Banc Ceannais na hÉireann
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Guidelines on Variable Remuneration Arrangements for Sales Staff

Contents

1. Foreword

The Central Bank of Ireland (the 'Central Bank') is committed to building a culture of consumer-focused sales within all regulated financial services providers, where the right products and services are sold based on their suitability to each individual consumer's needs. Accordingly, in embedding consumer protection into the sales process, firms must ensure at all times that the 'Knowing the Consumer' and Suitability requirements are met. It is the Central Bank's view that sales incentives and variable remuneration practices are key drivers of a firm's culture. Therefore, there is an onus on financial services providers to have in place structures that facilitate sales staff to act at all times in the best interests of consumers. By fostering this cultural change, financial service providers are creating an environment which moves away from short term sales based goals and promotes a longer term consumer focused and compliant approach.

The Central Bank considers that the structure of remuneration arrangements across financial services providers is paramount to facilitating this cultural shift. Consequently, firms must implement sales remuneration practices that focus primarily on the quality of sales to their customers rather than the quantity. All regulated financial service providers are required to act in their customers best interests and to provide products and services that are suitable to the needs of their customers. Thus, it is the responsibility of the Boards and Senior Management within each firm to ensure that the culture of the firm supports these objectives and that the remuneration arrangements are fully aligned with these goals.

The area of remuneration is high on the Central Banks agenda, and consequently a detailed and extensive themed inspection was conducted into variable remuneration arrangements across three sectors over an eighteen month period. We believe that this area warrants follow up work in the coming years to ensure that financial service providers have mitigated any inherent risks in their structures and fully implemented the Best Practice provisions aimed at promoting sound consumer protection practices and positive customer outcomes.

2. Executive Summary

The Central Bank has an important role in ensuring that the best interests of consumers of financial services are protected. The Consumer Protection Directorate is committed to delivering on its mandate of protecting consumers and therefore conducted an extensive body of work into the examination of variable remuneration arrangements in 15 firms across the banking, insurance and investment sectors over an 18 month period. We consider that the themed inspection into 'Sales Incentives to Direct Employees of Insurance Companies, Credit Institutions and Investment Firms (the 'Sales Incentives Review') is an important piece of work which significantly inputs into this goal of helping to protect consumers.

Objectives and Scope

The objectives of the Sales Incentives Review were:

(i) to identify and understand the specific risks that poorly designed sales incentive schemes pose to consumers;

(ii) to respond to and mitigate those risks by active engagement with firms and the industry;

(iii) to shift the focus of the design of sales incentives schemes to ensure that the best interests of consumers are achieved.

Phase One – Insurance Companies

In October 2012 the Central Bank initiated the thematic review which examined sales incentives offered to direct employees of insurance companies. The firms included in the review had either a direct employee sales channel or took full and unconditional responsibility for a tied agency sales channel providing advice and product sales to consumers. The review was conducted in two stages – stage one consisted of a desk based review of variable remuneration arrangements, remuneration policies, remuneration paid and product sales in 2012, sales-related complaints, sales files and sales quality monitoring conducted. Stage two consisted of onsite inspection of a number of insurance companies which entailed interviews of key staff including sales staff, sales managers, compliance and monitoring staff, HR and Finance representatives, senior management and board members. The outcomes of this tranche of work underpinned the Industry Guidance issued by the Central Bank in November 2013.

Phase Two – Credit Institutions and Investment Firms

During the insurance review it was decided to extend the remit of this inspection to include credit institutions and investment firms in order to get a comparative overview of practices in place across these sectors. As with the insurance review the work was conducted in two stages – a desk based review of all remuneration related documentation as well as conflicts of interest policies and procedures and a number of onsite inspections. Having recently completed phase two of the project, the Central Bank is now in a position to publish revised guidelines which incorporates issues and best practice identified from across the three sectors examined.

Phase Three - Next Steps

The next steps required of firms within the scope of the project are:

1. To review their variable remuneration structures, target setting practices, standards of client documentation and performance management processes in light of the risks highlighted and associated mitigants / best practice.

