Risky business: The case for reform of sales incentives schemes in banks

Executive summary

Inappropriate sales incentives schemes employed by retail banks are an underappreciated and undermanaged risk to financial consumers and financial stability. This is the headline conclusion of our unique look at the continuing lack of adequate consumer protection in financial services.

Drawing on evidence from consumer organisations, trade unions, banks and regulators in G20 nations and some OECD countries, *Risky business: The case for reform of sales incentives schemes in banks*, demonstrates the pain and despair suffered by individuals who have been persuaded to buy inappropriate financial products, as well as the threat that these schemes pose to financial stability.

The scale and impact of sales incentives schemes

Inappropriate sales incentive schemes are part of a toxic banking culture that promotes high risk, short-term gains and contributed to the financial crisis in 2008.

The scale of the problem is shown by the colossal compensation bills and losses to consumers that are already measured at more than US$53 billion globally. Even this figure may only scratch the surface as consumers continue to seek redress and problems take time to emerge. The headline case studies are staggering:

- Bank of America was fined US$1.27 billion for Countrywide's aggressive, volume-led sales incentive programme for mortgages.
- The default on inappropriate mortgages sold by Washington Mutual, contributing to the largest bank failure in US history.
- In the UK, the mis-selling of Payment Protection Insurance (PPI) has led to compensation payments of £24.3 billion (US$39.3 billion) and rising.
- Risky consumer investment products in Australia have led to losses of AUS$5.7 billion (US$4.97 billion).
- Compensation to Spanish consumers for mis-sold hybrid securities stands at €2.9 billion (US$3.65 billion).
- In Hong Kong, complicated structured products backed by Lehman Brothers, resulting in HK$3.4 billion (US$438 million) in compensation and a further HK$2.2 billion (US$283 million) in losses to consumers.
- €215 million (US$270 million) in compensation for consumers of failed DSB Bank in the Netherlands.
- €2.1 billion (US$2.64 billion) cost to Banco Espirito Santo in Portugal, contributing to its failure and taxpayer bail-out.

The examples given above have come to light as a result of investigations that followed bank failings. But a major concern highlighted in this report is that many regulators simply do not know how widespread the use of inappropriate sales incentives schemes is, and therefore what level of risk they pose to consumers and the financial system.

Where regulators have investigated and taken action, the risk is shown to be significant. The UK is one of a limited number of countries to have undertaken an investigation on this issue, with the regulator noting that many of the sales incentive schemes they looked at "*were likely to drive people to mis-sell to meet targets and receive a bonus, and these risks were not being properly managed".* The regulator went on to make a damning conclusion stating that some incentive schemes were *"… rotten to the core and made a bad problem worse."*[1]

The global nature of banking and the connection between different financial providers would suggest that practices in one jurisdiction are likely to have been replicated in others. Transparency in this area is weak with limited information available from banks on the detail of their schemes. Without proper investigations and regular monitoring, regulators are unlikely to know the extent to which inappropriate sales incentive schemes are used or their impact on consumer protection and financial stability.

Inappropriate sales incentives undermine regulatory compliance, harm consumers and create risk

Sales incentive schemes are developed by retail bank directors to encourage staff to sell more financial products. Evidence suggests that these schemes can be developed with no regard for the consumers' needs. This contributes to poor product design and leads to mis-selling and irresponsible lending.

Inappropriate sales incentives schemes create unfair pressure on retail staff, who may be trying to avoid disciplinary action and safe guard their job or who may rely on bonuses to earn a decent wage. The schemes can conflict with their duty and desire to do their best by customers.

Where inappropriate sales incentive schemes encourage the conditions for irresponsible lending, this can increase bank losses when borrowers default. The most catastrophic example being the mis-selling of mortgages to US consumers who could never afford to make repayments: widely recognised as the trigger of the financial meltdown that followed in 2008.

However, it can also lead to mis-selling of other products, creating additional risk and further losses as the misconduct and mis-selling associated is exposed. Compensation for mis-sold PPI in the UK, for example, stands at £24.3 billion (US$39.3 billion) and continues to rise.

This report shows that the money set aside by some banks to cover themselves against losses from mis-selling and misconduct, under rules on capital requirements for operational risk, was completely inadequate and severely underestimated the magnitude of the problem. This poses serious questions for those heralding a new transparent era of higher capital requirements and improved risk management and safety in the banking sector.

There is also little consideration given to potential losses from mis-selling and misconduct in the 'stress tests' banks and Ministers of finance are so keen to highlight as proof of stability in the post-crash banking system.

Our research presents a compelling argument for the reform of inappropriate sales incentives schemes being fundamental to a sustainable recovery. Reform would not only reduce risk but would also contribute to putting the need to serve the consumer before short-term returns.

[1] http://www.fsa.gov.uk/library/communication/speeches/2012/0905-mw.shtml

So what is the solution?

The financial crisis and the dramatic increase in the number of consumers accessing financial services makes it imperative for governments to strengthen financial consumer protection.

In 2010 Consumers International (CI) campaigned to put financial consumer protection on the G20 agenda and we have contributed to the development of the G20/OECD high level principles through detailed inputs and consultation. However we are concerned that until fundamental issues, such as banking culture, are properly addressed, compliance with new regulations will be undermined. Although there has been some reform of compensation schemes for senior executives, financial and non-financial incentives schemes for retail staff have not been adequately addressed to deliver root and branch reforms.

Regulatory action taken to address the issue of inappropriate sales incentives have resulted in some encouraging practices. A few banks have begun to make positive changes to their sales incentives schemes, to tackle risks and place a greater emphasis on rewarding staff for providing customer service and meeting customer needs. We welcome this action and encourage all banks to prioritise reform of their incentives schemes.

