selling whole [of life] insurance."[65]
    - In Mexico a mystery shopping study of bank selling practices for credit and savings products found that "staff voluntarily provided little information about avoidable fees, especially to auditors trained to reveal little knowledge about the market" and clients were "almost never offered the cheapest product, most likely because staff [were] incentivized to offer more expensive products that are thus more profitable to the institution". This was a particular concern because of a recent change in the law which had required all deposit-taking banks to offer a 'basic account' without account opening, deposit, withdrawal, balance enquiry or debit card fees. Staff offered the basic account in only two out of 54 visits conducted.[66]

2. ***Sales or revenue incentives***: Sales incentives schemes with specific sales targets or targets for the revenue the bank received from the customer. These can encourage staff to over-charge customers or to purchase more products than are necessary to meet their needs.
    - One firm examined by the UK Financial Conduct Authority (FCA) gave a bonus to sales staff based on the amount the customer paid for the product. The regulator "listened to a call

[64] Internal document seen by the author
[65] Anagol, Cole, and Sarkar (2011), Bad Advice: Explaining the Persistence of Whole Life Insurance
[66] World Bank (2014)

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."*[67]

3. ***Loan/credit targets and incentives***: Which encourage staff to make loans to customers or encourage them to borrow more money or to use a more costly form of borrowing.
   - The Central Bank of Ireland found that it was common within Irish banks for credit/lending targets to be "imposed upon either individuals or branches, ie, assigning target credit/lending levels in respect of products such as mortgages, loans and credit cards, which ultimately can impact whether variable remuneration payments will be made to the staff members concerned. Within these targets, product bias may occur, whereby higher weights were applied to some products over others, eg, higher weights applied to credit products, and within credit products higher weights applied to mortgage lending over other types of credit." The Central Bank was concerned that "that such practices may have fed into the recent credit bubble"[68] in Ireland.
   - Research in a European bank found that loan officers received a fixed salary and a bonus. The bonus was performance-based and could make up to 25% of the fixed salary. The bonus depended on the volume of loans made in a year and the conditions at which the loans were granted. Default rates on the loans had no impact on the remuneration. In particular, loan officers received a fee for each successful loan application. This fee increased if the loan had a higher interest rate or the creditworthiness of the customer was better (as rated on the bank's internal system). The research also found that at the same time, there was "significant pressure to perform well. Each week, or even during each week, 'run lists' are compiled to rank each individual loan officer." The researchers found that in some cases loan officers manipulated the information about the customer in a way that significantly affected the rating and the likelihood of a loan being granted. This occurred most often when a loan decision was around the 'cut-off' for whether a loan would be granted or refused. This behaviour could be related to the incentives loan officers faced to make loans. Loans where the information had been manipulated had higher default rates.[69]
   - Bank incentives schemes may offer an increasing number of sales points as the size of the loan given to the consumer increases. This could prompt staff to encourage consumers to borrow more than they want or can afford.

4. ***Incentives linked to measures of product profitability (particularly where these are short-term)***: These types of incentives can pose particular risks because complicated, poorer value or poorer quality products are likely to be more profitable for the firm and so accrue a higher incentive for the staff who sell them.

5. ***Incentives for products with 'tail-risks', including incentives for frontline staff to sell the bank's own debt and shares to retail customers***: Incentives for products for which there is a small risk of the consumer suffering a significant financial loss can pose a particular danger of mis-selling. A firm/employee selling structured products for which the consumer will only suffer a loss if the counterparty defaults or a specified event occurs could continue with inappropriate sales for a

[67] FCA (2012), Guidance consultation: Risks to customers from financial incentives
[68] Central Bank of Ireland (2014), Guidelines on variable remuneration arrangements for sales staff, page 18
[69] Berg, Puri and Rocholl (2014), Loan Officer Incentives, Internal Ratings, and Default Rates

number of years before consumers suffer losses when the counterparty defaults. The poor quality of the advice might only become apparent once consumers have begun to lose their money and make complaints.

- In Spain, branch managers were given targets for the sale of riskier 'preference shares' which encouraged them to target these products at consumers who held deposits within their branches, regardless of whether the risk of the product was appropriate or explained clearly. When banks were at risk of failure, consumers who had been sold these shares suffered losses. It also complicated the resolution of these banks as they were exposed to legal claims from consumers.
- In the UK, the falls in the stock market around the turn of the century led to significant losses for consumers who had purchased 'Precipice bonds' – products which paid a regular high rate of income, but with customers suffering losses of capital if the value of the shares fell beyond certain trigger points. These products were highlighted by the bank "as a potentially successful and popular product due to the high headline rate of income or growth, which could assist financial consultants in meeting their sales targets."[70]
- In Hong Kong, the default of Lehman Brothers exposed widespread mis-selling of Lehman-backed structured products and mini-bonds sold in retail banks.[71]

6. ***Add-on product incentives:*** Which encourage staff to recommend an 'add-on' product regardless of whether it is suitable for the customer. This may result in the impression being given to the consumer that the product is mandatory or could increase their chances of being 'approved' for the primary product such as loan.

7. ***Cliff-edges which lead to high rewards for marginal sales***: Schemes which include thresholds and cliff-edges for which the reward for making additional sales increases dramatically. These can include schemes where no bonus is paid unless the staff member has met a specific threshold within a period of time, such as 50 sales each quarter or for a specific percentage of their customers to have purchased a product.
    - One firm examined by the FCA 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 (US$16,125). This created a strong motivation to reach the 'super bonus' target as soon as possible, increasing the risk of mis-selling.[72]

8. ***Accelerators***: Accelerator schemes which offer increased incentives as the number of sales increases in a particular time period. For example, a staff member being offered £20 (US$32) for each product sold until a particular target is reached and then increasing the incentive paid to £30 (US$48) for each additional product sold above the target. Retrospective accelerators pose even higher risks as at defined thresholds they not only increase the payment for subsequent sales but also for previous sales. This can result in staff having their bonuses multiplied for reaching targets.

[70] FSA (2003), Final notice, Lloyds TSB Bank
[71] See earlier case study
[72] FCA (2012), page 14

9. ***Sales incentives for which staff are only providing 'information' around the product rather than specific 'advice' that it suitable for a customer's circumstances***: These schemes pose a particular risk as they may encourage staff to stray into 'recommending' the product to individual consumers. The impression may be given to the consumer that the product meets their needs and is suitable for their circumstances. Risks from these type of sales incentives schemes may be particularly difficult to monitor because to persuade the customer to purchase the product the member of staff may contradict written information about the product.

10. ***Upfront commission payments for long-term products***: Financial services products are long-term and it can be many years before the unsuitability of the product or advice becomes apparent. Sales incentives schemes which offer upfront commission payments for the sale of these types of products will increase the risks of inappropriate sales and the churning of existing products to generate repeated commission for the salesperson.
    - In Australia, Storm Financial paid upfront commission of 6-7% for advisers selling risky investment products with consumers taking out loans from banks secured on their houses to buy these investment products.

11. ***Variable-remuneration and changes to fixed pay***: Sales incentives schemes can still be inappropriate even when they do not result in the payment of a bonus, but instead lead to promotion or changes to fixed pay based on the volume of sales. These risks will be increased if fixed pay can decrease or if staff are demoted for not meeting sales targets.
    - Advisers selling insurance and investment products within a UK bank were placed in six tiers, with sales point targets and annual basic salaries increasing with each higher tier ranging from £18,200 (US$29,302) to £72,600 (US$116,940). An adviser who reached the sales point target of a higher tier over three consecutive quarters would automatically qualify for a promotion to that tier and receive a salary rise, subject to passing a risk gateway. When an adviser consistently failed over a period of nine months to meet 90% of the target for their existing tier, the bank would have the right to automatically demote them and reduce their salary. The drop in salary for a middle-tier adviser caused by a one-tier demotion would have been from £33,706 (US$54,287) to £25,927 (US$41,761) (a 23% base salary reduction), although advisers in lower tiers had lower sales targets to obtain bonuses. If the same adviser was demoted two tiers, their base salary could have fallen to £18,189 (US$29,297) (a 46% reduction). Advisers who were close to dropping a salary tier may have felt under pressure to increase their sales volumes.[73]
    - Unions in Spain reported that staff in some banks had their sales incentives schemes closely linked to promotion which had a negative impact and was a significant cause of stress.