2. The Chairperson of the board of each firm will be required to report back to the Central Bank confirming that they have undertaken a review of the sales incentive / remuneration arrangements within their firms, and that relevant changes have been implemented by 1 January 2015.

3. Following this in the first half of 2016 all financial service providers are required to have their Internal Audit function conduct a review of changes implemented in their remuneration arrangements in line with these Guidelines. Results of these Audits will be relayed to the Central Bank and may feed in to any future engagement tasks with firms.

The area of remuneration is a key priority of the Central Bank and so it will remain on our agenda. During 2015 we will review how each sector has responded to the guidelines issued.

Regulatory Landscape

Due to the cross sectoral nature of the review a number of Regulations and Guidelines were taken into consideration when assessing documentation, incentive schemes and monitoring in place by individual firms. Consumer Protection Code provisions 3.31, 3.32 and 3.35 were the focus for insurance companies and credit institutions. These provisions cover:

(i) conflicts of interest around commission to intermediaries;
(ii) firms remuneration arrangements with employees; and
(iii) gifts and inducements.

The Central Bank also considered the following chapters of the Consumer Protection Code in conducting this review:

- Chapter 2 – General Principles
- Chapter 3 – General Requirements
- Chapter 4 – Provision of Information
- Chapter 5 – Knowing the Consumer and Suitability

Markets in Financial Instruments Directive (‘MiFID’) Regulations 33, 74, 75, 76, 94 and 155 were the focus for investment firms included in the review. These provisions set out Conduct of Business rules applicable to investment firms, with a particular focus on Conflicts of Interest.

Additionally, in June 2013 the European Securities and Markets Authority (‘ESMA’) published ‘Guidelines on remuneration policies and practices (MiFID)’ which were also considered in a forward looking capacity in the context of the work undertaken for investment firms.

Main Findings

Most of the firms reviewed recognised the importance of properly incentivising staff to sell suitable products, however firms reviewed in this theme did not consider the structure of their variable remuneration arrangements to be inherently risky even though each scheme reviewed had a substantial focus on the achievement of sales volumes or revenues in order to determine variable remuneration. Thus each scheme carried the potential to encourage poor sales behaviours in sales staff, as quality measures were not formally linked to unlocking incentives in any meaningful capacity. Some of the key findings include:

1. **Risky Features of Incentive Schemes:**
   I. Across all sectors we found scheme features that were not designed with the goal of acting in the best interests of consumers and thus constituted a high risk of unsuitable sales practices.
   II. A high percentage of variable remuneration was paid based on the achievement of sales volumes, revenue or targets.
   III. Focus on Quantity v. Quality - Insufficient emphasis on linking quality measures and behaviours to unlocking incentives.
   IV. Widespread use of risky features such as 'accelerators', sales targets and thresholds, inappropriate product bias and multiple incentives paid for the same sale. Some firms incentivised obtaining new funds for investment from clients.
   V. Widespread use of targets and thresholds to measure and unlock variable incentives, whether based on an individual's performance or on a collective basis, for example bank branches, where incentives are earned on an 'all or nothing' scenario.

2. **Inadequate Management & Controls**
   I. There was inadequate use of penalties or deterrents against poor sales practices in the insurance sector while in investment firms, their application was inconsistent.
   II. Where poor sales related practices were identified, inadequate sanctions were imposed, for example the initial commission awarded was removed, but other incentives could still be paid to such individuals, including those related to quality / overall performance.
   III. Conflicts of interest were identified in that sales managers were remunerated on the performance of the sales staff that they supervised but in most firms they also had a key role in sales quality monitoring.
   IV. Firms set targets based on the needs of the firm or individual seller, potentially to the detriment of consumers. Such targets tended to be set by senior management.
   V. Regular and robust sales quality monitoring was not performed consistently across the banking and investment sectors.

3. **Insufficient Governance, Oversight & Monitoring**
   I. While all firms included in the review had a governance process in place for the design and sign off of incentives schemes, there was a failure to identify and thus mitigate the risks inherent in the schemes in place.
   II. There was inconsistent review at Board level of trends or patterns in the payment and allocation of variable remuneration, and thus ensuring that they were leading to suitable sales.

