



FinCoNet/Guidance

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# Guidance to Supervisors on the setting of Standards in the field of Sales Incentives and Responsible Lending

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# About FinCoNet

Established in 2013, FinCoNet is an international organisation of supervisory authorities, which have responsibility for financial consumer protection. It is a member-based organisation and has been set up as a not-for-profit association under French law. FinCoNet is recognised by the Financial Stability Board (FSB) and the Group of 20 (G20).

FinCoNet promotes sound market conduct and strong consumer protection through efficient and effective financial market conduct supervision. FinCoNet's initial focus is on banking and credit consumer issues.

Each member of FinCoNet has responsibility for and an interest in protecting the interests of consumers of financial services. FinCoNet seeks to enhance the protection of consumers and strengthen consumer confidence by promoting robust and effective supervisory standards and practices and by the sharing of best practices among Supervisors. It also seeks to promote fair and transparent market practices and clear disclosure to consumers of financial services.

# Executive Summary

1. FinCoNet's *'Report on Sales Incentives and Responsible Lending – A study of the impact of sales incentives on the sale of credit products'* (published in January 2016) sought to provide a holistic view of the role that sales incentives play in responsible lending in relation to the full suite of consumer credit products, with a focus on consumer protection.
2. This 2016 Report found ample evidence that poorly designed sales incentives can cause harm to consumers, individual firms and the financial system. Such harm can include not only unsuitable sales to individual consumers but also a more general erosion of a consumer-focused culture within individual firms and across an entire sector or industry. The Report highlighted that poorly designed sales incentives are especially prone to cause harm in the case of credit, where the consumer gets the financial benefit of the product up-front (giving rise to particular behavioural risks).
3. The 2016 Report also found that the nature of incentives for sales staff appears to be relatively uniform across jurisdictions, with the most common type of sales incentives being variable remuneration based on a firm or an individual's sales performance. It also found few specific rules and standards on sales incentives in place. This uniformity in industry practices across jurisdictions, coupled with the relative absence of specific rules and standards, marks sales incentives as a subject where an international approach is merited and where intervention has the potential to make a significant positive contribution to how credit is sold to consumers.
4. FinCoNet has developed the enclosed Guidance to Supervisors on the setting of Standards in the field of Sales Incentives and Responsible Lending based on its findings from the 2016 Report, the views of FinCoNet members on those findings and FinCoNet's consideration of submissions received to a public consultation launched in July 2016.
5. This Guidance to Supervisors on the setting of Standards in the field of Sales Incentives and Responsible Lending covers the following topics:
  - a. Appropriate Oversight;
  - b. Cross-selling;
  - c. Consumer-focused Culture;

- d. General Duties and Specific Responsibilities;
- e. Oversight of Different Sales Channels;
- f. Firms' Product Oversight and Governance;
- g. Monitoring;
- h. Disclosure; and
- i. Promotional Incentives to Consumers.

This paper also contains a list, as identified by FinCoNet, of the necessary pre-conditions of the overarching regulatory framework, if supervisory initiatives are to be effective in the field of sales incentives and responsible lending.

- 6. Through this work, FinCoNet aims to further contribute to the promotion of sound market conduct and strong consumer protection through the efficient and effective conduct supervision of sales incentives and responsible lending.
- 7. FinCoNet wishes to thank the members of its Standing Committee 2<sup>1</sup> on responsible lending for their work in developing this Guidance, as well as those who made submissions to the public consultation. All of these submissions were valuable to FinCoNet in its development of this Guidance.

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<sup>1</sup> FinCoNet Standing Committee 2 comprises of representatives from the Australian Securities and Investments Commission, the People's Bank of China, the Indonesia Financial Services Authority – the OJK, the Central Bank of Ireland (Chair), the Central Bank of Portugal and the Central Bank of Spain.

