Policy briefing

PFS | CII

March 2014

FCA Financial Incentives Thematic Review Update

Summary

On 4 March 2014 the FCA published the emerging results of detailed research to assess the extent to which firms have taken on this guidance one year later. This follows earlier Guidance Consultation on approaches to financial incentives that the FCA in 2012 and finalised guidance published in early 2013.

Early findings from the thematic research gives some reason for optimism, suggesting that on the whole, many firms have taken notice of the guidance published a year earlier:

- all the largest retail banks have either replaced or made significant changes to their incentive schemes;
- nearly all other firms also appear to have considered the guidance and many have made changes or improvements; however
- More progress is needed among firms of all sizes, especially small firms.

The guidance applies to all firms except sole traders and partnerships (though even they need to be mindful of potential mis-selling risks). This briefing also sets out some particular issues for small firms including some questions to consider.

Next steps: the FCA will continue to look at this area and work with the sector towards better implementation. It will especially look to guide small firms to improve their engagement and in-house practises.

Overview

The FCA has published research gauging the sector's approach to financial incentives among front line sales staff.[1] This is further to guidance the regulator consulted and put out about a year ago.[2] The research assesses the extent to which firms are implementing this guidance and highlights the progress that is still awaited.

Who does this apply to?

The FCA guidance applies to all firms including retail investment advisers. The only exceptions are situations such as sole traders and partnerships where the business owners are the only individuals selling products, or providing services such as advice to retail customers. However, even these firms need to be minded of the potential mis-selling risks that need to be identified by the principal and controlled effectively.

Please note that the FCA's guidance note also applies only to front-line sales staff, not senior executives who are caught by their own controlled function regulatory requirements.

---

[1] Financial Conduct Authority, Thematic Review TR14/4 Risks to customers from financial incentives – an update, March 2014.

[2] Financial Services Authority, Finalised Guidance FG13/1 Risks to customers from financial incentives, January 2013.

Background

In September 2012, the then Financial Services Authority set out the results of a preliminary review into the use of financial incentives within the financial services industry. This included:

- remuneration of senior executives in financial services, in both banking and to a lesser extent insurance that were highly topical at the time and posing reputational challenges to the industry as a whole;
- financial rewards for sales staff were also an important element in this debate, including the conduct risks posed by different arrangements. It also presents the results of findings into.

The Guidance Consultation summarised the findings of an investigation across a variety of authorised firms including insurers and financial advisers. It found that firms were not properly identifying how their incentive schemes might encourage staff to mis-sell. In effect, they were not sufficiently thinking about the risks to their customers or possibly "turning a blind eye to them". Highlighted problems included some firms relying too much on routine monitoring; complexity and value of their incentive schemes could increase mis-selling; and others having incentive schemes without proper assurances of sales quality.

Given these preliminary findings, the regulator consulted on and published in January 2013 a guidance document calling for several measures across large and small firms aimed at making firms more aware of the consequences of such incentive schemes and to mitigate them. It suggested such measures as improve quality monitoring to identify inappropriate behaviour within sales situations, better conflict of interest management, senior management oversight of incentive schemes; and regular reviews.

The regulator said that it would regularly review the use of financial incentives in the sector.

Latest Developments Main Findings

The FCA carried out a further review of incentives schemes for sales staff across all types of firms. It looked at the controls firms are using to mitigate the risk of mis-selling from their incentive schemes. The work included:

- on-site assessment of incentive arrangements at all of the largest retail banks
- an online assessment of incentive schemes at all other firms, and a sample of the smallest firms
- visits to 12 medium-sized firms who took part in the online assessment and
- individual feedback to all the large and medium-sized firms.

Significant change

Early findings from the thematic research gives some reason for optimism, suggesting that on the whole, firms have taken notice of the guidance published a year earlier:

- all the largest retail banks have either replaced or made significant changes to their incentive schemes;
- nearly all other firms also appear to have considered the guidance and many have made changes or improvements; however
- more progress is needed for the smallest firms.

More to be done

The research highlighted that while noticeable progress has been made by the sector since January 2013; more work is needed amongst firms of all sizes, particularly small firms:

- Higher-risk incentive scheme features: one in ten of the firms with sales teams did not seem to be managing the risk properly at the time of assessment.

