Summary of feedback received

January 2013

FSA
Financial Services Authority

Consultation title	Risks to customers from financial incentives
Date of consultation	5 September 2012 to 31 October 2012

Summary of feedback received

We received 58 responses to the Guidance Consultation Paper (GCP) from a range of respondents, such as:

- firms (across all sectors);
- trade associations;
- trade unions;
- consultancy firms;
- employees of firms responding in a personal capacity; and
- consumers.

The responses were generally very supportive of the guidance, and agreed that it would help firms to meet our requirements. We are therefore not making significant changes to it.

Respondents did raise a number of issues which are addressed in this document, and we have made some minor changes to the guidance. The most significant issue raised was how firms use performance management and target setting, which is also a key driver of a firm's culture. Some saw this as more likely to increase mis-selling at firms than financial incentives.

These responses support our view that performance management is an issue and we are considering what additional work we will undertake in this area. We comment on performance management in more detail below.

Many respondents expressed concern at the type of incentive schemes we had seen, and were pleased that we were taking action to address the risks to consumers from such schemes.

Most of the firms that responded said they were reviewing their incentives arrangements and some have already made changes or will be doing so soon. The trade associations that responded also indicated that many of their member firms are taking similar action. Some larger firms have publicly stated that they are changing their

incentive schemes, or piloting new schemes, which they say are not linked to sales volumes.

We are pleased to see signs that firms have recognised the importance of this issue and are taking swift action in response to our thematic findings and guidance.

However, our thematic work showed that often ‘the devil is in the detail’ when looking at the risks to consumers from a particular incentive scheme. So where firms are making changes with the intention of reducing risk, they will still need to think carefully about the risks and the likely poor behaviours by sales staff and sales managers that might arise. This is important to ensure they have effective systems and controls in place to adequately manage the risks.

We are planning a wider review of how firms have acted on our guidance. This will start in the second quarter of 2013.

The consultation period for this proposed guidance closed on 31 October 2012.

We invited views on the following:

1. Our proposed guidance in general and specifically for the following areas:

   - incentives scheme features that increase the risk of mis-selling (Section 3); and
   - managing the risks and governance of incentives schemes (Section 4).

2. The comments specific to smaller firms in Sections 3 and 4.

3. The cost benefit analysis, in particular the examples of cost estimates for the proposed guidance.

4. Whether our proposals have an impact on equality and diversity agendas.

Where we have received comments relevant to these areas we have summarised the main points raised and set out our response, including any changes made to the guidance.

Response to feedback received and changes made to the guidance as a result

1) General comments

1.1 Performance management and targets

Many respondents, including firms, consumers, trade unions and trade bodies, commented on target setting and the performance management of sales staff and sales managers, some in great detail.

Respondents argued that it is not sales incentives in isolation that lead to mis-selling. The culture of a firm and the way that it manages staff can have a significant impact on the way sales staff behave, including whether they mis-sell.

We were told that many firms have a strong focus on maximising sales and staff can be subject to extremely challenging sales targets, which are vigorously monitored. There can be significant pressure to meet targets and severe repercussions for failing to do so, regardless of any financial incentives.

Several consultation responses gave examples of how staff can be put under pressure. These examples include:

- Excessive reporting of sales results – in extreme cases this could be every hour during the day.
- Staff not being allowed to leave until they have achieved a sales target or booked a required number of customer appointments.
- Sales staff required to make ‘pledges’ of what products they will sell that day, without knowing which customers they will see.
- Aggressive performance management and threats of formal disciplinary measures that might lead to dismissal.

Several respondents mentioned that staff fear losing their jobs and that this can drive mis-selling as much, if not more, than the desire to achieve a bonus. The fear of not meeting expected sales volumes and being subject to performance improvement plans, disciplinary action or dismissal can be the driving force for staff to sell inappropriately. Two respondents said these issues are also adding to pressure, stress and sickness in the work place.

Three respondents also warned that if firms remove incentives in response to our guidance it is likely to result in a tougher approach to performance management within firms: without the ‘carrot’ of the financial incentives, firms would rely even more on the ‘stick’ of performance management.

Our response

By ‘performance management’ we mean how firms manage the day-to-day activities of sales staff and sales managers, what action is taken in relation to their performance against sales targets and other measures, and the sales culture they work under.

The strength of the concerns raised by respondents supports our view that this is an area of risk, which firms should be managing. Our guidance paper (page 7) makes it clear that we expect firms to manage the risks from sales targets and performance management. We also stress that firms should ensure that risks from their incentive schemes are not transferred to these areas.

We are considering what additional work we will undertake in this area.

1.2 Rules
A number of responses suggested we should create new rules in relation to how firms use financial incentives and manage the risks, and others argued we already have sufficient powers to deal with these issues.