12. ***High percentages of the total remuneration for staff are from sales incentives schemes***: Sales incentives schemes in which a high percentage of total remuneration depend on hitting sales and revenue targets can cause particular risk for consumers. Staff may feel under pressure to hit targets to meet day-to-day expenses. They also pose a risk in that new staff could focus on increasing sales quickly once they have been recruited, before they have received the relevant training or developed experience.

[73] FCA (2013), Final Notice: Lloyds TSB Bank and Bank of Scotland http://www.fca.org.uk/your-fca/documents/final-notices/2013/lloyds-tsb-bank-and-bank-of-scotland

13. ***Collective sales incentives schemes and targets***: When sales incentives/targets are given on a collective basis within a branch or call centre they can still lead to inappropriate sales and pressure for frontline staff. The focus on collective sales targets could also encourage the growth of a sales-based culture within the organisation – where sales performance is seen either implicitly or explicitly as the most important factor in measuring the contribution of individual staff.
    - The Central Bank of Ireland found that it was common for banks to impose 'collective targets' on branches whereby high minimum threshold performance levels were required in order to unlock incentives for staff on an all or nothing basis. It concluded that: "Such a situation raises the risk of a constant, group focus on selling at all times and potential to put pressure on individuals within the qualifying group to perform so that all staff entitled to such a group type incentive receive it – no one individual may want to be the reason for the group not qualifying for the incentive."[74]

Risks created by the lack of monitoring, management information and other controls

1. ***Lack of monitoring/risk management and a failure to take action once risks are identified***: Banks should have in place comprehensive monitoring schemes and risk management processes to measure regulatory compliance and the quality of sales. These should include gathering 'management information' about sales, trends and patterns which could indicate a risk of mis-selling. It should also include analysing data about complaints and identifying their root causes which could indicate problems with the overall selling process or the conduct of members of staff. Once risks are identified, action should be taken to mitigate those risks such as changing the remuneration scheme, sales process or product.
    - The Australian Securities and Investment Commission noted that of the 38 Commonwealth bank investment advisers rated 'critical' by the bank's compliance unit only 12 were removed from their posts and that there appeared to be some correlation between the amount of revenue earned and a decision not to revoke an adviser's authorisation.

2. ***Lack of sales quality metrics or monitoring of sales quality metrics not sufficient to result in loss of bonus***: Sales incentives schemes pose a risk when there is not a strong focus on the 'quality' of sales, to ensure that the product or advice is appropriate for the customer. This might occur if banks are not monitoring the sales of individual staff or conducting comprehensive programmes of testing and mystery shopping.
    - At Lloyds TSB, advisers had to have a significant number of their sales selected for checking and then be graded as non-compliant for them to be at risk of losing their bonus. The bank assumed that any sale which was not selected for checking by the automated tool was a compliant sale. This meant that 71% of advisers received a monthly bonus on at least one occasion even though a high proportion of their monthly sales had been classified as non-compliant. Indeed, 18% of advisers had received a monthly bonus on at least one occasion when all of the sales reviewed were classified as non-compliant.
    - A firm selling PPI only monitored one sales call per adviser per month and this could include calls in which no sale was made. This meant that a member of staff could sell PPI for months before having the quality of their sales process monitored. In addition to other assessment

[74] Central Bank of Ireland (2014), Guidelines on variable remuneration arrangements for sales staff Page 13

of the quality of sales, the call monitoring for a firm selling PPI assessed whether the sales staff adequately handled any 'objections' the customer had to purchasing the product.[75]

3. ***Lack of clawback or limited clawback***: Risks from sales incentives schemes will be increased where staff do not or are unlikely to face clawback of bonuses for inappropriate behaviour. However, the fact that a scheme does in some circumstances provide the clawback of bonuses will not on its own mitigate the risks.
   - In 2007, Countrywide, then the largest mortgage lender in the US, removed the reductions to their pay which loan officers would see for poor loan quality.
   - If clawback is only limited to the specific instances when a customer has cancelled the product or when there has been non-compliance then it is unlikely to provide a sufficient method of managing risks.
   - If clawback is only applied if the consumer cancels the product during a short 'cooling off' period then it is unlikely this will mitigate the risks from an inappropriate sales incentives scheme. For many financial services products, there can be significant lengths of time between purchase and it becoming apparent that the product is unsuitable.

4. ***Sales incentives for sales-managers/supervisors***: Within many banks, the 'first line of defence' against inappropriate sales will come from line managers, branch managers, supervisors or team leaders. In these circumstances setting an incentive scheme for these managers which focuses on sales can create a conflict of interest and lead to weak supervision.

Risks which can remain even after sales incentives schemes have been reduced or reformed

1. ***Non-financial competitions and prizes***: These can still lead to a risk of mis-selling as staff seek to hit the targets to receive the prize or to avoid the humiliation which could result from performing poorly in the competition.
   - The 'President's club' operated by Washington Mutual where the loan officers who were the top sellers would receive all expenses paid trips to Hawaii and the Bahamas.
   - Bank staff within Halifax who did not meet sales targets were presented with a cabbage.

2. ***Removing sales incentives for frontline staff but leaving in place incentives for middle management including branch, regional and product managers***: Even if sales incentives for frontline staff are removed there may still be a risk of mis-selling if these incentives remain at higher levels within the bank. Branch, regional and product managers may place implicit or explicit pressure on frontline staff to meet sales or revenue targets. Risks can also arise if senior management are given explicit targets such as high levels of 'return on equity' which can only be met in the short-term by increasing sales.
   - Stuart Davies of the union Unite told the UK Parliamentary Commission on Banking Standards that "Even though centrally the employers are saying to us, 'There are no longer any individual product targets or product pushes', at a more local level we find managers at area or regional level are communicating out to staff saying, 'You must get x of that this week and you must get y of that this week, otherwise the consequences are a, b and c.' They will then display on walls in branches that person a has sold so many, person b has sold so

[75] FSA (2008), Final Notice: Liverpool Victoria Banking Services, July 2008

many and person c has sold so many." He also stated that members were ultimately dismissed for not achieving sales targets.[76]

3. ***Replacing "sales targets" with "customer need" targets****:* A remuneration or target-based scheme can still pose a high risk of mis-selling even when the name of the targets or goals are changed. For example, simply changing the name of a target from "selling 10 mortgages" to "identifying 10 customers who have a need for a mortgage and meeting that need" will not in itself lead to a reduction in risk.

4. ***Moving to 100% 'discretionary' incentives*****:** Moving away from set formal targets to incentive schemes which are 100% discretionary might not reduce the risk of mis-selling. It will also make it harder for regulators and senior management at the bank to monitor and audit the basis on which incentive awards are paid.

5. ***Balanced scorecards*****:** Sales incentives schemes can still pose risks even if sales performance is only one part of a 'balanced scorecard' used to determine the overall level of financial incentive. Contributions to a 'balanced scorecard' could include sales performance, customer satisfaction/advocacy, customer service and process targets. 'Balanced scorecards' will continue to lead to risks of mis-selling if the amount of incentive for sales targets retains a significant influence on the overall financial incentive. It can also pose risks if the sales elements of the 'scorecard' act as a gateway for the incentive, meaning that regardless of the level of customer service, no incentive can be paid if the sales targets are not met.

6. ***Staff appraisal and promotion arrangements***: If staff appraisal or promotion arrangements depend or continue to depend on sales performance then there will be a risk of mis-selling.

7. ***Pressure to meet sales targets and league tables***: If staff remain under explicit or implicit pressure to meet sales targets (regardless of whether they are rewarded financially) then there will still be a risk of mis-selling.
   - In a survey of UK bank staff conducted by CI Member, Which?, 58% said that the number of sales an individual makes is made public within the team and 52% reported there are notice-boards on which the number of sales an individual makes is shown.
   - Unions in Greece reported that targets, though remunerated and not part of performance management, still led to extended working hours, pressure, physical and mental illnesses, insecurity, and competition that led to bad relationships between co-workers.
   - Unions in Italy reported similar centrally-directed sales incentives schemes with additional compensation, but with significant peer pressure and strong commercial pressures to sell products.
   - Spanish unions reported constant pressure on staff to meet targets
   - Unions in Ireland reported enormous pressure on frontline staff in particular.