# Guidance to Supervisors on the setting of Standards in the field of Sales Incentives and Responsible Lending

## Introduction and key terms

8. This Guidance relates to the role incentives play in the sale of consumer credit products. For the purposes of this Guidance, consumer credit is understood to mean “*credit provided to individuals for personal, domestic or household purposes and not business purposes*”. This includes both secured credit (such as mortgage loans) and unsecured credit (such as personal loans, lines of credit, credit cards, overdraft facilities, payday lending and micro-finance).
9. In its simplest form, an incentive is “*an arrangement under which a company makes extra payments to employees to reward good performance*”<sup>2</sup>. Hence, a ‘sales incentive’ is such an arrangement where the element of ‘performance’ concerned is the sale of a consumer credit product. Sales incentives therefore include the following, whether on an individual or group-basis:
- financial incentives, such as a bonus for reaching a particular target; commission on the sale of a particular product; variable part of salary based on performance against sales target(s) or volumes of products sold; sales competition where winner(s) earn additional payments; increase in base pay; stocks or stock options etc.; and
  - non-financial incentives, such as performance recognition by management or co-workers; promotion and career development opportunities; flexibility in work hours; training opportunities; vouchers and gifts; extra holidays; company cars etc.; being subject to disciplinary action, enhanced monitoring, performance management, humiliation in front of colleagues and dismissal for failing to meet sales targets.

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<sup>2</sup> Oxford dictionaries - <http://www.oxforddictionaries.com/fr/definition/anglais/incentive-scheme>

## Necessary Pre-conditions

10. While this Guidance focuses on supervisory initiatives, it also draws out what arose from the findings in FinCoNet's 2016 *Report on Sales Incentives and Responsible Lending* as necessary pre-conditions of the overarching regulatory framework if supervisory initiatives are to be effective in the field of sales incentives and responsible lending. These pre-conditions include:
  - a. having one or more oversight bodies that are explicitly responsible for consumer protection in relation to consumer credit (referred to in the Report as a 'primary regulator' though please note that this Guidance focuses on the role of the Supervisor);
  - b. the scope of the Supervisor(s)' jurisdiction being comprehensive of the various sales channels that might be employed to sell credit;
  - c. appropriate cooperation mechanisms being in place where there is more than one responsible oversight body;
  - d. appropriate institutional arrangements being in place to ensure independence in the Supervisor's performance of its functions and to avoid, where applicable, potential conflicts of interest; and
  - e. an appropriate level of transparency and accountability in the carrying out of the Supervisor's functions, including for example facilitating transparent communication channels between Supervisors and stakeholders.

## **Guidance to Supervisors on the setting of Standards in the field of Sales Incentives and Responsible Lending**

### **A. Appropriate Oversight**

Supervisors should include in their approach to responsible lending the assessment of whether sales incentives encourage lending practices that are not in the best interests of the individual consumer or consumers generally. This should include the oversight of:

- all types of consumer credit products and sales channels within the Supervisor's remit;
- incentives to staff and credit intermediaries who sell and market consumer credit products, as well as individuals managing those staff or intermediaries;
- incentives offered to consumers to promote a credit product or otherwise incentivise a consumer to borrow; and
- incentives given to staff involved in arrears-handling where their role can comprise agreeing alternative repayment arrangements or moving a consumer to a different financial product.

### **B. Cross-Selling**

Supervisors' oversight should seek to ensure that sales incentives do not encourage the cross-selling of credit products without proper consideration for the needs of the consumer.

### **C. Consumer-focused Culture**

Supervisors' oversight should take into consideration the role that sales incentives play in setting the culture within firms providing or distributing credit products. This should include the oversight of:

- variable remuneration arrangements which can encourage sales staff and credit intermediaries to focus on the achievement of sales volume at the expense of consumers' best interests;
- the extent to which incentive arrangements which are poorly designed from the perspective of protecting the best interests of consumers can act as an obstacle to other consumer protection measures, such as advisory or disclosure requirements; and
- the extent to which behavioural drivers other than the incentives themselves promote the best interests of the consumer, including staff training, messaging from senior management and what information is emphasised in internal reporting arrangements.