One respondent was concerned about the length of time taken to complete this work and felt we should be more decisive about changing or strengthening rules.

Our response
We concluded from the findings of our thematic work that we needed to issue guidance to help firms to comply with our requirements.

Guidance gives firms information about how to meet our requirements, while allowing flexibility for them to do so in a way that is most appropriate for their circumstances. Given the huge variety of incentive arrangements and the different types and sizes of firms and business models, guidance is a more flexible option compared to making new rules. We consider guidance should be effective in changing firms' behaviour rather than requiring a more prescriptive approach.

We have made it clear that if firms do not take sufficient action to effectively mitigate risks in response to our guidance, then we will assess whether we should change or strengthen our rules in this area.

We recognise the need to speed up the completion of thematic work and subsequent actions, in line with the FCA aim to intervene promptly in future.

1.3 Firms providing services
One respondent commented that the guidance paper is not clear enough about how it applies to firms that do not sell 'products' but rather provide a service – for example, investment management services.

Our response
We recognise we could have been clearer about this.

We did address this point in section 1 of the guidance (page 6), under the heading '*Who does our guidance apply to and what do we expect firms to do*', where we state that '*This guidance applies to all firms in retail financial services with staff [who] deal directly with retail customer transactions*.' The footnote to this sentence states '*This includes those in sales, advisory or discretionary and non-discretionary investment management roles…*'.

This signals that the guidance applies to roles that involve 'selling' or advising on the provision of services like investment management. Incentive arrangements can give rise to a risk of poor customer outcomes whether the staff or advisers are selling products, or influencing customers to take up a service.

We have tried to write the guidance simply to cover both selling products and the provision of services. While we often refer to 'mis-selling', this is defined in section 2 (page 9) as '*…a failure to deliver fair outcomes for consumers*' and one of the example outcomes provided refers to purchasing a product or service.

We have made a change to the final guidance on page 9 so that another example outcome also refers to products and services.

We have also added the following text (in bold) to the footnote on page 6 in the final guidance to reinforce these messages[1]:

'*This includes those* ***involved in selling products or providing a service, advisers and those*** *in discretionary and non-discretionary investment management roles…*'

We have also moved this footnote into the main body of text to make it more prominent.

1.4 Who the guidance applies to

Some respondents were concerned that we expect firms to follow all aspects of the guidance. They suggested we needed to recognise the impact of different business models, for example methods of distribution, the size of firms and the variance in the risk to consumers in different product ranges.

Other respondents commented on incentive arrangements they were aware of in their own sector of the industry.

Our response

We already comment in section 1 of the guidance (page 6), under the heading '*Who does our guidance apply to and what do we expect firms to do*' that '*The guidance…sets out a number of ways, but not the only ways, firms can comply with the relevant requirements…*'.

We have recognised that the amount of risk from financial incentives, and the effective management of this risk, will vary from firm to firm, and is affected by many factors – for example, the type of product and the method of distribution. We have written the guidance so that it is helpful to all firms and we included comments specifically to help smaller firms understand how the guidance applies to them. Individual firms are best placed to understand the risks from their incentives and can act as they see fit provided they can demonstrate that the risks are being managed effectively. Therefore, we have not made any changes to the guidance.

Where respondents commented on incentive arrangements in their own sector of the industry, these were generally consistent with the range of incentive scheme features in our guidance. The same principles from our guidance apply. Firms need to understand the risks in their incentive schemes, and ensure they have effective controls.

1.5 European guidelines

Some respondents mentioned the recent proposed guidelines from the European Securities and Markets Authority (ESMA) and felt it was important that our guidance was aligned.

[1] This is not intended to be an exhaustive list of where the guidance applies to firms that provide a service.

Our response
ESMA issued a consultation paper in September: *Guidelines on Remuneration Policies and Practices*.[2] We welcome this paper, which is consulting on remuneration guidelines in relation to MiFID[3] rules on conflicts of interest and conduct of business.

The guidelines aim to foster a consistent application and improved implementation of these requirements across the EU and are primarily targeted at sales activities with retail clients. The focus of these guidelines is the remuneration of all persons involved in providing investment services; in particular those who can have a material impact on the service provided and on the conduct of business risk profile and/or who can influence corporate behaviour. We contributed to the work of ESMA, and our guidance is consistent with their proposed guidelines. We will continue to ensure that our work takes account of this.

2) Incentives scheme features that increase the risk of mis-selling (Section 3)

2.1 Incentive bias
Two responses questioned whether our comments on 'inappropriate incentive bias' (page 15) could be read as promoting equal incentives for all products, which could cause the mis-selling of cheaper or easier-to-sell products when other products are more appropriate.

