Policy briefing

1912–2012 A CENTURY OF PROFESSIONALISM

CII

September 2012

FSA Guidance Consultation: Risks to Customers from Financial Incentives

Summary

- On 5 September, the FSA published a guidance consultation on **financial incentives** including the results of a **thematic review** into incentives across the industry. This briefing summarises the key points made by the consultation paper.
- Martin Wheatley, the incoming Chief Executive of the Financial Conduct Authority, gave a speech to accompany the publication during which he spoke about the importance of firms demonstrating the right culture - **from CEO level down to front line sales**.
- The FSA's review found **widespread evidence of poor practice**. In light of this, the regulator is considering strengthening the rules around remuneration.
- The FSA note examples of poor behaviour, not just in banks but across a range of firms **including insurers and financial advisers**.
- The regulator believes that **large and small firms** should be bound by very similar principles in the area of financial incentives, and the consultation sets out some guidance on good governance.

Link to the FSA consultation: http://www.fsa.gov.uk/library/policy/guidance_consultations/2012/1211

Link to Wheatley speech: http://www.fsa.gov.uk/library/communication/speeches/2012/0905-mw.shtml

Background

- As part of the current regulatory overhaul, the new FCA is set to become far more intrusive, acting as a consumer champion. As part of this new approach, the FCA will undertake an increasing number of thematic reviews - sector wide reviews of business practices that may pose a risk of consumer detriment.
- Remuneration of senior executives in financial services, in both banking and to a lesser extent insurance, is extremely topical, and poses a reputational challenge to the industry as a whole. But financial rewards for sales staff are also an important element in this debate.
- Against this backdrop comes this latest FSA Guidance Consultation. It looks at the financial incentives across the sector and some of the conduct risks posed by different arrangements. It also presents the results of findings into an investigation of practices across a variety of authorised firms including insurers and financial advisers.

Findings

- **Most firms [20 out of 22 firms assessed] did not properly identify how their incentive schemes might encourage staff to mis-sell. This suggests they had not sufficiently thought about the risks to their customers or had "turned a blind eye to them".**
- Many firms did not understand their own incentive schemes because they were so complex, making it harder to control them.

- Firms did not have enough information about their incentive schemes to understand and manage the risks.
- Most firms relied too much on routine monitoring, rather than risk-based monitoring, such as performing more checks on staff with high sales volumes.
- Some firms had sales managers with a clear conflict of interest that was not properly managed.
- Many firms had links to sales quality built into their incentive schemes that were ineffective.
- Some firms had not done enough to control the risk of potential mis-selling in face-to-face situations.

The FSA argue that given their findings, they are considering whether to strengthen the rules in the area of financial incentives.

Incentive scheme features that increase the risk of mis-selling

The FSA argue that customers are likely to lose out if firms exhibit the following remuneration practices:

- Firms reward staff through material incentive schemes based on sales volumes, fee income or similar measures.
- Firms' incentive schemes include features that are harder to manage.
- Management do not understand how the specific features, complexity and value of their incentive schemes could increase mis-selling.
- Poor quality sales or mis-selling are not adequately reflected in the eligibility for, or level of, incentive payments.
- Reflecting on one example of bad behaviour the regulator argues that ***"there may be a greater opportunity to increase the sales of additional products and add-ons through inappropriate sales conversations than is the case for primary product sales".***
- And with respect to incentives linked to **level or type of premium**, the FSA notes that: ***"sales staff seeking to maximise income will persuade customers to...take out more insurance than they need, or select a product term that is longer than required"*. This may also affect the choice between regular or single premium products.**

Smaller firms

FSA examples of high risk arrangements in small firms include:

- **Variable pay:** FSA argues that this is particularly relevant to mortgage and investment intermediaries who pay advisers based purely on the revenue that they earn.
- **Reducing costs:** the FSA is also concerned about advisers that have costs relating to compliance deducted from sales revenue. These costs, it is argued, might be reduced for future business if the adviser's revenue passes a certain threshold creating a "disproportionate reward for marginal sales".

How to reduce mis-selling

The FSA notes a number of ways for firms to reduce the risk of mis-selling including:

- **Emphasising quality**: Bonus and incentive schemes that **reward compliance** with sufficient deterrent to penalise poor behaviour.
- **Claw back:** For claw back arrangements to be successful, firms need to **carefully monitor** the levels of claw back and why customers are cancelling sales.
- **Capped or decreasing incentives:** Firms might choose to **limit variable incentive earnings** to a lower proportion of basic sales.