8. ***Performance management plans***: Risks will be increased if employees who fail to meet sales targets could be subject to formal or informal disciplinary action. These may be called 'performance management', 'performance improvement' plans or 'coaching'. These

[76] Parliamentary Commission on Banking Standards (2013b), Oral evidence to the mis-selling panel, Q286-303

arrangements pose a particular risk when, if sales performance does not improve, staff could face demotion or dismissal.

- Unions from Ireland reported that targets are very much a part of people's performance management process with both individual and collective targets being identified. Previously, delivering certain targets could result in opportunities for pay increases or bonuses, however, since the banking crisis, this has generally not been the case at any level. However, sales pressure continues and failure to deliver sales targets can, in some cases, result in disciplinary action up to and including dismissal. The bank managements' strategies are very clear and result in significant peer pressure in categories of workers, particularly in frontline areas. All of this creates enormous stress and pressure on staff.

9. ***Restructuring/redundancy***: Risks of mis-selling are particularly acute when targets are explicitly or implicitly linked to job security, either through restructuring (a common feature in the banking industry since 2007/08), and roles to be made redundant.
    - Unions from Ireland reported that most bank staff are given weekly targets and are questioned daily about their contribution to these targets. In the event of not achieving these targets they face transfer, disciplinary action or being put on performance improvement programmes. In line with this, restructuring attempts have been made behind the scenes to identify staff not achieving targets and to manipulate redundancy to ensure that they are specially included.

Measuring the effectiveness of changes to sales incentives schemes

The checklist of factors above also illustrates that merely changing the sales incentives scheme for frontline staff might not be enough to reduce the risks of mis-selling and financial instability. To effectively measure improvement, banks and regulators must conduct more formal assessments of the culture of banks and to act on any concerns that frontline staff remain under pressure to place sales ahead of product suitability, responsible lending or customer service. These concerns should be reported to the bank's board and included in the bank's disclosures regarding its management of 'operational risk'.

Evidence from CI Members, unions and regulatory reviews demonstrates that inappropriate sales incentives schemes create a level of pressure that is not good for consumers, frontline workers or the customer-bank relationship. Even when changes have been put in place to address inappropriate remuneration incentives, the persistent pressure on staff to sell has a range of negative impacts. This indicates that in addition to rules and regulations, there is a bigger behavioural question to address about moving from a high-pressure selling culture to one of strong long-term customer-provider relationships that minimise risks to all actors and to the financial stability of the system.

Case study: Which? Culture research – frontline bank staff

To assess the extent of cultural change within UK banks and whether staff remained under pressure to meet sales targets, CI Member Which? conducted a survey of 500 frontline bank staff. The research found that despite the changes to remuneration schemes, shifting the focus away from sales wasn't always filtering through to frontline staff.

The research[77] found that the sales culture remained even after the incentives had been taken away. For many staff (81%) the pressure to meet targets had stayed the same or increased in the past year,

[77] Which? (2012d), Here to help? Bank staff reveal the truth about working for Britain's big banks

even though 42% said that the availability of financial incentives had decreased. Individual bank staff quoted in the research explained the reasons for the pressure to sell, though some also highlighted positive changes such as an increased focus on customer service targets or that sales was a minor part of performance reviews.

> *"Everything is too fast and pressured… If [the bank] focused a bit more on customer service rather than a competitive sales environment and meeting points targets the sales would still come and it would be less stressful."*
>
> *"Each month each operator has a few calls listened to…if you fail your call monitoring then you lose your bonus, if you pass but don't hit your sales target you lose your bonus."*
>
> *"Sales is always the priority in terms of individuals' performance."*
>
> *"The ethos has changed a lot to focus on customer service and needs-based selling. Sales targets have moved over to customer service targets."*
>
> *"Being number one in customer service is the ultimate goal. Providing a high standard and putting the customer at the heart of everything we do."*

Percentage of frontline bank staff surveyed who agreed with the following statements

	Overall average	Lloyds Banking Group	RBS	HSBC	Barclays	Santander
I feel pressurised into selling by the culture	43%	56%	35%	41%	33%	29%
I feel pressurised into selling by my manager	37%	46%	31%	33%	30%	25%
The sales targets drive employees to sell even when it's not appropriate*	40%	45%	43%	39%	35%	23%
I know that some of my colleagues have mis-sold products to meet targets*	46%	47%	51%	53%	37%	31%
I am uncomfortable with the bank's approach to sales	32%	37%	32%	33%	27%	14%
I have to focus on sales over service	31%	39%	28%	32%	20%	18%

Base: Overall average (371), Lloyds Banking Group (140), RBS (71), HSBC (66), Barclays (66), Santander (28) *Base: All who have targets, Lloyds Banking Group (118), HSBC (57), Barclays (46), Santander (26). Santander has a small sample and therefore results should be taken as indicative

Part 5: Disclosure of frontline remuneration schemes by banks and the action they take to manage risks

CI undertook the following activity to ascertain the structure of sales incentives and remuneration schemes for frontline staff and the action that the banks take to manage and control risks:

- Wrote to 90 of the largest banks in the G20 and some OECD countries asking a series of questions regarding:
    - The type of sales incentives scheme in existence at the bank
    - Whether employee assessments or performance reviews include considerations regarding the volume of sales that an employee has made
    - Whether a senior executive is responsible for the design, implementation and resolution of issues relating to incentives schemes
    - Whether employees are provided with independent mechanisms that enable them to confidentially, and without threat of reprisal, report concerns about policies or practices in the bank that affect interactions with customers and potential customers
    - Whether the bank uses incentive mechanisms that are linked to customer satisfaction and retention or the long-term success of the company, rather than short-term sales targets
- Reviewed the annual reports of 27 banks, including the remuneration disclosures and details of the bank's 'operational risk' management framework

Responses from banks to the letters

Transparency

CI received responses from 25 banks [i] to the letters, with most of them sharing high-level policy content. Several banks had removed variable pay entirely or removed the sales elements from variable pay and provided details of changes. Other banks also disclosed details of the principles underlying the design of their incentive scheme and the governance arrangements which were used to approve the scheme.

However, most banks did not reply to the letter or refused to answer the questions. Commercial confidentiality was cited as reasons for not sharing further details. One bank provided a full response from its head office, which was welcome, while its office in another jurisdiction refused to participate in the survey. The wide variation in the level of detail shared indicated that there is scope for greater transparency. Lloyds TSB (UK) was the only bank to state that it updated the regulator on its sales incentives schemes on a regular basis.

Some extracts of the responses received from individual banks

Barclays (UK policy)

> "Over the last few years, Barclays has evolved its incentive arrangements, taking account of regulators' guidance as well as insight from colleagues and consumer bodies. In December 2012, Barclays removed all reference to product sales from its incentives."

HSBC (global policy)

> "No bonus or other forms of variable pay are paid by HSBC to encourage our employees to either a) sell products or services or b) promote the sale of a particular product or service over other suitable products or services. Incentives paid to our front line employees are assessed on a discretionary basis using a balanced scorecard. There is no formulaic/mechanistic link between products sold and the incentives that employees receive. The balanced scorecard is not only product agnostic when assessing "Outcome" KPIs but also takes into account the activities undertaken (Activity KPIs), the fulfilment of sales quality and customer service controls (Control KPIs) and the Values and Behaviours (V&B) exhibited by employees. We also pay employees no more frequently than quarterly to allow for any control issues to surface prior to making a payment. All recognition programmes in HSBC reward for good customer service and compliance with sales quality requirements. These plans are "thank you" plans with rewards ranging from thank you cards left on desks to cinema tickets to vouchers for meals."

Unicredit (global policy)

> "To support the design of employee remuneration and incentive systems, and with particular reference to network roles and governance functions, the following "compliance drivers" have been defined by the basis of the proposal made by Group Compliance Holding function:
>
> - maintenance of an adequate ratio between financial and non-financial goals
>
> - promotion of a customer-centric approach which places customer needs and satisfaction at the forefront and which will not constitute an incentive to sell unsuitable products to clients
>
> - create incentives that are appropriate in avoiding potential conflicts of interest with customers, having fairness as the objective in dealing with customers and the endorsement of appropriate business conduct
>
> - avoidance of incentives on a single product/financial instrument as well as single banking product
>
> - avoidance of incentives with excessively short timeframes (eg, less than three months)"

Rabobank (policy for The Netherlands)

> "Rabobank uses a performance management system in assessing the employee. The manager and employee agree a balanced set of targets with the customer's interest as a starting point. These targets include result as well as competency targets. It applies specifically to employees with customer contact that the targets must keep customer's interest central. Targets should never include incentives that drive conduct that is not in the interest of the customer. This may include volume or sales but they are of subordinate importance and are not included without any customer's interest context. In the Netherlands this is strictly monitored by the external regulator the Dutch Authority for the Financial Markets (Autoriteit Financiële Markten: 'AFM') with which we have a regular contact.
>
> "The overall assessment is based on the realisation of the result and competency targets. Both have equal weight in the assessment. The 'focus on customer's interests' competency

is obligatory for all employees. That is why the assessment of the employee always also includes - apart from their general performance and compliance with the Code of Conduct - how the employee has looked after the customer's interests. In this connection for the instance the Net Promotor Score (NPS), the way in which complaints are dealt with and the customer satisfaction score are considered as important as KPIs.