Our response
This is a valid concern, which we considered when drafting the guidance, and this was addressed in the footnote on page 15. We do not currently prescribe what incentives firms should or should not have, including whether they should have any product bias. We also stressed that it was 'inappropriately larger incentives' which were likely to be a feature that could significantly increase the risk of mis-selling.

It is for firms to decide whether some differentiation is appropriate for their incentive arrangements because, for example, a product takes longer to sell, and how they should monitor the feature to mitigate risk. The footnote on page 15 in the guidance gives examples of when some difference may be appropriate. We also point out that where products are 'substitutable', the risk from any bias is likely to be greater. Therefore, we have not made any changes to the guidance.

Even where a firm opts for having no incentive bias between products this does not remove the risk of mis-selling, as the responses point out (see also 2.2 on unintended consequences). Firms still need to identify possible mis-selling behaviours and manage the risks effectively.

2.2 Unintended consequences
Some respondents raised a concern about the guidance for incentives scheme features that increase the risk of mis-selling. They suggested that changing incentive schemes to reduce risks could have unintended consequences resulting in different risks to consumers.

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[2] http://www.esma.europa.eu/consultation/Consultation-Guidelines-remuneration-policies-and-practices-MiFID

[3] The Markets in Financial Instruments Directive (Directive 2004/39/EC)

An example of this is referred to in 2.1, where the respondents identified a potential risk from removing incentive bias between products in some scenarios. Another respondent mentions that a cap on incentives could reduce risk, but might also cause sales staff to delay completing a sale until the next incentive period, which could result in customer detriment in some situations.

Our response
We agree with these concerns. Firms are responsible for understanding the risks from their incentives schemes and ensuring they manage these risks effectively. This includes considering any unintended risks arising from how they design incentive schemes or when they make changes to them.

In view of this we have added the following text to the final guidance in Section 3 (page 13):

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

2.3 Features that might reduce risk
Some respondents wanted more examples of 'good' incentive features and others provided information about features or approaches they considered could reduce the risks of mis-selling. These included (in summary):

- deferral arrangements for a proportion of variable incentive payments;
- 'rolling' target thresholds before incentives can be earned (e.g. over a 12-month period) rather than having a set threshold each month/quarter; and
- using a 'balanced scorecard' approach for awarding variable incentive payments.

In addition, three firms who responded explained that they had incentive schemes for staff that had no link to sales volumes.

One respondent suggested that we should be clearer about what we mean by 'quality' under the heading of 'Emphasising quality' on page 18.

Our response
In Section 3 of the guidance (page 17), we provided guidance about incentive scheme features that might reduce the risk of mis-selling. However, we also gave examples of how such features might not always be implemented effectively.

We have added some further examples to the guidance in Section 3 (starting on page 19) based on the comments received. In some cases we have also highlighted how these additional examples might not always be effective. It is important for firms to understand that introducing such features does not eliminate risk and the design and implementation needs to be carefully considered.

We have added the following text (in bold) under the heading of 'Emphasising quality' on page 18 of the final guidance:

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

2.4 Materiality of incentives
Some respondents commented on how some of the incentive scheme features we described as higher risk would be less of a concern if the value of the incentive payments were ‘modest’, and therefore materiality needs to be taken into account. Others suggested that a lower proportion of variable pay would help to reduce risk, although some argued that incentives in sales roles were necessary.

Our response
We agree that the materiality of the incentives available needs to be taken into account. In Section 3 of the guidance (page 13), we state:

‘*The likelihood of mis-selling increases when the value of incentives available to sales staff increases, or when incentives make up a high proportion of a remuneration package for sales staff.*
Customers are likely to lose out if:

- *firms reward staff through material incentive schemes based on sales volumes, fee income or similar measures;*’

We have not made any changes to the guidance, however, firms still need to consider how an incentive feature will affect the behaviour of staff and take appropriate steps to manage the risks. Where a firm considers that an incentive scheme is less material, this does not mean that risks can be ignored.

3) Managing the risks and governance of incentives schemes (Section 4)

3.1 Sales managers’ conflicts of interest (Section 4, page 25)
One respondent suggested that the risks in this area were a significant issue within financial sales organisations.

Another respondent commented that senior management at firms are either too remote from the detail of the sales managers’ remuneration arrangements to understand how the conflict manifests itself in practice, or they may turn a blind-eye to the risks.

Our response
These responses are consistent with the findings of our thematic work. Our work suggests it is common for sales managers to have conflicts of interest, where they earn incentive payments based on the volume of sales made by the staff they supervise.

As highlighted in our guidance, the severity of the conflict depends on how involved the sales manager is in the business quality monitoring of the staff they supervise.

We have not made any changes to the guidance, however, firms will need to consider carefully if their controls are sufficient to manage this conflict, or whether they should take steps to reduce or eliminate the conflict.

