

November 2018

# Bank Incentive Structures

Findings from an FMA review of incentive structures  
in the banking industry

EMBARGOED

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# Executive summary

## Purpose of this review

How people are incentivised influences the way they act, and tells them what behaviour is valued. In banks, incentives linked to sales encourage staff to sell products and tells them that a sale is a good outcome. This creates a conflict of interest between the staff member and the customer, as it is not always in the customer's interest to purchase a product. Banks need to manage this conflict of interest to ensure their customers get good outcomes.

The purpose of this review was to understand and assess the design of banks' incentives schemes for salespeople, and how related conflicts of interest are managed. To do this we looked at:

- incentive schemes for salespeople and their line managers
- controls for managing the risks associated with incentive schemes
- board and management oversight of risks related to incentives.

This review was signalled in the Financial Market Authority's (FMA) Annual Corporate Plan 2017/18, and aligns with our strategic priorities of Sales and advice, Conflicted conduct, and Governance and culture. This review also complements the Bank Conduct and Culture review<sup>1</sup> of banks in New Zealand by the FMA and the Reserve Bank of New Zealand (RBNZ).

## What we found

Incentives of bank salespeople are highly sales focused, meaning there is a high risk of inappropriate sales practices occurring. Despite this, banks are not adequately monitoring and controlling this risk.

### 1. Incentive schemes are highly sales focused.

Sales performance typically determines the majority of a salesperson's variable pay. Incentive schemes are structured to encourage high sales performance, commonly incorporating minimum sales thresholds and larger rewards for bigger sales. Manager incentives are typically based on the sales performance of their salespeople, likely adding more pressure on staff to sell.

This means that the risk of inappropriate sales practices occurring is high. It is therefore unsurprising that we were told by some salespeople of inappropriate sales practices taking place.

### 2. Controls appear to be ineffective at mitigating conduct risks.

Given incentive schemes are highly sales focused, controls to effectively manage the risk of inappropriate sales are crucial. We found that controls are often designed and conducted in a way that makes it unlikely they will be effective at identifying inappropriate sales. This means poor customer outcomes are likely to go undetected.

### 3. Boards and senior management often seek and receive little information on the risks of inappropriate sales.

While boards and senior management receive information on the operation of incentive schemes themselves, some receive little information on the risk of inappropriate sales and how that risk is being managed.

1. The Bank Conduct and Culture review was published on 5 November 2018.

#### 4. Banks are making significant changes to their incentive schemes.

Significant changes are being made to incentive schemes across the banking industry. Incentive schemes for salespeople are generally becoming less sales focused, and some banks are entirely removing sales-based incentives for some salespeople and managers.

#### Our expectations

The FMA expects banks to ensure they achieve consistently good outcomes for their customers<sup>2</sup>. This includes designing and managing incentive schemes in a way that leads to good customer outcomes.

*“Customers must be confident that their interests are being properly considered; that they are getting the right financial products and services at a reasonable cost; and that they understand them”*

– A Guide to the FMA's view of conduct, 2017

It is for banks to determine the most appropriate way to design and control incentive structures in a way that sustains good customer outcomes. Removing incentives linked to sales measures is a significant step towards this goal. However, pressure to sell that senior managers place on more junior managers and salespeople cannot be underestimated, so the design of incentives for senior and middle managers also needs to be carefully considered.

We expect banks to revise their sales incentive structures for salespeople and through all layers of management. We expect banks to implement changes to their incentive schemes no later than the first performance year beginning after 30 September 2019.

In March 2019 we will ask all banks how they will meet our expectations regarding incentives, and we will report on their responses. Any bank that does not, by that date, commit to removing incentives linked to sales measures<sup>3</sup> for salespeople and their managers will be required to explain how they will strengthen their controls sufficiently to address the risks of poor conduct that arise with such incentives.

Many banks have acknowledged the need to make significant changes to their incentive schemes. Progress appears to be in a positive direction, with banks generally reducing the focus on sales performance. However, none of the changes announced by banks to date go far enough to create a sustainable culture of good conduct. We also expect banks to manage the risks associated with these changes, as changes to incentives may have unintended consequences. As banks develop indicators of customer outcomes<sup>4</sup>, we expect they consider incorporating these into staff incentives.

We expect to see improvements in board and senior management oversight of the risks associated with incentives. Boards and senior management should be more proactive at identifying and managing these risks. We also expect them to question whether a lack of issues detected means issues do not exist, or issues are not being identified.

While this report and its expectations apply to banks, many of the issues are relevant to other types of financial services firms. We recommend that all financial services firms consider this review, the issues raised, and how they relate to their business.