"Since variable remuneration is no longer paid, the assessment only determines what percentage an employee can move up his pay scale, for as long as the end of this pay scale has not been reached. The pay scale growth rates linked to a certain assessment are laid down in the remuneration policy (collective labour agreement). For that matter these rates were adjusted downwards in 2013."

Societe Generale (global policy)

"The Group has implemented strict governance concerning the design and implementation of remuneration schemes. In accordance with delegation rules in force within the Group, as well as validation of any modification or set up of an incentive scheme by the local management of the group entity, the scheme must also be submitted for prior validation by the Group Compensation and Benefits Department. Moreover, in application of ESMA's position (ESMAl2013/606), the Compliance Department of the entity concerned must ensure locally that the remuneration policy and practices do not generate conflicts of interests and guarantee respect of business conduct rules. The implementation of the remuneration policy is subject to review on an annual basis with various stages of validation by senior management at entity, core business division and Group level and a final validation of the policy (principles, budget and individual allocations for senior management and the highest earners) by the Board of Directors upon recommendation by the Compensation Committee."

Westpac (global policy)

"Our reward structure is based on promoting deepening customer relationships and providing appropriate service - rather than driving or promoting individual products. And to achieve these outcomes we provide extensive training and apply an overall balanced scorecard approach to our targets/KPIs which underpin our variable reward schemes. This ensures a focus on appropriate advice, strategy and product recommendations and on-going service based on customer needs.

In the case of our bankers, our reward frameworks include comprehensive customer and risk metrics. These include encouraging appropriate behaviours in line with our organisational values as well as consideration of a number of gate openers including compliance, quality of advice and client satisfaction (NPS). For example,_tellers across the Westpac Group are not employed to sell any products to customers. However they do help customers by referring them to the relevant specialists who are qualified to provide appropriate advice. Tellers are remunerated for referrals to specialists based on the customers' best interest and needs."

CaixaBank (policy for Spain)

"Caixabank's remuneration system is based on a model combining a fixed salary and a bonus, the latter of which is established based on the professional category of each employee, the tasks performed and the involvement and commitment shown in reaching individual targets and contributing to the team's objectives.

> "In 2012, an annual bonus system linked to results, sales targets and the management of assigned client portfolios was instituted at the retail bank branches. This system, which benefited from greater transparency and objectivity, was previously implemented for people dedicated to certain groups of companies and private banking as well as to other central services areas. This model also takes into account the service quality provided by customers."

Alpha Bank (policy for Greece)

> "Alpha Bank considering both the critical changes that take place in the Greek Banking Market and the general developments of the Greek economy didn't implement any incentive scheme for its employees related to the achievement of the sales target set during the last twelve months."

AIB (policy for Ireland)

> "As a result of the recapitalisation of AIB Group by the Irish Government, the Group is subject to certain obligations under a number of Subscription and Placing Agreements which impact on the Group's remuneration policies. Consequently, while AIB's remuneration policies reflect the required regulatory design features of variable incentive schemes, there is currently little scope to implement such schemes and there are no bonus or share incentive schemes in operation."

Review of bank annual reports

We reviewed the annual reports of 27 banks, paying particular attention to the sections on remuneration and 'operational risk'. For senior executives and high-earning staff, detailed disclosure was normally provided regarding the overall quantum of remuneration. There was also detailed disclosure for senior executives and directors concerning the overall structure of their remuneration scheme broken down between fixed pay, annual bonuses and long-term incentive plans. In some cases, there was also a breakdown of the targets senior executives needed to achieve to receive their incentive pay.

However, other than the banks already covered in the previous section, few banks provided any detail regarding the sales incentives schemes for frontline staff or the procedures in place to manage risks. Where disclosure was provided it was typically at a generic level, rather than getting into the specifics of the scheme.

Almost universally, sections on the management of 'operational risk' lacked any disclosure of the measures put in place to identify, monitor or mitigate the risks to customers from inappropriate sales incentives schemes. In the main, they included basic descriptions of overall risk-management frameworks, the 'three lines of defence' model and listed the various managers or committees which were responsible for examining 'operational risk'. They occasionally covered other areas of 'operational risk' such as financial crime, cyber-crime and 'information security'. However, one bank - Pt Bank Mandiri – from Indonesia, disclosed details of the structure of the whistle blowing scheme for frontline staff, how this had been promoted internally and the number of reports which had been made under the scheme.

Examples of disclosures from bank annual reports

ANZ bank

> "The Short-term Incentive (STI) arrangements support ANZ's strategic objectives by providing rewards that are significantly differentiated on the basis of achievement against annual performance targets coupled with demonstration of values led behaviours. ANZ's Employee Reward Scheme (ANZERS) structure and pool is reviewed by the HR Committee and approved by the Board. The size of the overall pool is based on an assessment of the balanced scorecard of measures of the Group. This pool is then distributed based on relative performance against a balanced scorecard of quantitative and qualitative measures."

National Australia Bank

> "Our remuneration framework recognises and rewards performance and ensures that our levels of remuneration remain competitive. The framework applies to all employees of the Group, including senior executives. We support well-structured variable remuneration programs that reflect shareholder returns over time and that promote longer-term business growth. Variable remuneration (short-term and long-term incentives as appropriate) for all employees is directly linked to individual and organisational performance. Risk outcomes are also embedded in the variable remuneration element of the framework. Deferred variable remuneration may be adjusted where the Board considers the remuneration inappropriate based on a subsequent review of individual and business performance."

Santander - Chile

> "Santander-Chile and its affiliates have designed variable-compensation plans for their employees, based on performance targets and objectives, the achievement of which are evaluated and paid on a quarterly and/or annual basis. There are also multi-year variable-compensation plans designed to retain and motivate executives, whose compensation depends on the achievement of overall group-wide and individual targets over the course of a time period exceeding one year."

PT BANK MANDIRI - Indonesia

> The report mentions the provision of a whistle-blowing scheme called "Letter to CEO" enabling employees to raise concerns about fraud such as deceiving customers or departing from the bank's internal procedures. Each report is given a number, and whistle blowers can use this to check the status of the investigation. The bank reported that it had received 41 submissions through the scheme, of which 21 had been acted upon and 10 reports had been completed. However, it did not disclose the types of issues raised or what action the bank might have taken in response.

Global v national policies

A number of the banks surveyed operated in multiple countries. Some banks had global policies for their sales incentives schemes covering all jurisdictions, while other respondents noted that their schemes varied by country. The level of detail reported meant that it was not possible to determine whether the same bank employed significantly different or more risky sales incentives schemes in different countries. One response noted that its variable policy existed to take account of local conditions and requirements.

UniCredit in Italy stated:

"The principles of the Group Compensation Policy apply across the entire organization and shall be reflected in all remuneration practices applying to all employee categories across all businesses, including staff belonging to external distribution networks, considering their remuneration specifics."

Deutsche Bank reported the following:

"Deutsche Bank's policies and practices including, wherever necessary, local applicable amendments, eg, as a result of local legal requirements, are applicable across all jurisdictions in which Deutsche Bank operates. In particular, stipulations of MIFID and § 33 Abs. 1 Satz 2 Nr. 3 a WpHG are implemented in respective rules and policy sales guidelines within the bank."

Individual board level responsibility

A number of respondents noted that their sales incentives schemes were approved by senior executives in the bank, with many using remuneration committees or similar for this task.

VTB (Russia) reported that its head of human resources was responsible for the design, implementation and resolution of issues relating to incentive schemes and that the "Head of HR usually reports directly to [the] CEO".