- Use of management information: most firms with incentive schemes had at least some improvements to make in this area.
- Almost all of the large and medium-sized firms involved in this work have confirmed that they have, or will have, completed improvements by the end of March or shortly thereafter.
- Firms of all sizes need to embed their new schemes and controls, and determine if they are delivering the intended outcome and if they will be effective in the long term.
- This may be part of a wider programme of cultural change to put the consumer at the heart of their business.
- There is also a question whether new schemes that have eliminated or significantly reduced the amount of bonus driven by sales will last, for example, if there appears to be a negative impact on profits. If firms decide not to maintain such schemes and the risk to consumers increases, controls will need to be strengthened.

The next 12 months will be important in establishing whether the sector carries out genuine change in the area of front-line staff remuneration. To deliver real improvement for consumers, firms need to ensure that they do not ostensibly substitute financial incentives with other forms of pressures that have similar effect. The FCA will carry out work on other performance management approaches.

The report highlights some of the key areas that firms should focus on when managing their incentive arrangements:

- Using management information to check for spikes or trends in the sales patterns of individuals to identify areas of increased risk.
- Doing more to monitor behaviour in face to face conversations.
- Managing the risk in discretionary schemes and balanced scorecards.
- Monitoring the risk of staff who are incentivised for non-advised sales giving advice.
- Improving the 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.

Implications

When the FSA published its financial incentives guidance consultation in September 2012 prior to the founding of the new FCA, it provided an early indication of the type of interventionist approach the new regulator would adopt. At the time, we had highlighted in a policy briefing that this would be a precursor of more proactive regulation to come,[3] and this has certainly played out in the raft of thematic investigations and market studies undertaken in the last few months across so many areas of its remit.

Sales staff incentives to sell financial services products to the public is a key element of conduct risk, which in turn indicates a firm's culture and attitude towards its customers. Martin Wheatley explains in his foreword to the thematic review paper:

"This was a wake-up call for all areas of the industry. Many firms agreed that the model needed to change and publicly committed to doing so. This was welcomed not only by my organisation but by customers as well. I made a commitment that we would carry out a piece of follow-up work on financial incentives to check how firms had responded to our findings and the guidance which we provided to help them meet our requirements."[4]

---

[3] The Chartered Insurance Institute, CII Briefing: FSA guidance consultation on financial incentives, Sep 2012.

[4] FCA Thematic Review TR14/4, see note 1, p.3.

SMEs: Key Questions to Consider

As stated above, the FCA guidance applies to all firms including most small firms, and even the exceptions have to consider other potential mis-selling risks that need to be identified by the principal and controlled effectively.

Aside from the normal range of compliance monitoring activity (e.g. file reviews) that applies to all firms, small firms should be minded about several issues specific to them. In helping small firms to understand the guidance, we have set out some questions that they might want to consider:

- Do we consider how the way our people are remunerated might cause them to act in a way that benefits them and is bad for clients? How would we spot such activity if it occurred? For example, an increase in business in the run up to a deadline that could impact on the earnings of the adviser?
- Do we need to review the Key Performance Indicators we currently use, to ensure they provide this information?
- Do we undertake extra monitoring for potentially suspicious or unusual activity, or extra monitoring for our people that achieve increased levels of business (and hence increased levels of remuneration)?
- Do we pro-actively look to identify where customers could be mis-informed or wrongly advised in a face-to-face conversation, in a way that might not show up in a file review? For example, do we call a sample of customers to independently verify their understanding of the products or service they have taken up, why it was suitable for them and the risks/costs/charges?
- How do we satisfy ourselves that anyone speaking to clients is not putting their own interests ahead of the client?
- Can we demonstrate effective controls in these incentive related areas?

Our View

A central theme of this FCA thematic 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.

This latest FCA statement does provide further recognition that small firms need to be as aware of financial incentives as large firms and this paper provides some ideas of the sorts of questions small firms should consider.

Next Steps

The FCA is not proposing any rule changes at this time but financial incentives will remain on their agenda. It will:

- continue to focus on financial incentives through its supervision of firms because it is an important area of inherent risk;
- take steps to increase the engagement of the smallest firms on this issue, because this work indicates they are less engaged in this area than other firms; and
- carry out work looking at the related area of how firms manage the performance of their sales staff and whether pressure put on staff (through, for example, sales targets) increases the risk of mis-selling.