2. More detail on the conduct we expect is detailed in A Guide to the FMA's view of conduct 2017

3. We define sales measures as measures that are achieved by retail customer sales or referrals, whether at an individual or a team level. This includes sales/referrals numbers, sales value and asset or liability growth.

4. The FMA and RBNZ have stated this is expected of banks following the Bank Conduct and Culture review.

# Background to the review

## What are incentive structures?

While variable pay is most commonly associated with incentives, incentive structures also include fixed pay (salary), competitions, and performance management (eg how staff are selected for promotions, and how staff are selected for performance improvement plans and, ultimately, termination of employment).

Incentive structures are a key part of an organisation's culture. They:

- recognise and reward well-performing staff
- indicate to staff what behaviours senior management value and the goals they want to be achieved.

There is no ideal model for bank incentives. Different banks have different strategies and cultures, and should design their incentive structures with those in mind.

However, it is important for banks to ensure:

- their incentive scheme is appropriate for their organisation
- risks associated with their scheme are identified, monitored, and effectively managed.

In particular, we expect banks to design and manage incentive schemes in a way that sustains good customer outcomes.

## What are the risks to customers?

Where sales performance determines the incentives salespeople receive, the risk of potential harm to customers can be significant.

This risk stems from the fact the customers generally have less understanding of bank products and services than bank staff. This 'asymmetry' leads to customers relying on information provided by bank staff. It is

therefore important that staff are clear on whether they are providing advice (personalised or class) or simply information about the product, so the customer understands its limitation. Nonetheless, whether providing information or advice, if salespeople are incentivised to prioritise selling products over meeting the customer's needs, potential risks include the following:

- Sales of products or services that are unsuitable or unnecessary for customers.
- Customers not being offered a cheaper alternative product or service that meets their needs.
- Sales where customers are provided with incomplete, unclear or misleading information.
- Failure to exercise due care when dealing with vulnerable customers.
- Insufficient assistance provided to existing customers when there is no prospect of a sale.

### Types of harm that may occur

- A customer switches their investment product to their bank, not understanding that the fees may be higher.
- A customer who requests an increase to their credit card limit is instead encouraged to buy a new credit card with a higher fee, despite it not meeting their needs better than their current, cheaper card.
- A customer buys a new insurance policy, not understanding that they will be unable to claim on it, as the salesperson did not explain the limitations of the product.

## Scope of review

Nine banks were included in this review:

- ANZ Bank New Zealand Limited (ANZ)
- ASB Bank Limited (ASB)
- Bank of New Zealand (BNZ)
- Heartland Bank Limited
- Kiwibank Limited (Kiwibank)
- Southland Building Society
- The Co-operative Bank Limited
- TSB Bank Limited
- Westpac New Zealand Limited (Westpac)

We asked all banks for information on:

- incentive structures for salespeople and their managers, including details of bonuses, commissions, competitions and prizes
- how the risks associated with incentive structures are managed and controlled
- internal reporting to senior management and the board about how risks associated with incentives are managed.

We met with 68 salespeople and 22 managers from ANZ, ASB, BNZ, Westpac, and Kiwibank – the five largest banks based on number of customers – to understand their perspective of incentives, and talked to staff who operate key controls in these banks. We also shared information with the Bank Conduct and Culture review.

### Salespeople and their managers

We defined salespeople as staff who sell to New Zealand retail customers, whether in person, on the phone or via online channels. This included Qualifying Financial Entity advisers, branch staff, contact centre staff, rural

staff, small and medium sized enterprise (SME) business banking staff, and Mobile Mortgage Managers.

We excluded Authorised Financial Advisers, Registered Financial Advisers, and specialist sales staff within banks<sup>5</sup>. We also excluded staff who sell to wholesale customers. Our definition also excluded third parties such as external brokers.

We defined managers as the managers and supervisors of salespeople.

### Products

We included the incentives relating to all banking products that are within scope of the Financial Advisers Act 2008. This includes home loans, personal loans, credit cards, term deposits, transactional accounts, life insurance, general insurance and investments, including KiwiSaver.

### Timing

The review focused predominantly on the incentive structures and controls in place as at 21 May 2018. We recognise that some banks are in the process of making changes to their incentive structures and controls. While this report includes our high-level findings regarding these changes, we have not assessed them in detail, as information was limited at the time of our review.

### Assessment criteria

We assessed how incentives are designed and controlled to mitigate the risk of inappropriate sales. We did not test whether customer harm is being caused as a result of the way incentives are designed and controlled.

Our assessment has been informed by recent international work. This includes the Sedgwick review<sup>6</sup> in Australia and work by the UK's Financial Conduct Authority.

5. While these staff were excluded from our definition of salespeople for the purposes of this review, our expectation that banks remove incentives linked to sales measures applies to these staff.