CaixaBank (Spain) cited its HR general manager as the senior executive in charge of sales incentives schemes. It was the only respondent to provide the name of an individual responsible for these schemes.

Whistle blowing

Respondents reported a wide variety of whistle-blowing mechanisms and procedures, with some good practices in place. A number of these were internal mechanisms which highlighted policies preventing discrimination against complainants.

Anonymity: Many respondents reported anonymous channels for whistle blowers to report concerns. For example, Westpac (Australia) reported it has a system "Concern Online" to facilitate anonymous whistle blowing.

KfW (Germany) is a promotional bank that takes measures on behalf of the government for the good of society. Its consumer loans are usually on-lent through other financial institutions such as banks. KfW Group's whistle blowing arrangements are set up so its staff can either "contact the internal Compliance Unit or its external ombudsperson in confidence. Contractual regulations guarantee that the name and identity of the whistle-blower will remain secret. The identity of the whistle-blower will only be revealed to the compliance department of the affected Group company by wish and express consent of the person in question. Any concerns reported but not covered by the ombudsperson will be handed over anonymously to the relevant department, eg, the data protection officer."

One bank noted that, while it did facilitate anonymous whistle blowing, it actively discouraged anonymous reports for a variety of reasons including support for full investigations and preventing discrimination against the complainant. However, it further noted that in some jurisdictions it may be unable to investigate anonymous reports.

Internal mechanisms: Scotiabank (Canada) report that under its 'Pathways to Resolution' programme it "recognizes that each employee and problem is unique and may require a different process to resolution. This is part of our commitment to providing employees with a fair, equitable and inclusive work environment that is free of retaliation, violence and discrimination.

"In addition, through our 'Open door' option, employees are always encouraged to speak to their immediate supervisor about any concerns or issues. Recognizing that employees may not always feel comfortable with this option a Staff Ombudsman Office is available for all employees."

Including third parties: ABN AMRO (The Netherlands) stated that "It is important for ABN AMRO to be aware of potential irregularities. Therefore not only employees are encouraged to make reports under this [whistle blowing] policy, also third parties can report their concerns relating to this policy to ABN AMRO. Reporting can be done anonymously. Third parties are for example suppliers, agents, etc."

Independent and confidential phone line and web reporting: Royal Bank of Scotland (RBS) in the UK reported that it had introduced: "*'Right Call' is an independent, confidential, 24/7 telephone and web-based whistleblowing facility which is available to all employees globally".*

Standard Bank (South Africa) reported: "Under our Code of Ethics we have a number of [whistle blowing] mechanisms. Key amongst them is training, however this is supported by an anonymous whistle blowing hotline and a firm commitment to publish the names of staff convicted of fraud and or corruption. While the legal process is ongoing certain suspension processes are put in place. Once the individual is convicted by a court their name is published. The whistle blowing hotline is run independently by KPMG."

Email: VTB (Russia) reported that it had: "a special internal email address any employee can use to express any concerns about business practices, professional or personal matters. Confidentiality of the employees is protected."

Proactive actions: HSBC (UK) noted that in addition to its whistle-blowing function, its operational risk team carried out confidential focus groups and interviews with frontline staff as part of its review of implementation and operation of the banks Growth Wealth Incentive Framework (GWIF).

Part 6: Action taken by regulators to reform sales incentives/remuneration schemes, manage risks and take enforcement action

International level

Financial Stability Board

At an international level, significant attention has been given to reforming senior executive remuneration. The Financial Stability Board (FSB) has issued principles and standards for sound remuneration/compensation practices. National jurisdictions within the G20 are subject to peer review by the FSB concerning the extent to which they have implemented the requirements.

Principles[78] and standards[79] issued by the FSB include:

1) Effective governance of compensation
2) Effective alignment of compensation with prudent risk taking
3) Effective supervisory oversight and engagement by stakeholders

These include requirements around:

1. Forming a remuneration committee to oversee the design of the remuneration system and conduct an annual review of the remuneration scheme
2. The total level of variable remuneration and its allocation across the firm, ensuring that it does not limit its ability to strengthen its capital base, is based on the quantity of capital required and the timing of potential future revenues
3. Senior executives and Material Risk Takers (MRTs) should have a substantial proportion of their compensation as variable, linked to individual, business-unit and firm performance; paid in shares or non-cash instruments and deferred for a number of years
4. Avoiding 'guaranteed bonuses', and having provisions to reduce remuneration in the event of government intervention
5. Disclosing the composition of the remuneration committee, the most important design characteristics of the compensation system and aggregate amounts
6. Supervisors ensuring effective implementation of FSB principles and standards

The FSB approach, principles and standards does little to highlight or tackle the inappropriate sales incentives schemes for frontline staff which have led to mis-selling and financial instability. The FSB's approach suffers from the following weaknesses:

Lack of coverage: The FSB's approach only applies to the largest banks and occasionally insurance companies and other companies within jurisdictions. Some jurisdictions have chosen to specifically exclude non-bank financial institutions, smaller banks, microcredit institutions and investment firms.

Lack of transparency: The transparency requirements are limited to aggregate amounts and high earners and banks are not required to provide full transparency of the details of the sales incentives schemes for frontline staff.

Focuses on senior executives, high earners, traders and MRTs, but ignores frontline staff: MRTs typically include senior executives, high earners, traders and other senior staff. This excludes the

[78] FSB (2009), FSF Principles for Sound Compensation Practices
http://www.financialstabilityboard.org/publications/r_0904b.pdf
[79] FSB (2009b), FSB Principles for Sound Compensation Practices: Implementation Standards
http://www.financialstabilityboard.org/publications/r_090925c.pdf

vast majority of staff who work in retail banking. MRTs only account for between 0-2% of retail banking staff.

Embeds the failings of methods for the calculation of operational risk capital: The FSB principles and standards require the scale of remuneration to reflect the amount of capital needed to back the bank's activities – this means that, other things being equal, the greater the level of capital required to back an activity, then the lower the scale of remuneration which should be paid. As demonstrated above, the amount of capital banks set aside for 'operational risk' is inadequate and not required to reflect the risk of inappropriate sales incentives schemes. This means that remuneration of staff within retail banks might not be aligned with the potential risks that their activities create. Non-financial sales incentives schemes create risk and would also be excluded under this method.

Fails to mention the importance of aligning remuneration schemes with the fair treatment of customers: The principles and standards do not stress the importance of aligning sales incentives and remuneration schemes with the fair treatment of customers and nor do they provide any examples of good and poor practice.

Fails to mention risks to financial stability from sales incentives schemes surrounding banks selling their own debt or shares to their customers: The experience of Spain and Portugal have demonstrated that banks selling their own debt or shares to retail customers poses significant risks to financial stability and consumer protection. Inappropriate sales incentives schemes can cause losses to consumers, difficulty in resolving failing banks and increase the probability of taxpayer bail-outs.

OECD

In 2011, the Task Force on Financial Consumer Protection of the OECD Committee on Financial Markets led the development of the G20 'High level principles on financial consumer protection'. These principles were endorsed by the G20 Finance Ministers and Central Bank Governors at their meeting on 14-15 October 2011.[80]

Principle 6, titled Responsible Business Conduct of Financial Services Providers and Authorised Agents, includes the following text:

> "The remuneration structure for staff of both financial services providers and authorised agents should be designed to encourage responsible business conduct, fair treatment of consumers and to avoid conflicts of interest. The remuneration structure should be disclosed to customers where appropriate, such as when potential conflicts of interest cannot be managed or avoided."

The taskforce expanded on these issues in its report into 'Effective approaches to support the implementation of the high level principles'.[81] It listed the following 'innovative/emerging' approaches to implementing this principle:

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[80] OECD (2011), G20 High-Level Principles on Financial Consumer Protection, October 2011 http://www.oecd.org/daf/fin/financial-markets/48892010.pdf

[81] OECD (2013), Update report on the work to support the implementation of the G20 high-level principles on financial consumer protection, para 2.1.4 http://www.oecd.org/g20/topics/financial-sector-reform/G20EffectiveApproachesFCP.pdf

"Financial services providers' and authorised agents' remuneration policies are designed in such a way as to encourage responsible business conduct with the aim of preventing mis-selling practices, unreasonable risk taking, or other irresponsible conduct.

"The regulator, when appropriate, bans remuneration structures and other types of incentives that lead to practices which are not in the best interest of the consumer or prescribe remuneration structures that will minimise the risk of conflicts of interest.