Higher Risk Features of Variable Remuneration Arrangements:

While a comprehensive list of all inherent risks identified in variable remuneration is set out in Section 4 of the guidelines, the Central Bank's risk appetite is low for a number of higher risk components of remuneration structures, and we expect firms to eliminate them from their variable remuneration arrangements for sales departments, as follows:

- In the variable component of remuneration, sales volumes or sales revenue metrics should not make up 50% or greater of the measures used to determine or allocate variable remuneration.
- The use of collective targets to unlock collective incentives without the use of a sufficient weight of quality metrics linked to unlocking variable remuneration for individual staff members.
- Elimination of conflicts of interest where a substantial portion of sales manager remuneration is based on the sales performance of the sales staff that they supervise where Sales Managers also have a key role in monitoring the quality of sales.
- The payment of multiples of salary based on achieving certain levels of sales or revenue generated by an individual (e.g. a sales bonus greater than or equal to 100% of fixed salary).
- Paying a higher level of incentive on one investment or product type over another which may lead staff to sell such products in order to earn a higher commission or meet targets linked to unlocking incentives.
- Where remuneration is 100% variable (no basic salary) and based solely on the achievement of sales volumes, revenue or targets.

Additional Risks Identified:

While the structure of variable remuneration schemes can have significant risks to encourage poor sales behaviours, a lack of adequate monitoring and oversight of sales staff can pose additional risks to consumer interests whereby patterns or trends in sales behaviours may go unnoticed. Such risks include:

A. A lack of regular, adequate sales quality monitoring conducted post-sale on relevant staff where the client's situation and objectives are compared with the recommendation made, for example, failure to conduct a post-sale review of any / all new business issued or a lack of post transaction suitability testing.

B. Insufficient regular trend analysis of key risks and metrics that may be indicators of whether patterns or instances of poor sales related behaviours are occurring, for example failing to calculate and link measures such as an individual's poor persistency or high lapse rates on new business with recurring sales related complaints and earning high levels of variable incentives, or a bias towards selling products that carry a higher level of or greater ability to earn incentives.

C. Lack of adequate independent oversight of sales staff by suitably qualified individuals who understand the structure of variable remuneration arrangements applicable and how to identify the potential risks or indicators of poor sales related behaviours such as mis-selling.

Inappropriate Sales Behaviours to Consumers / Clients:

In addition to the risks identified above, the Central Bank considers that inappropriate sales behaviours occur in the following instances:

- Providing advice, recommendations or information to clients or potential clients on financial instruments, products or services that are unsuitable based on / not in line with / contrary to the information gathered on the client's needs and objectives, financial situation and personal circumstances.
- Treating clients / consumers unfairly, for example providing advice or recommendations to clients that carry a benefit to the firm and / or the financial advisor rather than best suited to meeting the needs of the client / consumer. Examples include:
  - recommending the product that carries a higher potential commission / incentive for the seller rather than a cheaper option that equally meets the needs of the client;
  - recommending that a client sell one financial instrument held with the firm in order to raise proceeds to buy another financial instrument recommended, when the switch is unnecessary, but the firm imposes a separate charge for the buy and sell, thereby generating double the revenue for the firm and / or the financial advisor.
- Failing to explain the nature of the service being provided to the client, be it at the account opening stage or in subsequent recommendations made to the client.
- Clients should understand whether they are being advised on a once off or on-going basis, or whether information is being presented to them in order to make an investment decision themselves. Clients should not believe that advice is being rendered when in fact the firm considers that the service they are providing is presenting information to the client to assist them to make an investment decision.

Firms are reminded that when providing the service of investment advice or making recommendations to clients, that the MiFID and / or Consumer Protection Code requirements regarding suitability apply.