6. Retail Banking Remuneration Review by Stephen Sedgwick in Australia.

# What we found – incentive structures

Overall, we found that salespeople's incentives are highly sales focused. Sales performance typically determines the majority of a salesperson's variable pay. Incentive schemes are structured to encourage high sales performance, and commonly incorporate minimum sales thresholds and larger rewards for higher sales volumes. Manager incentives are typically based on the sales performance of their salespeople, likely adding more pressure on staff to sell.

Incentives that are highly sales focused means that the risk of inappropriate sales practices occurring is high. It is therefore unsurprising that we were told by some salespeople of inappropriate sales practices taking place.

Significant changes are being made to incentive schemes across the banking industry. Incentive schemes are generally becoming less sales focused, and some banks are entirely removing sales measures for some salespeople. However, none of the changes announced to date go far enough to create a sustainable culture of good conduct.

## Variable pay

Total variable pay for the 12 months ending 31 March 2018 for salespeople was \$71 million across the nine banks.

The \$71 million in variable pay represents 9% of total pay for salespeople across the nine banks for the 12 months ending 31 March 2018. While the average annual variable pay of salespeople is relatively modest at \$6,180, some salespeople earn significantly more – the largest amount of variable pay earned by a salesperson in financial year (FY) 2016/2017 was \$279,000. The average amount of variable pay across each bank's highest variable-pay-earning salesperson was \$104,000 in FY 2016/17.

A higher proportion of variable pay within total pay indicates a higher risk of inappropriate sales practices. However, the actual risk is determined by the way eligibility for, and size of, variable pay is calculated – not just the dollar value.

We have split incentive scheme features into three categories, based on their impact on sales behaviour:

- Features that increase risk
- Features that can increase or decrease risk (depending on how they are used)
- Features that can decrease risk

In describing how certain features are used, we have summarised the approach of banks rather than detailing every aspect. This, in part, reflects the complexity of the incentive schemes of many banks, with many operating multiple incentive schemes with different features, eg for different business units and different salesperson roles.





### Incentive scheme features that increase risk

These features reward staff for selling, increasing the risk that they will use inappropriate practices to sell more. The impact of these features can be heightened when used in combination.

#### Sales measures

This is when sales performance is a factor in determining variable pay. All banks assess sales performance when determining variable pay. The risk of inappropriate sales is increased when sales is the main, or only, factor in determining eligibility and amount of variable pay – which was the case in most banks (once some minimum non-sales standards are met).

Some banks label sales as ‘customer needs met’, but the definition of meeting the customer’s needs was the customer purchasing a product or service. Needs that were not sales-related (eg addressing a query about an existing product) were not included in the definition.

#### Sales gateways

These are sales thresholds, such as a minimum number of product sales, that staff must meet to be eligible for variable pay. Their use sets an expectation that a certain level of sales must be achieved, creating pressure on staff to sell. Sales gateways are used in the majority of banks. A number of banks have multiple sales gateways, where minimum sales of a number of different products need to be achieved. This increases the risk further, and staff may become biased towards selling a particular product to reach a particular product sales gateway.

#### Disproportionate reward from marginal sales (or retrospective accelerator)

This is when one additional sale results in a significant increase in variable pay. This feature is present in some banks, often combined with a sales gateway. At one bank, the difference between just missing the target and achieving it is \$2,000 per quarter.

### Accelerators and accelerator-type features

These involve the rate of reward increasing as the number or value of sales increases. Some banks have accelerator or accelerator-type features, although they were more commonly used in the incentives of Mobile Mortgage Managers (see page 14 for more detail).

### Sales rewards that are not product-neutral

A number of banks vary the sales rewards depending on the product sold. This can bias a salesperson in favour of a product that will earn them more, regardless of whether it is most suitable for the customer. However, the differences in reward can reflect the differences in effort and time required to sell certain products – for example, it will normally take longer to sell a home loan than a transactional bank account.

The risk of rewards that are not product-neutral increases further when substitutable products, such as different types of credit card, have different sales reward values.



Rewards for products such as home loans, investments and insurance are often based on the product value, not the number of products sold. This means staff are incentivised to encourage customers to borrow, invest, or insure more than they may want or need to.



### Incentive scheme features that can increase or decrease risk

These features can increase or decrease risk, depending on how they are designed.

#### Team or branch performance measures

Some banks have team or branch measures. In some instances, the salesperson's eligibility for an individual reward is tied to team performance. In others, the team and individual targets are separate. The use of team or branch measures can vary depending on the role of a salesperson – for example, tellers who refer customers to other team members for sales are sometimes incentivised based on their branch's sales performance, while the person who completed the sale is incentivised based on their individual sales performance.