"The policy, including the structure of the remuneration on which direct sales staff or authorised agents are remunerated is disclosed on a company level at the pre-contractual stage to the consumer.

"Financial services providers and authorised agents ensure adequate procedures and controls are in place so that staff are not remunerated solely on sales performance but include factors such as consumer satisfaction, loan repayment performance, product retention, compliance with regulatory requirements/best practices guidelines and codes of conduct which are related to best interest of customers, satisfactory audit/compliance review results and complaint investigation results."

At a high level, some of these approaches could lead to improvements for consumers if they were implemented strongly and consistently. It is positive that the "effective approaches" to these principles recognise non-financial incentive schemes. However, these factors could be built upon with further detail about the high-risk features of remuneration and sales incentives schemes. There is also further action which could be taken by regulators beyond simply banning remuneration structures.

Currently, introduction of the high-level principles is not mandatory across the G20, compliance with the high-level principles is completely voluntary, and there is no process to ensure implementation or to conduct peer reviews such as the country diagnostic reviews undertaken using the World Bank's Good Practices for Financial Consumer Protection[82].

Regional and national regulators

Europe

In Europe, the legislation implementing Basel III included further requirements which went beyond the FSB principles and standards. These were part of the Capital Requirements Directive (CRD IV). The key elements of the rules include[83]:

(a) The variable component of the total remuneration must not exceed 100% of the fixed component of the total remuneration of individual MRTs
(b) EU member states may allow shareholders to vote to approve a higher level of up to 200% of the fixed component. Member states can also permit banks in calculating this requirement to apply a 'discount rate' of up to 25% of the total variable compensation, provided it is to be paid in instruments that are deferred for at least five years.
(c) New criteria setting technical standards for the identification of MRTs will be set by the EBA

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[82] World Bank (2012), Good Practices for Financial Consumer Protection http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/Good_Practices_for_Financial_CP.pdf
[83] Allen and Overy (2014), Capital Requirements Directive IV Framework, January 2014 http://www.allenovery.com/SiteCollectionDocuments/Capital%20Requirements%20Directive%20IV%20Framework/European%20Additions%20to%20Basel%20III.pdf

(d) Additional transparency relating to the number of individuals earning more than €1 million per year (US$1.3 million)
(e) Enhancing the enforceability of malus or clawback arrangements

Like the FSB's approach, these requirements are focused on high earners and senior management and will do little to tackle the risks from inappropriate sales incentives for frontline staff. They will also do little to address non-financial sale incentives schemes.

National regulators

CI surveyed a number of national market conduct and prudential regulators from G20 and OECD countries on their approach to sales incentives rules and enforcement in retail banks. There were inconsistencies and a lack of clarity in many countries regarding which regulator had responsibility in this area. This appeared to be a particular problem where regulation was organised on a federal basis. There were also instances where responsibility was shared. This presents a challenge for improving regulatory action as well as for data collection.

Regulatory requirements

The data we collected indicated that regulators have issued a range of legislation, rules, guidance and principles on or relating to sales incentives schemes.

A focus on remuneration for high earners and senior executives

As noted above, national implementation of FSB principles and standards on remuneration practices has generally been limited to certain types of firms such as the largest banks or only to high-earners, senior executives and traders. Many of the respondents cited these regulations as the basis for their rules. Jurisdictions may be unwilling to apply these more widely, for example the UK prudential and market conduct regulators noted that applying these principles more widely, to include retail staff would "go well beyond the international standards on remuneration".[84] Although, the FCA noted that it: "Intends to revisit financial incentive schemes for sales staff as it implements the revised Markets in Financial Instruments Directive (MiFID II)".

Responses to our survey indicate that international guidelines have a significant influence on how far the national regulatory frameworks reach. Below are some of the responses CI received.

Remuneration committees were widely used. Many focus on remuneration policies reflecting international standards and rules in this area. Customer orientated measures feature in some approaches.

The Netherlands Authority for Financial Markets (AFM) noted that national: "legislation stipulates that remuneration policies and practices should not affect the interests of customers. Furthermore financial service providers are required to have a written policy and practice in place in which they indicate which components may lead to the detriment of customers and how they are managed. Banks are required to use balanced performance criteria for sales staff." The AFM also noted that this policy was preceded by principles on controlled remuneration policy. Bonuses will also be capped at 20% of the normal salary from 1 January 2015.

In 2014 the Central Bank of Ireland issued: "Guidelines on Variable Remuneration Arrangements for Sales Staff which sets out requirements on banks regarding the structure of their variable

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[84] Bank of England and FCA (2014), Consultation Paper, Strengthening the alignment of risk and reward: new remuneration rules http://www.bankofengland.co.uk/pra/Documents/publications/cp/2014/cp1514.pdf

remuneration arrangements with sales staff and the associated monitoring and controls to be conducted." These requirements are in addition to Conduct of Business requirements and its Consumer Protection Code (revised 2012).

The Saudi Arabian Monetary Agency (SAMA) has issued: "Rules on Compensation Practices (2010) and each bank must have a written Compensation Policy approved by its Board of Directors. The Compensation Policy should comprehensively cover all aspects of compensation so as to ensure that risks related to compensation have been prudently managed; banks shall ensure that the incentives provided by their compensation systems take into consideration risk, capital, liquidity and the likelihood and timeliness of earnings; The Compensation Policy should not be solely based on industry practices but should also take into account the business model, financial condition, operating performance and business prospects of the bank. Every bank must have a Board Compensation Committee with responsibility to oversee the compensation system design and operation on behalf of the Board of Directors."

The Financial Services Agency (FSA) in Japan uses: "'directions of supervision' to minimize banks' incentive to employ inappropriate profit and remuneration structure, including: the salary or remuneration system that is excessively related to short-term profit earning or the sales performance of sales staff; and the products' compositions that concentrate on the foreign exchange, investment trust, and other derivative embedded products which is aimed for obtaining the fee profits. The supervisory guidelines stipulate to review whether the compensation committee is, through monitoring implementation of the compensation structure, checking excessive volatile movement of compensation amount due to the short-term profit earning and/or excessive reflection of sale staff's performance on their salary and bonus".

The Australian Securities and Investments Commission (ASIC) and New Zealand's Financial Markets Authority (FMA) both noted the role of their licensing regimes. ASIC reported that: "The Australian Government introduced a legislative reform package in 2012, designed to address conflicts of interest within the financial advice industry. This package is collectively referred to as the Future of Financial Advice reforms (FoFA), and came into effect from 1 July 2013. As part of FoFA, the Corporations Act 2001 (the Corporations Act) was amended to prohibit:

a) AFS Licensees and their representatives (including authorised representatives) from accepting conflicted remuneration (sections 963E, 963G and 963H);

b) Product issuers and sellers from giving conflicted remuneration to AFSL Licensees and their representatives (section 963K); and

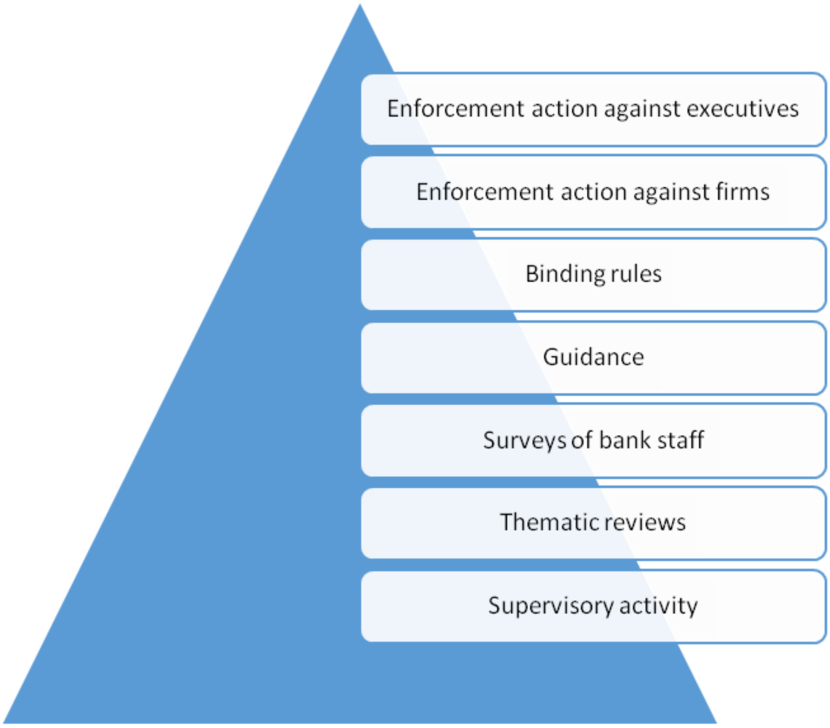
c) Employers from giving their AFS Licensee or representative employees conflicted remuneration for work they carry out as an employee (section 963J)."