Guidance on governance of incentive schemes

The FSA outlines how firms can ensure that they have effective systems and controls in place:

- Robust **risk-based business quality monitoring** and adequate controls to mitigate the risk of inappropriate behaviour during sales conversations;
- Management information to identify, and act upon, trends or patterns in individual sales staff activity that could indicate an increased risk of mis-selling.
- Proper management of sales managers' **conflicts of interest**.
- **Effective oversight of incentive schemes** by appropriate senior management, including approval of the incentive schemes; and
- An effective risk identification and mitigation process, including **regular reviews of incentive schemes and the effectiveness of controls**, taking into account customers' interests.
- The FSA argues that; "*inappropriate staff behaviour during sales conversations is* ***unlikely*** *to be identified by firms undertaking reviews of written sales records or from* ***training and competence schemes****.*"

Smaller firms

The FSA notes that there are likely to be some differences in compliance requirements between small and large firms though the central principles remain the same for both. With respect to small firms:

- **Management information (MI)** – the information needed is likely to vary depending on the nature, scale and complexity of the firm's business.
- **Business quality monitoring** – may not be proportionate for such firms to have a separate independent monitoring function.
- **Sales managers' conflicts of interest** – the guidance relating to sales managers' conflicts of interest applies to smaller firms where this role, or a similar role, exists.
- **Controls for inappropriate behaviour by sales staff** – for small firms some of the examples referred to would cost too much such as "independent mystery shopping". Smaller firms should consider **how they can obtain and use customer feedback** to assess what is said to customers during sales conversations.
- **Governanc**e - FSA expect smaller firms to be aware of the risks arising from the way in which their sales or advisory staff are paid, to identify these risks and to mitigate them. The degree of formality required for governance arrangements will depend on the nature, scale and complexity of the firm's business.

Implications for firms

The FSA's financial incentives work outlined in the consultation paper is a clear indication of the likely direction of travel for the new FCA – with a more "proactive", interventionist remit. We can expect to see more action by the regulator in this vein, especially once the FCA is up and running early next year (expected to be fully operational by spring).

Reaction

BIBA Chief Executive Eric Galbraith: "The FSA's announcement is a step towards recognising the role that banks have played in the mis-selling of financial products, however the FSA could explore the merits of adopting a similar approach to Canada where banks are prevented from directly selling general insurance products altogether. Our sector has been tarnished by the practises of other institutions, whose main business is not insurance and have mis-sold insurance products. Banks and other organisations should focus on their core business and not be allowed to directly sell general insurance."

Aifa policy director Chris Hannant: "For too long, the regulator has wasted a lot of time over comparatively minor issues, particularly within the advice sector. It is right the FSA is now focusing its attention on these mass-scale areas where the largest harm is done."

Financial Services Consumer Panel Adam Phillips: "We welcome the publication of the FSA's guidance consultation and the regulator's commitment to action. However, the FSA has been slow to respond. Consumers continue to suffer from inappropriate pay and bonus practices in banks and other financial institutions. Incentives that encourage client service staff to make a profit at the expense of the customer need to be removed now."

Institute of Financial Planning chief executive Nick Cann: "It is right to crack down and penalise the banks. It is akin to call centres putting pressure on people to sell them stuff. We do not want the financial planning profession tarnished with that kind of practice. There is no ethical behaviour, it is being driven by the fact every customer has to have a product because that is the way staff are remunerated."

Association of Mortgage Intermediaries chief executive Robert Sinclair: "This is an opportunity for [mortgage] brokers to put their head above the parapet. It is an opportunity for lenders which might want to get out of direct distribution and move into the intermediary space because we can take away some of the risks that they are running with their incentives."

British Bankers' Association spokesman: "Bank staff are employed on a salaried basis and performance is measured on a wide range of criteria, including appropriateness of products sold and levels of customer satisfaction."

Essential IFA managing director Peter Herd: "The regulator needs to look at whether banks are product providers or advisers. If they are advisers, any advice has to be for the benefit of the client. The whole bank culture needs to be addressed."

Tenet group distribution and development director Keith Richards: "This issue has been raging for years and sadly some within the banking sector have adopted aggressive sales processes, with the focus on leveraging short-term profitability. It is incumbent on the FSA to deal with individual firms more effectively."

CII View

A central theme of this FSA paper is how individual culture is as important to future regulation as compliance.

We welcome this, as long as the regulatory approach positively promotes a corporate culture of professionalism, rather than enforcing a mere box-ticking mentality.

If the public interest is to be served, then embedding transparency and a better professional culture into firms' everyday thinking are essential, and the best firms should be recognised for driving change for good customer outcomes.

Next steps and key links:

The deadline to respond to the consultation is **31 October** 2012.

Link to the FSA consultation: http://www.fsa.gov.uk/library/policy/guidance_consultations/2012/1211

Link to Wheatley speech: http://www.fsa.gov.uk/library/communication/speeches/2012/0905-mw.shtml

Ben Franklin
Policy and Research Manager
Chartered Insurance Institute