Designed appropriately, team targets can create an environment where collaboration that benefits customers is rewarded. Designed inappropriately, they can create a culture where staff prioritise sales over good customer outcomes.

For example, one bank identified that individual targets resulted in some staff 'hoarding' referrals, rather than passing them to other less-busy salespeople, resulting in delays for customers. The bank is moving to team targets, to increase the incentive to collaborate in the customers' interests.

Where team or branch measures are used, we expect banks consider the culture they create and whether they will help achieve good customer outcomes.

#### Manager incentives

Incentives for managers based on the overall performance of their team can increase the pressure managers put on staff. In all banks, performance measures of team leaders and branch managers are based (to differing extents) on the culmination of those of their team members. This aligns the goals of sales staff and their managers. Whether this increases the risk of inappropriate sales depends on whether the performance measures are sales-dominated or focus on non-sales aspects. In all banks the incentives of managers are based, in part, on the sales performance of staff. While managers' performance measures often have less weighting to sales performance than salespeople, they often make up a significant proportion. This is likely to add pressure on staff to sell.

#### Manager discretion

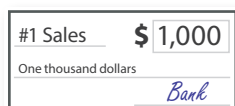
Some banks give managers discretion to rate a salesperson's performance, with the rating tied to an incentive. One bank has an entirely discretionary variable pay incentive scheme, where each individual had their own performance measures, and managers assess performance against this to determine variable payments. Manager discretion can enable a more complete assessment of performance, particularly for aspects that are difficult to measure (such as an individual 'going the extra mile'). However, if a manager's own incentives are based on the sales performance of their staff, they may reward staff behaviour that increases the risk of inappropriate sales.

We expect banks to take reasonable steps to ensure manager discretion is exercised appropriately. This may include providing guidance and training to managers, and monitoring how discretion is being applied in practice.

## Competitions and performance management

Competitions and performance management indicate to staff what types of behaviours are valued by the bank. If those who win competitions and receive promotions do so based on sales performance, staff are incentivised to focus on selling the most.

All banks have competitions designed to reward staff performance. Prizes awarded to individuals, teams or branches can include monetary and non-monetary rewards such as cash, travel vouchers, contributions to team social activities, and additional annual leave.



Some competitions are based solely on sales performance, such as one bank's 'Salesperson of the Year' award, which had a \$1,000 top prize. Other competitions, such as one bank's 'Employee of the Year', are partly based on sales, while others are entirely non-sales based (eg rewards for excellent customer feedback or innovative problem-solving).

Performance management can also demonstrate behaviours the bank does not want to see. Across all the banks, 117 sales staff were entered into formal performance improvement plans (PIPs) during the year ending 31 March 2018. 45% of these instances were due, at least in part, to poor sales performance.

While PIPs capture a formal aspect of performance management, there are other less-formal aspects that can be positive or negative – including praise or criticism

(whether in public or private) by a manager, coaching and feedback – all of which can create pressure on an individual to sell. Some banks have sales leader boards, which allow staff to compare their sales performance with peers, adding to a sales-focused culture and creating pressure on staff to sell. Some banks have removed leader boards, or are in the process of doing so.

We have not explored the less-formal aspect of performance management in detail in this review given the difficulty of robustly assessing informal aspects. However, that does not mean they are unimportant or their impact on staff behaviour is insignificant.



### Incentive scheme features that can decrease risk

These features reward non-sales performance, or limit the rewards that can be earned based on sales performance.

#### Risk and behaviour gateways

These are minimum non-sales standards that staff must meet to be eligible for variable pay. The gateways have specific eligibility criteria, with staff typically assessed on:

- behaviour in line with the expected standards and bank values
- compliance with internal policies and procedures (for example, passing quality assurance checks)
- training and accreditation requirements.

Most banks use risk and behaviour gateways to ensure that staff with poor compliance and behaviours are not eligible for variable pay. This can send a powerful message about what is expected of staff and what behaviour is unacceptable, and is likely to be more effective at driving good behaviour than including a low weighting to compliance in a balanced scorecard.

If a gateway poses a realistic barrier and is an effective deterrent, we expect that some staff should fail it. While the proportion of staff who failed risk and behaviour gateways is often around 5-10%, for some banks it is approximately 1% and in others above 20%.

#### Caps

Caps to limit the amount salespeople can receive in variable pay can reduce the risk of inappropriate sales by preventing unlimited rewards from being earned. Some banks use caps – whether based on a percentage of the salesperson's fixed pay, or on a fixed dollar amount.

#### Clawbacks

A clawback is when pay already earned by a staff member is repaid to the bank (or deducted from future payments) in certain circumstances, such as when the product is cancelled shortly after the sale. This can reduce the risk of salespeople selling products the customer does not want.