ASIC further noted it also had general conduct requirements.

The FMA in New Zealand also reported a principles-based approach to remuneration and conduct.

Possible regulatory interventions against inappropriate sales incentives schemes

The pyramid below indicates the possible regulatory interventions which could be made against inappropriate sales incentives schemes.



Monitoring by regulators

Most regulators noted that they did not require banks or other financial institutions to provide details of their sales incentives schemes. However, the FCA in the UK, the Central Bank of Ireland, ASIC in Australia and the AFM in the Netherlands reported that they had the power to require this information and did so for investigations and thematic reviews. A number of respondents reported that they had requirements for regular reporting of remuneration structures, compensation payments and conflict of interest. There was no explicit mention of disclosure requirements relating to non-financial sales incentive schemes.

Thematic reviews

A limited number of national regulators have conducted thematic reviews of sales incentives schemes. Where these have been undertaken, they have found widespread poor practice which posed risks to consumer protection and financial stability.

Thematic reviews by the Central Bank of Ireland, the FSA (now the FCA) in the UK and the Netherlands Authority for Financial Markets (AFM) have been important in identifying risks and signalling the importance of the issue for consumer protection. In its response to CI, the Central Bank of Ireland noted that: "The themed inspection conducted is a forward-looking body of work aimed at changing the culture within banks and other regulated entities to ensure that the needs of the consumer are prioritised and that variable remuneration arrangements are focused on encouraging the right behaviours in sales staff through the use of a sufficient weight of quality measures in incentive schemes in order to have a meaningful impact on the payment or deduction of incentives, while actively discouraging poor sales related behaviours, aided by robust sales quality monitoring and the use of adequate penalties or deterrents."

These reviews are discussed in more detail below. The Financial Services Board in South Africa had instigated routine on-site visits to major and smaller banks and included a review of compliance with its conflict of interest requirements in each visit since 2010. The FSA in Japan stated that it includes sales incentives as verification points in the Financial Monitoring Policy 2013 and that its study on investment trust selling included assessing of employees' sales performances. SAMA had conducted on-site thematic reviews to assess the compensation practices of individual banks.

These actions and studies by national regulators are welcomed and the findings suggest that regulators elsewhere would benefit from reviews of sales incentives schemes to better understand the scale and nature of risks in their jurisdiction.

However, most of these reviews have examined financial incentive schemes and excluded other types of sales incentives schemes such as performance appraisal and staff being put under informal pressure to put sales before fair treatment of customers. Although the FMA in New Zealand notes that: "We have also at times discussed these topics [sales incentive schemes] during interviews with front-line staff members." We are not aware of any regulators conducting specific surveys of frontline bank staff to measure whether the sales culture within their banks and the incentive schemes put pressure on them to place sales ahead of fair treatment of customers.

The ASIC in Australia reported that it gathered information relating to sales incentives as part of its consultation process on banning conflicted remuneration.

Limited enforcement action

In the UK and Ireland, the regulators have issued guidance to firms on financial incentives schemes and the CFPB in the US has introduced new rules in the mortgage market. In one case in the UK, enforcement action has been taken against a bank for an inappropriate sales incentive scheme which increased the risk of mis-selling. However, not a single senior executive has had regulatory action taken against them for setting an inappropriate sales incentive scheme or for failing to manage risks.

However, the Japanese regulator (FSA) indicated it had the following in place: "The supervisory guidelines provide on ensuring that a senior executive is individually responsible for the design, implementation and resolution of issues relating to incentive schemes. The guidelines stipulate that the chief administrator in the sales department should make efforts to understand the reality of solicitation by sales staff, by conducting the face-to-face interviews with customers as necessary, and should take appropriate measures" (Supervisory Guideline for Financial Instruments Business Operators Ⅲ-2-3-2).

Proactive action against risk at the national level

United Kingdom

Thematic reviews and guidelines

The FCA has taken a more proactive approach to tackling the risks to consumer protection from sales incentives schemes. As part of this more proactive approach, the FCA published research in September 2012 of a thematic review of financial incentive schemes for frontline staff.[85] This research reviewed the financial incentive schemes of 22 firms, including high-street banks, insurers and investment firms. The FCA were concerned to find that:

- 20 of the 22 firms assessed had features in their incentive schemes that increased the risk of mis-selling – in six cases the risks were significant
- 11 out of the 20 firms were not properly addressing the increased risk of mis-selling
- 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 that the quantity sold
- 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
- 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.

The FCA issued guidance in January 2013, which required 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.

It published the results of a follow-up thematic review in 2014[86] which found that:

- The regulator's intervention had resulted in significant change and all the largest retail banks have either replaced or made significant changes to their incentives schemes to reduce risk to consumers and improve their controls
- Nearly all other firms also appear to have considered our guidance and many have made changes or improvements

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[85] FCA (2012), Guidance consultation: Risks to customers from financial incentives
[86] FCA (2014), TR 14/4, Risks to customers from financial incentives – an update
http://www.fca.org.uk/news/tr14-4-risks-to-customers-from-financial-incentives

However, the FCA highlighted that there continued to be a need for further improvement:

- One in 10 schemes at the largest retail banks continued to have at least one 'high-risk' feature
- 56% of sales incentives schemes at other firms still had high-risk features
- Many firms needed to make improvements around how they used 'management information' to monitor the risks of incentive schemes including:
    - Checking for spikes or trends in the sales patterns of individuals to identify areas of increased risk
    - Doing more to monitor poor behaviour in face-to-face sales conversations
    - Managing the risks in discretionary incentive schemes and balanced scorecards, including the risk that discretion could be misused
    - Monitoring non-advised sales to ensure staff who are incentivised to sell do not give personal recommendations
    - Improving oversight of incentives used by appointed representatives
    - Recognising that remuneration that is effectively 100% variable pay based on sales increases the risk of mis-selling and managing this risk

Enforcement action against firms

The FCA is the only regulator we identified to have taken specific enforcement action against a bank for failings in its sales incentives schemes. It fined Lloyds Banking Group £28 million (US$45 million) for serious failings in the design of its incentive scheme.[87] It found that the "incentive schemes led to a serious risk that sales staff were put under pressure to hit targets to get a bonus or avoid being demoted, rather than focus on what consumers may need or want." Failings included:

- The incentive scheme rewarded advisers through variable-base salaries, individual and team bonuses and one-off payments and prizes
- While advisers were required to meet certain competency standards to be eligible for promotions and bonuses, this control was seriously flawed and seven out of 10 advisers at Lloyds TSB and three out of 10 at Halifax still received their monthly bonus even though a high proportion of sales were found - by the firms themselves - to be unsuitable or potentially unsuitable. 229 advisers at Lloyds TSB received a bonus even when all of their assessed sales were deemed unsuitable or potentially unsuitable; and 30 advisers received a bonus in the same circumstances on more the one occasion
- The managers who were responsible for ensuring good practice by advisers also had their own performance measured against sales targets - a clear conflict of interest that needed careful management

The FCA also noted in its response to CI's survey that: "There have been a number of other cases involving mis-selling and consumer detriment at banks. In some of these sales incentives were identified as a factor, if not the main issue. There have also been many cases relating to other types of firms where sales incentives were a significant factor".

Australia

As outlined in section 2 of this report, ASIC in Australia reported that it took enforcement action in a number of cases related to remuneration policies, most notably the Commonwealth Financial

[87] FCA (2013), Final Notice: Lloyds TSB Bank and Bank of Scotland

Planning Limited (CFP) (CFP is a wholly-owned subsidiary of the Commonwealth Bank of Australia [CBA]) this followed an investigation into the provision of advice by some of its financial advisers.