#### **D. General Duties and Specific Responsibilities**

Supervisors' oversight of responsible lending should include both general obligations on the firm to act in the best interests of the consumer and more detailed requirements on sales incentives.

Specific requirements could include, for example;

- restrictions on incentives (see below);
- clawback of incentives which lead to irresponsible lending;
- specific corporate governance requirements;
- requirements that incentives be disclosed; and
- the requirement of one or more incentive features that positively promote the consumer's best interests.

The following are examples of the types of restrictions that could be placed on sales incentives where the Supervisor considers it appropriate to do so, following due assessment of relevant information and evidence:

- banning the payment of specific types of incentives, or specific incentive structures, where the risk(s) arising from the incentive cannot be managed in a manner that protects the best interests of consumers;
- placing limits or other restrictions on the types of incentives that can be granted or the structure of incentives that are permitted;
- placing limits or other restrictions on the amounts that can be paid as incentives; and
- limiting the variable component of an individual's remuneration (e.g. as a proportion of total remuneration).

#### **E. Oversight of Different Sales Channels**

The sales incentives provided by lenders to all those involved in the selling of its credit products, from front line sales staff involved in direct sales (including both employees and tied agents) to credit intermediaries, should be subject to appropriate standards and supervision.

The standards set and the approach to their supervision should:

- apply consistently across the channels through which a given credit product is sold whether staff are providing specific advice about the credit product or just information about the product; and

- include, as well as sales staff and credit intermediaries (and their practices), the overall architecture of a given sales network. This should include taking into consideration:
  - the propensity for a practice restricted or prohibited in one area to migrate to another; and
  - the importance of non-sales functions and management practices to the effective operation of controls in this area (as set out further below in G. Guidance on Monitoring).

#### **F. Firms' Product Oversight and Governance**

Supervisors' oversight of a firm's product oversight and governance of credit products should include an assessment of incentives comprised in credit products. This should include the oversight by the Supervisor of:

- the role, if any, that incentive arrangements play in how credit products are designed;
- the relationship between incentives and how consumers are targeted;
- the relationship between the scale of the target market and the volume of sales rewarded by the incentive scheme; and
- the scope and strength of a firm's product oversight and governance arrangements.

#### **G. Monitoring**

Supervisors' oversight should include an assessment of firms' arrangements for monitoring the operation of incentives within their sales force. This oversight should include consideration of the following:

- ensuring that firms have measures and procedures in place to adequately and effectively monitor the implementation of incentive schemes so as to avoid poor outcomes for consumers, including appropriate reporting thereon to the management body of the firm;
- that the governance structure includes appropriate alert systems within the firm to detect high risk situations as they emerge and address them appropriately. This should include effective whistleblowing arrangements and root cause analysis of any instances of poor behaviour. It should also include systems which alert the firm to unusual or exceptional items (e.g. higher than average sales) which, while not of themselves evidencing poor behaviour, may be indicative of underlying actions that do not promote the best interests of the consumer;
- that financial and non-financial reward arrangements and practices include qualitative metrics by which sales staff and credit intermediaries are rewarded, such as quality of service,

complaints analysis or loan performance over a period of time, as well as inputs from the monitoring exercises themselves;

- that there is proper support and priority for control functions whose input goes towards any qualitative scoring affecting incentives. This should include having reward arrangements for staff in control functions that are independent of the arrangements for sales staff and credit intermediaries, to secure the independence of these control functions;
- that the monitoring arrangements are appropriate to the nature, scale and complexity of the firm, the credit product being sold and the volume of sales; and
- that firms periodically review the efficacy of their policies and procedures in this regard.