Most banks with clawbacks explained they are used only in exceptional cases, such as where inappropriate sales practices had been identified. One bank used clawbacks more frequently, clawing back pay for sales if the customer cancelled the products within a certain period after the sale.

#### Deferrals

A deferral is when a portion of variable pay is withheld from the staff member for a certain period, during which time the bank can cancel the payment in certain circumstances. Deferrals allow more time for performance issues to be identified (eg through customer complaints).

One bank has a deferral scheme where, if variable pay was 10% or more of fixed pay, a proportion of variable pay is often deferred for a year. If the salesperson has any material compliance or conduct issues during that time, or left the bank, they forfeit the payment.

#### Decelerator

A decelerator is when the rate of reward or commission decreases as the number or value of sales increases. The use of this feature was very limited.

#### Non-sales measures

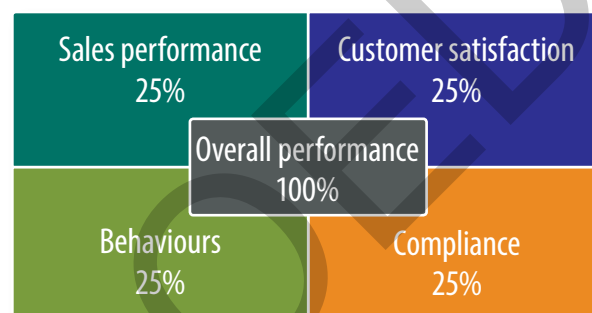
The use of non-sales measures in determining incentives can reduce the risk of inappropriate sales practices by rewarding staff for performing well on measures other than sales. The majority of banks include non-

sales measures in their incentive schemes, although they typically account for a lower weighting than sales performance.

Non-sales measures typically include one or more of the examples in the table below.

Most banks use a scorecard, where different performance measures (both sales and non-sales) each has their own weighting, which is used to calculate the overall performance rating and variable pay.

#### Example scorecard



Non-sales measure	Description and potential impact
Customer satisfaction	<p>This rewards staff based on the feedback customers have given following an interaction.</p> <p>This can mean that staff who prioritise helping customers to understand products will score highly, and those with unduly aggressive sales tactics will likely score poorly.</p>
Productivity	<p>This rewards staff based on productivity measures, such as call queue time in a contact centre.</p> <p>These measures can incentivise good customer outcomes. For example, incentives that reward salespeople for a short call queue time may help ensure customers do not wait too long for their issue to be resolved.</p> <p>However, banks should be aware of the potential unintended consequences of such measures. For example, measures linked to call duration may incentivise staff to rush calls and inadequately explain important information. This may be a particular issue for some vulnerable customers who require explanations that are more thorough.</p>
Behaviours	<p>This rewards staff based on how they demonstrate the values of the bank and exhibit appropriate behaviours.</p> <p>If the expected values and behaviours are consistent with good customer outcomes, this can mean those who achieve good outcomes for their customers and behave appropriately are rewarded for doing so.</p>
Compliance	<p>This rewards staff for adherence to company policies. This may be based on the outcome of compliance checks.</p> <p>If the company's policies are consistent with good customer outcomes, this can mean those who achieve good outcomes for their customers and behave appropriately are rewarded for doing so.</p>

Instead of a scorecard, some banks use a 'modifier' for some non-sales performance measures. For example, variable pay may be initially calculated based on sales

performance, but the final amount is increased or decreased based on the individual's performance in compliance checks.

## Mobile Mortgage Managers

Mobile Mortgage Managers specialise in home loan sales. They are typically subject to less direct oversight by colleagues or managers because they often conduct sales at a customer's home or workplace.

We found that Mobile Mortgage Managers' incentive schemes are higher risk than those of non-specialist sales staff. The reasons for this include:

- The potential amount of variable pay is significantly higher. For example, one Mobile Mortgage Manager earned \$196,000 in variable pay alone in FY16/17.
- Variable pay is primarily based on sales performance in most banks, with salespeople rewarded more for issuing larger loans (illustrated below).