<u>Guidelines on Variable Remuneration Best Practice</u>

The Central Bank has set out what it considers to be best practice by firms in meeting the needs of the consumer and aligning their variable remuneration arrangements with a positive cultural focus on needs based selling. While this work was focused on the banking, insurance and investment firm sectors, the Central Bank considers that these guidelines apply to all financial service providers when remunerating staff for selling products or services to retail clients / consumers. The guidelines are applicable to the banking, insurance and investment firm sectors initially, and engagement with the remaining sectors will follow in 2014. The variable remuneration arrangements in scope relate to rewards to all staff involved in the sales process for a firm, when providing investment advice, portfolio management and selling financial instruments such as insurance, investments, credit and pension products directly to consumers, whether staff are employed or self-employed (e.g. tied agents).

The best practice principles are set out under the following headings:

1. Governance
2. Use of Quality Measures
3. Inclusion of Penalties / Deterrents and Clawback
4. Managing Performance
5. Managing Conflicts of Interest and Risky Components of Incentive Schemes
6. Sales Quality Monitoring and Controls

7. Client Service and Standards of Documentation

This best practice is set out in addition to and not in conflict with any other remuneration related rules or requirements imposed on financial services providers. Further details on how financial services providers can meet the best practice principles are set out in Section 6.

Expectations and Conclusions

The Central Bank expects that when firms remunerate sales staff on a variable basis, that the composition of such remuneration arrangements focus on encouraging the right culture and behaviours in sales staff, while actively discouraging poor practices. Firms should aim to do this by re-shifting the focus away from setting and driving incentives based on sales volumes or revenues, and instead replace such measurements with quality focused metrics such as individual customer service scores, compliance performance, regulatory issues, quality of sales conducted, upheld complaints, training and development performance etc.

We expect firms to ensure that sufficient weighting is given to quality assurance factors in order to prioritise good behaviours. They are also required to utilise deterrents against poor sales related behaviours and to discourage a short-term sales mindset through the use of appropriate remuneration structures. Regular and robust sales quality monitoring and controls must be enforced to ensure that any instances of poor sales related behaviours are captured and addressed accordingly, and that firms act at all times in the best interests of their consumers when designing and implementing sales incentive schemes. Those charged with governance must ensure that the design of incentive schemes incorporates these requirements.

3. Main Findings

Broadly, similar findings were identified across the three sectors. Incentive schemes examined were found to have risky elements and the capacity for sales staff to earn substantial bonuses based in the main on sales volumes generated. While some evidence of managing the risks associated with such incentive schemes was identified, these measures nonetheless needed to be strengthened in order to negate the potential for sales staff to mis-sell products. Most firms did not consider the structure of their variable remuneration arrangements to be inherently risky.

The responsibility is on the board and senior management of firm's to ensure that their remuneration arrangements promote and require the right behaviours in sales staff, client facing front office staff, sales managers and those charged with the governance of such arrangements. This is necessary to ensure that the regulatory requirement to act in the client's best interest is fully complied with. Poorly designed remuneration arrangements (for example, those with substantial sales or revenue related targets) have the potential to impact negatively on consumers. The Central Bank expects financial services providers to ensure that the best interests of consumers are prioritised in all sales interactions with firms.

Findings identified that pose risks and could encourage short term sales practices and mis-selling include:

- Each sales based Incentive Scheme reviewed carried the potential to encourage poor sales behaviours in sales staff in order to earn a variable incentive, be it commission, bonus or salary. This was due to the substantial focus on the achievement of short term sales in order to earn variable incentives.
- While some firms build quality assurance measures into their incentive schemes, none were used effectively or had a sufficient weight in order to have a consistent, meaningful impact on the payment (or deduction) of variable incentives.
- Most firms did not sufficiently use financial penalties or deterrents, other than the claw back / deduction of initial commission earned, as a threat or mitigant against poor sales related behaviours.
- Widespread use of revenue / sales volume targets and thresholds to measure and unlock variable incentives, whether based on an individual's performance or on a collective basis where incentives are earned on an 'all or nothing' scenario.

Positive features found include:

- Using a deferred payment of variable incentives through share options or equity ownership schemes to align the payment of variable remuneration to the longer term interests of the firm, which is also in the interests of consumers in writing quality business.
- The use of quality related targets such as customer service scores to unlock substantial levels of variable remuneration.
- A governance structure for the design and sign off of variable remuneration schemes was in place in all firms reviewed.