#### **H. Disclosure**

Disclosure to consumers of incentives received by a salesperson can be beneficial for the protection of consumers' best interests. These benefits include promoting a healthy level of skepticism and self-reliance which may encourage consumers to take extra measures such as shopping around or seeking a second opinion. In particular, this may be the case where the consumer credit product is simple, the nature of the incentive and its disclosure is transparent and the consumer possesses an adequate level of financial literacy to allow him or her to understand the nature of the disclosure in question.

The approach of Supervisors to disclosure as a protection for consumers should take into account:

- that it should always be seen as complementary to (and not a substitute for) the other tools to mitigate poorly designed incentive arrangements, such as those listed in the other FinCoNet Guidance to Supervisors on the setting of Standards in the field of Sales Incentives and Responsible Lending;
- that disclosure may have perverse behavioural effects, such as inappropriately increasing the level of trust a consumer places in the salesperson or giving the salesperson a sense of moral licence (having disclosed their conflict) to disregard their duty to continue acting in the best interests of the consumer;
- the need for the disclosure to provide a meaningful opportunity for the consumer to understand, interrogate and challenge the incentive arrangement disclosed; and
- the need for firms to have conducted proper testing to measure consumer comprehension of the disclosure and its impact on consumer behaviour.

### **I. Promotional Incentives to Consumers**

Supervisors' oversight should include consideration of the benefit of promotional incentives offered to consumers versus the cost of the credit product.

This oversight should consider:

- whether the benefit is significantly outweighed by the cost of the credit, including having regard to how that cost of credit compares to other equivalent credit products;
- whether specific disclosures or warnings are required;
- the timing and nature of the presentation of the promotional incentive and how such timing and presentation may influence the consumer's decision; and
- when to restrict or prohibit this practice on the grounds that the apparent benefit of the promotional incentive is in fact illusory.

# Report on FinCoNet's Public Consultation on this Guidance

## Introduction

11. FinCoNet's 2016 *Report on Sales Incentives and Responsible Lending* found ample evidence that poorly designed sales incentives can cause harm to consumers, individual firms and the financial system. Such harm can include not only unsuitable sales to individual consumers but also a more general erosion of a consumer-focused culture within individual firms and across an entire sector or industry. The Report highlighted that poorly designed sales incentives are especially prone to cause harm in the case of credit, where the consumer gets the financial benefit of the product up-front (giving rise to particular behavioural risks).
12. The Report found that the nature of incentives for sales staff appears to be relatively uniform across jurisdictions, with the most common type of sales incentives being variable remuneration based on a firm or an individual's sales performance. It also found few specific rules and standards on sales incentives in place. This uniformity in industry practices across jurisdictions, coupled with the relative absence of specific rules and standards, marks sales incentives as a subject where an international approach is merited and where intervention has the potential to make a significant positive contribution to how credit is sold to consumers.
13. Having discussed the findings of this research at its Annual General Meeting in Cape Town, FinCoNet decided that, following the publication of the report itself, FinCoNet would launch a public consultation on a number of key topics arising from the Report. This was done with a view to informing the development of standards and guidance in this field.
14. To this end, a Consultation Paper was published on 1 July 2016 setting out a number of points of draft guidance for responsible supervisory authorities in the field of sales incentives and responsible lending, on which FinCoNet sought views.

FinCoNet received eight responses to the consultation paper from supervisory authorities and other public bodies working in this field, consumer associations and one industry body (herein the 'respondent(s)') namely: the Bank of Mauritius, Brokers Ireland; the Central Bank of Brazil; the Consultative Group to Assist the Poor; Consumers International; the National Credit Regulator of South Africa; the Saudi Arabian Monetary Agency; and the Superintendency of Banking, Insurance and Private Pensions Funds Administrators of Peru.<sup>3</sup> All responses received in response to the Consultation Paper were considered in the formulation of this guidance.

15. Overall, respondents were positively disposed towards FinCoNet's initiative in the area and the content of the Guidance itself, although a number of specific points of concern and suggestions for enhancement were made, which are discussed below.