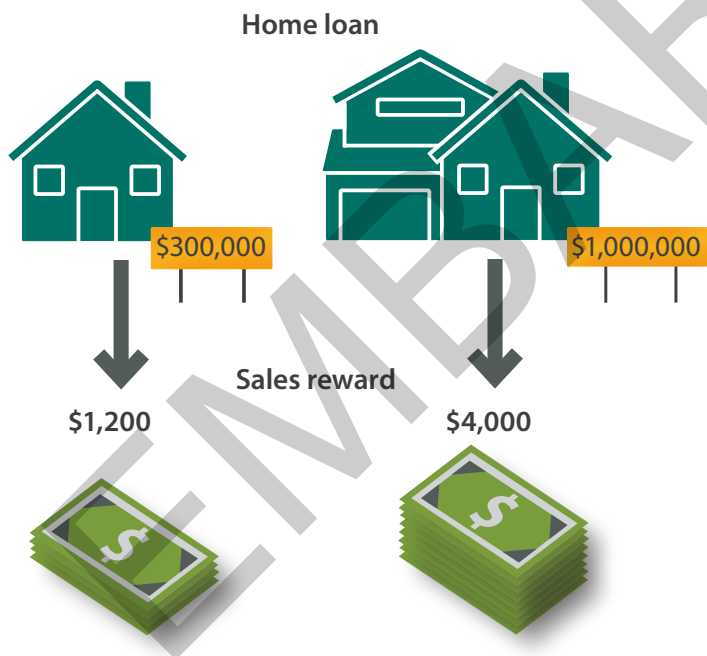
### Example of an accelerator

A Mobile Mortgage Manager has a monthly sales target based on the dollar value of their lending. They earn variable pay based on a percentage of the amount they lend, with the marginal rate they earn increasing as they lend more as follows:

- Below target – 0%
- 0 to 25% above target – 0.32%
- 25 to 50% above target – 0.35%
- 50 to 100% above target – 0.38%
- 100% or more above target – 0.40%

Features that reduce incentive-related risks are typically more prevalent for Mobile Mortgage Managers, which is positive given the greater use of higher-risk features. For example:

- Some banks have caps limiting the maximum variable pay that can be earned over a certain period of time.
- Many banks use deferrals for Mobile Mortgage Managers, usually for a period of 12 months.
- Some banks have clawbacks for Mobile Mortgage Managers, where commissions can be clawed back in certain circumstances, for example, if the loan is paid back within six months.



- Sales gateways are often used, where a minimum lending target must be met to be eligible for variable pay.
- Accelerators were common, where the percentage of variable pay increased along with the amount of lending.

## Changes to incentive schemes

Most banks have acknowledged the need to make significant changes to their incentive schemes, and have started this process. This appears to be due to a number of factors, including:

- this review
- the Bank Conduct and Culture review
- the Sedgwick review and associated recommendations
- the Australian Royal Commission
- overly complex incentive schemes.

The changes appear to be in a positive direction, with banks generally reducing the weighting given to sales measures in determining variable pay. In some instances, sales measures are being removed entirely from some roles. However, even in these banks, the removal of sales measures does not apply to all salespeople, such as Mobile Mortgage Managers.

Reducing the weighting of sales naturally involves an increase for non-sales measures, including behaviour, customer satisfaction, and compliance with internal policies. Some banks are also using other features to reduce risk, such as greater use of risk and behaviour gateways, and introducing or lowering caps for Mobile Mortgage Managers.

Banks are also generally reducing the frequency of variable pay, for example, reducing monthly or quarterly payments to six-monthly or annually.

While banks are at different stages of change, the industry overall is at an early stage. For example, some banks have announced they are introducing non-sales measures but have not yet decided what form they will take.



# What we found – controls and oversight

Controls are necessary to manage the risk of inappropriate sales due to sales incentives. We define controls as documented processes and procedures that mitigate specific risks. Controls should be tailored to the specific risks of the business, reflecting the incentive structure, and the nature and scale of the business.

Overall, controls often appear to be ineffective at mitigating the risk that sales incentives will lead to poor customer outcomes. The way controls are designed makes them unlikely to be effective at identifying inappropriate sales. Further, boards and senior management often seek and receive little information to help them assess the risk of inappropriate sales.

We recognise that all controls have drawbacks and limitations. Just because a control is imperfect does not mean it is of no value. Instead, we expect banks to recognise the limitations and manage them appropriately. Banks should consider the following when designing controls:

- What the controls assess
- The independence of those operating the controls
- The ability of salespeople to manipulate the control
- The sophistication of approach to determining which sales or staff are subject to controls

## Key controls

There are a number of ways that banks can prevent staff from selling inappropriately, including the following:

- Greater use of incentive scheme features that can decrease risk (see page 12)
- Employing staff with appropriate skills and knowledge
- Training and accreditation
- Clear guidance and processes for sales
- Maintaining a customer-focused culture

While these are important preventative measures, we do not consider them sufficient to mitigate the risks associated with incentives based on sales performance. We expect banks to have controls to detect inappropriate sales practices, tailored to the specific risks of the business.

We identified examples of the following controls designed to detect instances of inappropriate sales.