3.2 Controls for inappropriate behaviour by sales staff (Section 4, page 26)
A number of respondents gave examples of inappropriate behaviour and poor selling practices similar to those described in the guidance and agreed that it was not sufficient to use broad measures of customer satisfaction to mitigate these risks. Respondents agreed that firms should consider the customer outcomes that need to be tested.

Several examples were given of firms who had introduced post-sale customer contact programmes to assess the customer outcomes for face-to-face sales, using staff independent to the sales process.

Our response
Our thematic work showed that few firms with face-to-face sales staff had fully considered the risks of poor sales conversations (for example, leaving out important information or pressuring customers to buy a particular product), or the specific controls that might reasonably be needed to monitor staff behaviours, including what is actually being said to customers.

While we welcome signs that firms might be developing new controls, like using post-sale customer contact programmes, there was not always enough information in the responses to show if these would be effective in mitigating the risks. We have added one additional good practice example on page 27. It is important that any approach to obtaining customer feedback is designed and implemented effectively. For example, in Section 4 of the guidance (page 27) we provide a poor practice example where seeking customer feedback is not effective.

We are also aware of other firms who have introduced mystery shopping to test customer outcomes in face-to-face sales, or are planning to. In one case this involves an audio visual record of the sales conversation which is subsequently reviewed independently by staff in the firm's business quality monitoring team.

We have added this audio visual mystery shopping approach as a good practice example in section 4 of the guidance (page 27).

3.3 Governance
Some respondents mentioned that good governance arrangements of incentive schemes should involve a number of functions at a firm, for example human resources, finance, compliance, risk and the sales team itself.

Our response
In Section 4 of the guidance (page 28), under the heading '*Governance arrangements*' we state that '*Senior management should approve incentive schemes with input from risk management and compliance functions into the design and review of incentive policies.'*

While our requirements do not prescribe governance arrangements, we agree that it is likely to be appropriate to include other functions like human resources and finance. However, it is for individual firms to decide what is appropriate taking into account their size and business model. We have not made any changes to the guidance in this area.

4) Comments specific to smaller firms in Sections 3 and 4

4.1 Different types of smaller firm and appointed representatives
Some respondents highlighted that smaller intermediary firms are not the same as larger vertically integrated businesses, and therefore the guidance should reflect these differences.

There was acknowledgement that the examples of higher-risk incentive arrangements for smaller firms we give in Section 3 (page 20) were the most relevant. However, one respondent felt we could have given more examples to help smaller firms.

It was also suggested that we need to say more about how the guidance applies to directly authorised intermediaries and appointed representatives – for example, members of networks, many of whom might also be self-employed. One respondent also asked for more clarity about any incentive arrangements operated by appointed representatives who have their own sales staff or advisers.

Our response
We recognise that smaller firms are different and we did include information to help smaller firms understand how the guidance was relevant to them, while trying to keep the guidance short and concise. Where we refer to smaller firms in Section 4 (page 28), the guidance recognises that the approach taken will depend on the nature, scale and complexity of the firm's business.

In Section 1 of the guidance (page 6), we state under the heading '*Who does our guidance apply to and what do we expect firms to do*' that '*This includes those in a sales, advisory or discretionary and non-discretionary investment management roles, intermediary firms and firms with appointed representatives and smaller firms, whether staff are employed or self-employed. This also includes intermediary firms where sales staff or advisers are paid a proportion of revenue earned for the firm, whether or not they also receive a basic salary.*'

We think it is clear that our guidance applies to directly authorised intermediaries and appointed representatives. The additional specific comments for smaller firms in Sections 3 and 4 should help firms. However, we have moved this footnote (including the amendments set out in 1.2) into the main body of text to make it more prominent.

We have also added additional text to page 6 to help clarify the situation where there are incentive arrangements operated by appointed representatives who have their own sales staff or advisers, as follows:

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

We drew attention to our guidance in our regulation roundup newsletter to smaller firms. We also anticipate undertaking some briefings after the final guidance is published, to further help firms to understand how it applies to them.

5) The cost benefit analysis

5.1 Variable pay
We received very few comments about the cost benefit analysis.

One respondent questioned whether it was our intention to prohibit arrangements involving 100% variable pay, raising the concern that this could affect the availability of advice in some sectors, as this would affect firms with self-employed advisers. They pointed out this was not considered in the cost benefit analysis.

Our response
The guidance does not suggest that any firm should not use 100% variable pay or commission only arrangements, where the risks can be managed effectively. Therefore, the impact on the availability of advice was not specifically considered in the cost benefit analysis.

6) Equality and diversity

6.1 Responses about equality and diversity

No responses were received that disagreed with our assessment

We remind firms of their obligations under the Equality Act. We encourage the firms we work with and our stakeholders to engage with the issues raised in relation to access and to work with others to ensure they are considering the needs of all consumers.

You can access the full text of the guidance consulted on here