16. FinCoNet then compiled revised Guidance which was then discussed and agreed by FinCoNet at its Annual General Meeting in Jakarta on 16 November 2016.

## **Consideration of the Consultation Responses**

17. When considering the submissions received, the following factors were taken into consideration:

- (a) the relevance of the submission to the specific subject matter of the Guidance;

The topic of incentives penetrates a number of regulatory fields and concerns, as well as wider policy issues. Not surprisingly, therefore, in some cases the submissions touched on points which did not fall directly within the ambit of FinCoNet's Guidance.

Examples of this included proposals surrounding:

- i. stockholders'/shareholders' expectations and overall market pressures on continuous growth;
- ii. disclosure to stockholders/ shareholders; and
- iii. complaints and arrears-handling (although we have added text to the Guidance on Appropriate Oversight to capture where a consumer is being moved to an

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<sup>3</sup> The submission made by the various respondents can be read, in full, on the FinCoNet website.

alternative repayment arrangement or alternative product, which may occur in an arrears case).

(b) whether the proposal was supported by the data and findings in FinCoNet's 2016 report;

While possibly relevant to the area of sales incentives more generally, some of the submissions touched on issues that were not captured at all or in sufficient detail in the 2016 Report to support their inclusion in this Guidance. Examples of such proposals include the insertion of new provisions to cater for:

- i. including micro-entrepreneurs/small and medium-sized enterprises in the application of this Guidance, as they can often be vulnerable borrowers (just like individual consumers)<sup>4</sup>; and
- ii. profitability of certain products as compared to others (although we did add a reference to the relevance of this in the case of promotional incentives to consumers).

While there may have been insufficient evidence to incorporate some of these proposals into this Guidance on the basis of the 2016 Report, this does not preclude FinCoNet from undertaking work on these and related topics in the future. FinCoNet may draw on these and other comments made in response to the consultation as a basis for informing its future work, particularly in the area of responsible lending. Also, by publishing the responses themselves, individual Supervisors can form their own view whether to also incorporate these points into their approach.

18. Where FinCoNet considered the point made merited a change to its Guidance, FinCoNet sought to make as minimal a drafting change as possible to accommodate the point(s) raised vis-à-vis the draft Guidance on which views were sought as part of the consultation process.

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<sup>4</sup> See the definition of 'consumer credit' at page 16 of the 2016 Report.

## **Key themes**

19. Of the aspects of the submissions which we considered as falling within the scope of the specific subject matter of FinCoNet's Guidance, a number of key themes emerged.

### ***Scope***

20. It appears from the responses that some respondents were unclear as to the types of incentives referred to in this Guidance. In keeping with the 2016 Report, this Guidance focuses on the incentives given by lenders to both its staff and those who sell products on its behalf (i.e. credit intermediaries and tied agents). The Guidance is to be applied consistently across all channels that fall within the relevant authority/authorities' supervisory remit, be they direct or indirect, as restrictions imposed by a Supervisor in one sales channel could give rise to the incentivisation practice concerned migrating to another sales channel. We have amended the wording of the Guidance on Oversight of Different Sales Channels to be clearer on this point.

### ***Restrictions versus other Measures***

21. There was a perception among some respondents that the Guidance was perhaps unduly focused on banning and limiting certain types of incentives. The respondents submitted that more recognition should be given to the role that other measures such as clawback, governance, disclosure and positive design features can play. We have amended the Guidance on General Duties and Specific Responsibilities to acknowledge this perspective, while retaining the guidance on the role of specific restrictions.

### ***Disclosure of Remuneration***

22. Some reservations were also expressed regarding the appropriateness of disclosing an individual's remuneration, on the basis that this information may be confidential and that this is the internal policy of the organisation. It was also feared that disclosing the terms of remuneration of selling agents might have a significant impact on competition and could result in unfair practices or possibly a higher staff turnover across the industry. FinCoNet recognises the legitimacy of the concern that certain disclosures could infringe on the privacy of a salesperson inappropriately and the potential for unintended consequences arising from disclosure. However, FinCoNet considers that Supervisors should be able to strike a balance between these concerns and what FinCoNet considers to be an appropriate measure to



protect consumers. FinCoNet has therefore retained the references to disclosure in the Guidance.