### 1. Real time observations

All banks conduct observations of salespeople. This typically involves a manager or assistant manager observing and assessing a salesperson's competence in customer interactions, and knowledge of products and processes, as well as ensuring all disclosures are provided to the customer. Managers provide feedback to the salesperson afterwards.



### 2. Post-sale reviews

All banks undertake post-sale reviews, which involve an assessment of records and documentation from the sale, including the salesperson's notes about the interaction. Reviews of contact centre sales also typically include listening to the call recording.

Post-sale reviews can be process-based or outcomes-based, or a combination of both.

Process-based reviews include an assessment against the steps required by the banks' internal policies. For a home loan this could involve checking the staff member obtained all required information. However, a limitation of process-based reviews is that, if the process is poorly designed, a poor customer outcome could occur even if the correct process is followed.



Outcomes-based reviews typically consider whether the outcome of a customer interaction was positive. This may include testing whether:

- the customer was treated fairly
- proposed products were appropriate and suitable for the customer
- the customer understood the purchase they made.

Outcomes-based reviews are more likely to identify poor customer outcomes because they consider the sale holistically, rather than just adherence to policies. While all banks conducted post-sale reviews, many are process-based.

### 3. Customer feedback



Inappropriate sales practices can be identified through formal complaints, or through channels such as customer satisfaction surveys or post-sale calls.

Many banks stated that complaints monitoring is a key control to help identify instances of inappropriate sales practices. We agree that customer feedback is a valuable source of information about various aspects of a customer's experience, including whether they were pressured to purchase the product. However, as identified in the Bank Conduct and Culture review, the processes of some banks mean some complaints (such as those that are resolved at the first point of contact) are not always recorded as a complaint. This can result in complaints going unrecorded.

In addition, some feedback methods, particularly complaints and customer satisfaction, rely on the customer knowing they may have purchased a product that is not appropriate for them. They may not identify situations where sales staff have over-sold benefits and

under-emphasised drawbacks – and in the case of some products such as insurance, it may take years for the customer to realise the problem. Further, complaints and poor customer satisfaction results are a 'lag' indicator, meaning they typically identify poor customer outcomes that have already occurred.

Post-sales calls can overcome these limitations by using questions that test the customer's understanding of the product they purchased. This can help to identify and resolve potential negative outcomes before they occur (eg by switching the customer to a suitable product). However, while a small number of banks make post-sales calls for certain products, they typically focus on welcoming customers and clarifying certain aspects of the sale.

### 4. Mystery shopping



Some banks use mystery shopping, which typically involves third-party providers posing as customers and reviewing their interaction with branch staff. This is used

to assess whether the correct disclosures were provided, and customer service elements such as friendliness, professionalism and efficiency. Where it is used, it is typically not designed to identify inappropriate sales behaviour.

## Factors affecting the effectiveness of controls

We identified four key factors that affected the effectiveness of controls:

### 1. What the controls assess

Many of the controls are not designed to assess the appropriateness of a sale. They often address other risks, such as manipulation of the sales system to record ineligible sales as eligible, poor customer experience, poor record-keeping, disclosure, credit risk<sup>7</sup> and non-compliance with internal policies. While these controls may inadvertently identify poor customer outcomes, they are not designed to systematically control for the risk of poor customer outcomes.

### 2. The independence of those operating the controls

Many key controls, such as observations and file reviews, are operated by managers who are typically incentivised for their staff to sell more. This means they are conflicted during the observation or review and are unlikely to be effective at identifying inappropriate sales practices. Some salespeople told us the outcome of manager reviews is often feedback that they had not done enough to sell additional products to the customer. This indicates that the control can be used to add pressure on the individual to sell, rather than control for inappropriate sales.

The most effective controls are generally carried out by competent, experienced and independent staff, thereby eliminating conflict. Some banks mitigate this conflict by having independent staff review a sample of manager reviews (a 'check the checkers' approach).

### 3. The ability of staff to manipulate the controls

Some controls are susceptible to manipulation and therefore less effective, particularly in branches, where

sales interactions are not typically recorded as they are in call centres. For example, in the case of observations, branch staff could modify any usual deliberate inappropriate practices for the purposes of the observation. Similarly, for file reviews, salespeople could record conversations inaccurately to help justify sales. This was demonstrated by comments from staff that file notes often do not sufficiently justify why a sale was made but, when challenged, the salesperson explains the justification was obtained but simply not recorded in the notes.

### 4. The sophistication of approach to determining which sales are subject to controls

The approach to identifying which sales are reviewed is important. Random selection involves review of a set number of files per salesperson over a given period. Risk-based selection involves sales or staff that are determined to be higher risk being reviewed more frequently.

A hybrid of the two approaches is likely to be the most appropriate. This way, higher-risk sales are reviewed more frequently, but all staff know they may be reviewed at random. When determining higher-risk sales and staff, we expect banks to take account of the specific features of their incentive schemes.