However, transparency in sales incentives schemes is limited. This report shows many banks do not disclose anything other than cursory details of their sales incentives schemes in their annual reports. While it is positive that a number of regulators have requested details of such schemes for investigations, we found no evidence of on-going monitoring of sales incentives schemes.

Risky business: The case for reform of sales incentives schemes in banks, argues that robust financial consumer protection is a major part of good financial management. Without it, individual consumers suffer hardship: lives are ruined and dreams are shattered. Without it, our global financial system remains on red alert.

If action is not taken, banking culture will not change, the system will continue to be open to collapse; and consumers will remain the victims of short-term sales incentives stacked up to exploit, rather than serve, them.

CI is calling on the G20 to:

1. *Request urgent reviews of capital requirements for operational risk to include substantial increases to address risks and costs associated with inappropriate sales incentives schemes and the problems they cause including mis-selling.*

International standards for the capital held by banks to cover losses through mis-selling have not been reviewed since before the 2008 crash. This needs to be addressed.

2. *Ensure accountability from senior executives in the banks.*

Having a named director responsible for sales incentives schemes and for the regulator to take enforcement action if the executive doesn’t do their job would be a positive step.

3. *Reform also needs to tackle the pressure staff face to meet sales targets, such as threats of disciplinary action, performance management or dismissal.*

Changes to financial incentives schemes alone will not be enough to improve standards. Sales targets can be equally problematic and need to be tackled.

Policy recommendations

Inappropriate sales incentives schemes have led to significant risks to consumer protection and financial stability. Improvements to these schemes and transparency about the risks they create would lead to benefits to consumers, banks, their staff and investors.

Recommendations for the G20 and international regulators

- The G20 should ask the FSB to review its remuneration principles and standards and develop best practice guidelines for the approach which should be taken surrounding the structure, risk management, controls, governance and regulation of sales incentives schemes.

- Working with banks, national regulators, unions and consumer groups, the FSB should identify a list of high-risk features of sales incentives schemes. These should include:

a) High-risk features created by the structure of sales incentives schemes
b) High-risk features created by the lack of monitoring, management information and other controls
c) High-risk features which can remain even after sales incentives schemes have been reduced or reformed

- The G20 should ask the Basel Committee on Banking Supervision to conduct an urgent review of the measures which can be used by banks to calculate capital held against 'operational risk'. The objective of these reforms should be to achieve a substantial increase in the amount of capital banks should set aside. It must ensure that in addition to models, the level of capital is based on judgment, transparency and is forward-looking.

Recommendations for national prudential regulators

National prudential regulators should:

- Ensure that banks disclose, as soon as possible, all possible legal and regulatory risks and possible litigation which could have a financial impact on the bank
- Require banks to disclose details of how they have calculated their provisions for legal risks, litigation and mis-selling and the breakdown between different issues
- Incorporate 'operational risks', including those which are caused by inappropriate sales incentives schemes into bank stress tests and publish full details regarding how they have been undertaken
- Ensure that requirements imposed by the prudential regulator to raise capital by issuing new forms of hybrid securities do not result in banks breaching regulations by reviewing the banks plans for distributing these securities
- Work with conduct regulators to prevent banks from using inappropriate sales incentives schemes or performance management schemes to encourage their staff to promote these products to retail customers

Recommendations for national conduct regulators

The experience of the UK, Ireland and the Netherlands shows that regulatory reviews of sales incentives schemes for frontline staff can uncover widespread poor practice and risks to consumer protection. National regulators should:

- Conduct detailed thematic reviews to assess the risks of sales incentives and performance management schemes in operation for frontline staff, starting with retail banks and then widening out this work to other financial institutions
- Ensure that the risks identified in these thematic reviews are tackled by introducing new regulation and guidance for firms concerning the structure, risk management, controls and governance of sales incentives schemes
- Require banks and other financial institutions to implement this regulation and to make any necessary changes to their sales incentives schemes
- Take enforcement action against banks and other financial institutions which do not implement the new regulation and guidance
- Require all banks to have a named individual senior executive responsible for approving the sales incentives schemes for frontline staff and controlling the risks of mis-selling
- If the sales incentives scheme leads to mis-selling or risks to financial stability by putting excessive pressure on frontline staff then the national regulator should take enforcement action against the bank and the named senior executive responsible for the scheme. Regulators should impose financial penalties on the senior executive and consider banning them from working in a senior position in a bank or other financial institution
- Measure and assess the culture and selling pressure throughout banks by interviewing and surveying frontline staff
- Ensure proper whistle-blowing arrangements, enabling frontline staff concerned about selling pressure put on them to be able to raise concerns with senior executives at the bank and/or with regulators

Recommendations for banks

Banks do not need to wait for regulatory intervention before making changes. A number of banks have already made changes to their incentive scheme to reduce or remove the sales element and to increase the focus on customer service and fair treatment. All banks should:

- Reform formal and informal sales incentives and performance management schemes for frontline staff to prioritise meeting the needs of customers, providing suitable advice and promoting customer service
- Ensure the structure of the sales incentive scheme and the controls which are put in place to prevent mis-selling are reviewed and approved by the remuneration and risk committees
- Disclose the details of the scheme in their annual report, whether their scheme includes any of the high-risk features identified by regulators and the measures which have been taken to control risks
- Ensure that changes to sales incentives schemes are a key part of any ‘cultural change’ programme and assess the culture and the selling pressure throughout banks by interviewing and surveying frontline staff
- Ensure proper whistle-blowing arrangements enabling frontline staff concerned about selling pressure put on them to be able to raise concerns and provide rewards to staff who highlight concerns to management