### ***Other Specific Enhancements***

23. A number of other enhancements were suggested by respondents and have been taken on board. These include:

- the wording used in the necessary pre-conditions of the regulatory framework section has also been changed to:
  - (a) include consumer representation, independence and transparency; and
  - (b) a new pre-condition has been added to reflect the importance of coordination between Supervisors, particularly where there is more than one Supervisor responsible for consumer protection;
- the term “sales network” used in the draft Guidance has been replaced throughout the text by “sales channel(s)”;
- the Guidance on Appropriate Oversight has been revised to clarify that this Guidance is intended to cover an individual who markets a consumer credit product to consumers, as well as a person who concludes an individual sale, given the role that marketing can play in securing a sale of a credit product (e.g. in a non-advised/execution only sale);
- the Guidance on Consumer-focused Culture has been revised to capture a point made around the messaging surrounding sales incentives within a firm;
- the “Guidance on Oversight and Governance” has been renamed as the guidance on “Firms’ Product Oversight and Governance”, in response to a suggestion received that the term ‘Oversight’ be replaced by ‘Internal Control’ to avoid duplication and/or confusion with Supervisors’ Oversight;
- the Guidance on Monitoring has been amended to:
  - (a) reflect that, as well as poor behaviour, alert systems should be able to detect irregular behaviour across transaction records and trigger a warning for investigation;

- (b) emphasise the point that the monitoring of sales, both individually and collectively should be sufficiently robust and thorough so as to ensure that risks arising from incentives schemes are identified and actioned; and
  - (c) a bullet point has been added to make more explicit the link between the level of monitoring and the nature, scale and complexity of the firm, the credit product being sold and the volume of sales;
- the Guidance on Disclosure has been revised:
    - (a) to recognise the role of financial knowledge and literacy and the promotion of consumer awareness and education;
    - (b) the phrase “*the propensity for disclosure to have perverse behaviour effects*” has been revised to bring it more closely in line with the wording used in the 2016 Report in respect of the role and effectiveness of disclosure;<sup>5</sup> and
    - (c) a bullet point has been included on foot of a recommendation that firms conduct proper testing to measure the impact of their disclosures;
  - finally, the Guidance on Promotional Incentives to Consumers has been amended to:
    - (a) avoid any implication that misleading promotional incentives are ever permitted; and
    - (b) recognise the link between promotional incentives and both the cost of credit of the product compared to other products and the surrounding circumstances of the sale.

## Challenges

24. The consultation also asked respondents to cite challenges they might envisage with respect to the implementation of this Guidance. Submissions included:
- balancing legitimate commercial interests with the need to protect consumers;
  - the need to ensure that any protections that are put in place do not make accessing credit so difficult that consumers are precluded from getting financing for their needs;
  - the fact that, for some jurisdictions, the Guidance might require a change to laws and regulations over which Supervisors do not have control;
  - a lack of rigorous or reliable metrics to measure culture;

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<sup>5</sup> See page 76 of the 2016 Report

- capacity and resource constraints, especially in smaller economies;
- differences in jurisdictions' market conditions, population size, culture and norms in respect of remuneration; and
- detecting sales incentives that are not set out in the financial institution's policies. This can include "discretionary" incentive schemes, where formulaic rewards linked to sales may have been removed, but managers are still using incentive schemes to indirectly reward sales.

25. These submissions highlight the importance of the pre-conditions to effective supervision in the Guidance being firmly in place and the complexity of the task that Supervisors face in this field. Through its Guidance, FinCoNet seeks to support Supervisors to meet these challenges and we believe that this Guidance provides a comprehensive and practical framework for Supervisors to do so.