Most banks use a hybrid approach, but typically the only risk factors that are systematically and consistently used are that top sellers undergo more checks and sales of particular products are checked more frequently. However, these factors were not necessarily the only indicators of higher risk sales given the way the incentive scheme was designed.

7. Credit risk checks are primarily operated to manage the bank's credit risk (ie the risk that the customer defaults on the loan), rather than to test the appropriateness of the sale. While an unaffordable loan is also an inappropriate sale, we consider the definition of appropriateness to be wider than just whether the loan is affordable. For example, whether the term of the loan is appropriate.

### Other factors that may indicate a higher risk of inappropriate sales include the following:

Staff or branches that sell a higher-than-normal percentage of certain products, especially where those products have a greater impact on variable pay

Unusual combinations of products being sold to individual customers

Staff who achieve or miss a sales gateway by a small margin

High levels of product cancellations or non-use by customers

Customer use of a product that indicates they do not understand how it operates – for example, a savings account that the customer uses as if it is a standard transactional account, incurring high fees as a result

Sales of products that are unusual given the customer's characteristics

Sales to vulnerable customers

Complaints or poor customer feedback

Unusual customer purchase patterns, such as multiple transactional accounts

We believe that, if carried out with a sufficiently risk-based approach, effective controls are likely to identify inappropriate sales where incentives are based on sales performance. However, a number of banks told us that their controls had not identified any instances of inappropriate sales in the last year.

Positively, some banks told us of their intention to improve the way they identified potentially inappropriate sales through improved analysis of, for example, how customers use products they have purchased.

### Board and senior management oversight

We requested information about reporting to and discussions of the board and senior management committees responsible for overseeing the risks associated with incentives.

We found that there is some reporting on the risks and the outcome of controls that detect inappropriate sales practices, although this varied between the banks and some receive very limited information. This is of significant concern to us, as risks that are not identified cannot be effectively mitigated and monitored.

In some instances, reporting on performance of controls related to inappropriate sales is provided and monitored at a middle management level, and banks stated material issues would be escalated to the bank's senior management and board on an exceptions basis. However, we expect that senior management and boards should not overly rely on this. We expect they proactively request information on the performance of controls, to give them confidence about the effectiveness of the bank's control framework. We also expect them to question whether a lack of issues detected means the issues do not exist, or that they are not being identified.

We did find evidence of boards and senior management receiving and discussing changes to incentive structures, such as those following the Sedgwick review. It is positive that they are engaged on the subject of incentives. However, we expect them to also be engaged in the ongoing oversight of risks associated with incentives, in addition to changes to incentive schemes themselves.

## Next steps

We will write to all banks included in this review stating our expectations.

We expect banks to implement changes to their incentive schemes no later than the first performance year beginning after 30 September 2019. In March 2019 we will ask all banks how they will meet our expectations regarding incentives, and we will report on their responses. Any bank that does not, by that date, commit to removing incentives linked to sales measures for salespeople and their managers will be required to explain how they will strengthen their controls sufficiently to address the risks of poor conduct that arise with such incentives.

# Glossary

Bank Conduct and Culture review	Review by FMA and RBNZ to understand whether there are widespread conduct and culture issues present in New Zealand banks.
Salesperson	<p>Individual who sells directly to customers. Includes: branch staff; phone staff; online help staff; rural staff; Mobile Mortgage Managers; and Small and Medium Sized Enterprise (SME) business banking representatives.</p> <p>It does not include staff that sell to wholesale customers. Authorised Financial Advisers, Registered Financial Advisers, and specialist sales staff within banks. It also excludes third parties, such as external brokers.</p>
Sales measure	A criteria based on sales performance against which an individual is assessed against, for example, when determining their variable pay. Sales measures are measures that are achieved by sales or referrals, whether at an individual or a team level. This includes sales/referrals numbers, sales value, asset or liability growth.
Scorecard	<p>Scorecards assess performance against a number of performance measures. Each measure has its own weighting, which is used to calculate the overall performance rating and, in turn, variable pay. Example:</p> <ul style="list-style-type: none"> <li>• 25% based on sales performance</li> <li>• 25% based on customer satisfaction</li> <li>• 25% based on behaviours</li> <li>• 25% based on compliance</li> </ul>
Sedgwick review	Retail Banking Remuneration Review by Stephen Sedgwick in Australia.
Vulnerable customer	Someone who, due to their personal circumstances, is especially susceptible to harm, in particular when a firm is not acting with appropriate levels of care (based on definition from “Customer Vulnerability” paper published by the UK Financial Conduct Authority, 2015).



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