Ireland

The Central Bank of Ireland conducted a thematic review of the incentive schemes for employees in 15 banks, insurance companies and investment firms. It published the results in July 2014[88] which found that there was a failure to recognise the inherent risks from financial incentive schemes and to mitigate those risks accordingly. Key findings included:

- A greater emphasis was placed on rewarding higher amounts of sales than achieving suitable consumer outcomes;
- Bonus payments paid fully or largely on the achievement of sales volumes and targets, with little emphasis on the quality of sales to the consumer;
- Limited use of penalties or deterrents against poor sales practices;
- Widespread use of branch targets in the banking sector as a means of focusing on the bank's goals;
- Incentives earned on an 'all or nothing' basis; and
- Regular and robust sales quality monitoring not performed consistently

The Central Bank published Guidelines on the Variable Remuneration Arrangements for Sales Staff and will require all banking, insurance and investment firms to review and restructure their remuneration arrangements in light of these guidelines. The chair of each firm must confirm to the Central Bank that this has been completed in advance of the remuneration period commencing on 1 January 2015.

Evidence from frontline workers obtained from unions indicated that aggressive sales targets linked to performance management, with penalties including termination of employment, were widely in place in Ireland. This creates significant pressure on frontline bank workers given the state of the job market. This highlights the importance of including all types of incentive schemes in risk management strategies.

The Netherlands

The Netherlands Authority for Financial Markets carried out thematic reviews on sales incentives and related topics. It identified the following good practices:

- Use of balanced performance criteria for sales staff, including financial targets and quality of service to customers (eg, quality of advice, educational criteria, long-term perspective and research on customer satisfaction)
- The percentage of variable remuneration had been cut down drastically or even abolished

The AFM also identified the following bad practices:

- Lack of a good balance between financial targets and other criteria. This has been specifically found with respect to certain positions: specialist services like trading desk and traders and senior staff

[88] Central Bank of Ireland (2014), Guidelines on variable remuneration arrangements for sales staff

Whistle blowing

Most regulators require firms to have a whistle blower policy in place and this information is held by the firms. A number of regulators had their own whistle blowing procedures in place. Others noted that their general complaints line was accessible by potential whistle blowers.

Japan's FSA reported that it had: "established a whistleblowing system where employees can perform the internal reporting with their confidentiality protected. Any disadvantageous treatment, including dismissal, for this whistleblower is prohibited by law".

The Central Bank of Ireland reported: "In the last 36 months, five employees of credit institutions have reported concerns about such practices [policies or practices in the bank that affect interactions with customers and potential customers] to the Regulator. Each alleged concern is reviewed by the supervising team and is taken into consideration for possible future thematic work and supervisory engagement with regulated entities".

The FCA stated: "To improve the process for whistleblowers, the FCA and the PRA will start to publish annual reports on the whistleblowing disclosures we receive and how we handle them. The FCA will publish its first report towards the end of 2014."

The FSB in South Africa noted that, in addition to its tip-off service where any individual could report concerns, a provider's: "compliance officer is obliged by law to report any material irregularities" to the FSB.

ASIC in Australia reported: "Australian legislation protects certain whistleblower activities and protects whistleblowers from persecution. These protections are designed to encourage people within companies, or with special connections to companies, to alert ASIC and other authorities to illegal behaviour".

Summary of the lessons from action taken by regulators against inappropriate sales incentives

Information gathered from regulators for this report demonstrates that there are good practices in place by regulators such as thematic reviews which help identify problems with sales incentives schemes. There is a lot we can learn from colleagues in different countries in terms of national and international regulation. However, the lack of enforcement action with regards to sales incentives is a particular concern. Experience from other sectors shows that holding senior executives individually accountable for poor practice provides a strong incentive for compliance.[89]

[89] Office of Fair Trading (2009), An assessment of discretionary penalties regimes

Part 7: Policy recommendations

Inappropriate sales incentives schemes have led to significant risks to consumer protection and financial stability. Improvements to these schemes and transparency about the risks they create would lead to benefits to consumers, banks, their staff and investors.

Recommendations for the G20 and international regulators

The G20 should ask the FSB to review its remuneration principles and standards and develop best practice guidelines for the approach which should be taken surrounding the structure, risk management, controls, governance and regulation of sales incentives schemes.

Working with banks, national regulators, unions and consumer groups, the FSB should identify a list of high-risk features of sales incentives schemes. These should include:

1) High-risk features created by the structure of sales incentives schemes
2) High-risk features created by the lack of monitoring, management information and other controls
3) High-risk features which can remain even after sales incentives schemes have been reduced or reformed

The G20 should ask the Basel Committee on Banking Supervision to conduct an urgent review of the measures which can be used by banks to calculate capital held against 'operational risk'. The objective of these reforms should be to achieve a substantial increase in the amount of capital banks should set aside. It must ensure that in addition to models, the level of capital is based on judgment, transparency and is forward-looking

Recommendations for national prudential regulators

National prudential regulators should:

- Ensure that banks disclose, as soon as possible, all possible legal and regulatory risks and possible litigation which could have a financial impact on the bank
- Require banks to disclose details of how they have calculated their provisions for legal risks, litigation and mis-selling and the breakdown between different issues
- Incorporate 'operational risks', including those which are caused by inappropriate sales incentives schemes into bank stress tests and publish full details regarding how they have been undertaken
- Ensure that requirements imposed by the prudential regulator to raise capital by issuing new forms of hybrid securities do not result in banks breaching regulations by reviewing the banks plans for distributing these securities
- Work with conduct regulators to prevent banks from using inappropriate sales incentives schemes or performance management schemes to encourage their staff to promote these products to retail customers

Recommendations for national conduct regulators

The experience of the UK, Ireland and the Netherlands shows that regulatory reviews of sales incentives schemes for frontline staff can uncover widespread poor practice and risks to consumer protection. National regulators should:

- Conduct detailed thematic reviews to assess the risks of sales incentives and performance management schemes in operation for frontline staff, starting with retail banks and then widening out this work to other financial institutions
- Ensure that the risks identified in these thematic reviews are tackled by introducing new regulation and guidance for firms concerning the structure, risk management, controls and governance of sales incentives schemes
- Require banks and other financial institutions to implement this regulation and to make any necessary changes to their sales incentives schemes
- Take enforcement action against banks and other financial institutions which do not implement the new regulation and guidance
- Require all banks to have a named individual senior executive responsible for approving the sales incentives schemes for frontline staff and controlling the risks of mis-selling
- If the sales incentives scheme leads to mis-selling or risks to financial stability by putting excessive pressure on frontline staff then the national regulator should take enforcement action against the bank and the named senior executive responsible for the scheme. Regulators should impose financial penalties on the senior executive and consider banning them from working in a senior position in a bank or other financial institution
- Measure and assess the culture and selling pressure throughout banks by interviewing and surveying frontline staff
- Ensure proper whistle-blowing arrangements, enabling frontline staff concerned about selling pressure put on them to be able to raise concerns with senior executives at the bank and/or with regulators

Recommendations for banks

Banks do not need to wait for regulatory intervention before making changes. A number of banks have already made changes to their incentive scheme to reduce or remove the sales element and to increase the focus on customer service and fair treatment. All banks should:

- Reform formal and informal sales incentives and performance management schemes for frontline staff to prioritise meeting the needs of customers, providing suitable advice and promoting customer service
- Ensure the structure of the sales incentive scheme and the controls which are put in place to prevent mis-selling are reviewed and approved by the remuneration and risk committees
- Disclose the details of the scheme in their annual report, whether their scheme includes any of the high-risk features identified by regulators and the measures which have been taken to control risks
- Ensure that changes to sales incentives schemes are a key part of any ‘cultural change’ programme and assess the culture and the selling pressure throughout banks by interviewing and surveying frontline staff
- Ensure proper whistle-blowing arrangements enabling frontline staff concerned about selling pressure put on them to be able to raise concerns and provide rewards to staff who highlight concerns to management

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[i] CI received responses from the following banks: Westpac (Australia); ScotiaBank (Canada); Banco de Chile (Chile); Societe Generale (France); Commerzbank (Germany); Deutsche Bank (Germany); KFW (Germany); Alpha Bank (Greece); Bank Mandiri (Indonesia); AIB (Ireland); Intesa (Italy); UniCredit (Italy); ABN AMRO (Netherlands); ING (Netherlands); Rabobank (Netherlands); ASB (New Zealand); Westpac (New Zealand); VTB (Russia); Barclays Africa (South Africa); Standard Bank (South Africa); CaixaBank (Spain); Lloyds (UK); Barclays (UK); HSBC (UK); RBS (UK).