<u>Post Inspection Response from Firms</u>

The Central Bank is pleased to note that following completion of Phase One with insurance companies, where risky variable remuneration structures and / or components were identified to firms, the response has been to incorporate changes and enhancements to variable remuneration arrangements, including the restructuring of schemes to re-align / enhance the weight of quality measures used to allocate and unlock variable remuneration. Other actions have included the introduction of appropriate penalties and deterrents over and above clawback of initial commission for instances of inappropriate sales behaviours, while some firms have committed to substantial monitoring and control improvements, where required. While much work remains to be done, the Central Bank welcomes the cooperation received from participating firms in respect of this review which has led to positive changes and undertakings to carry out further reviews of remuneration arrangements in place and we anticipate that this will be on-going.

4. Inherent Risks identified in Variable Remuneration Arrangements

Incentive schemes are used by firms as a means of rewarding staff for achieving sales, revenue generation, new funds under management and / or other measures as determined by firms such as performance against pre-defined targets. However, the structure or features of incentive schemes may contain components that encourage sales staff and sales managers to achieve sales in order to maximise their own potential income, rather than to meet the needs of the consumer. Thus a non-exhaustive summary of the inherent risks in incentive schemes and variable remuneration arrangements is identified below which may:

a) increase the potential to mis-sell and/or
b) discourage customer needs based selling and financial advice to consumers.

The best practice set out later will assist firms in the mitigation of these risks.

Risks Inherent in Structures of Variable Remuneration Arrangements:
Incentive Scheme Features
100% Variable Salary
The use of a 100% variable remuneration model to both remunerate and incentivise sales staff may promote poor sales behaviours in order for sales staff to receive a regular income, particularly when the awarding factors are based on sales volumes or sales revenues. Furthermore, without any element of fixed salary, sales staff may sell products to earn commissions in order to meet their own financial commitments rather than to meet the needs of consumers.
Lack of Quality Metrics in Incentive Schemes
An over-focus on generating sales volumes or revenue in determining variable remuneration arrangements, coupled with an insufficient use of quality metrics in the design and composition of incentive structures can encourage a culture focused on the achievement of sales / revenue, potentially leading to detriment for consumers. While it is recognised that firms operate in a competitive landscape with a focus on growing new business, if quality metrics do not have a sufficient weight (50% minimum of total metrics or higher) in order to have a meaningful impact on the payment or deduction of variable incentives, they are an ineffective measure and compensation arrangements are considered to be inherently risky.
Accelerator Features
The Accelerator feature can occur in many forms and essentially awards higher levels of incentives with the achievement of higher sales revenue / volumes.

It may also include the ability to increase current or future earnings by reaching or exceeding targets, leading to an enhancement in remuneration payable to sales staff once such ‘hurdles’ have been met.

This form of incentive creates increased risk that staff may try to maximise their sales over and above target levels, particularly towards the end of an incentive period or to recommend higher investment values in order to earn a higher total commission, as the greater the investment, the higher the potential commission to be generated.

Incentive Bias between Products

Products may carry different rates of commission and / or additional incentives, thereby incorporating the risk that staff will sell the most lucrative product rather than matching the most suitable product to the client need. Alternatively, product bias could be built into remuneration arrangements through the target / threshold setting process, whereby firms impose a higher percentage target to one product type / basket over another, and / or they may also require minimum performance levels in such product baskets.

Firms may consider that some products warrant a higher incentive due to the complexity of the product and the length of time involved in the sales process. However, the length of time required to sell one product over another or the ability to earn a higher incentive does not diminish the overarching requirement to act in the best interests of the consumer and to recommend the most suitable product(s) based on the client’s needs, objectives, personal circumstances and financial situation

Inappropriate Requirements for Incentive Accrual

The imposition of requirements, for example, a ‘product mix’ percentage, minimum sales thresholds, sell ’X’ number of life assurance products or the running of specific product sales campaigns (e.g. sell 50 Mortgage Protection policies) to unlock commission / bonus / equity participation / non-financial incentives are considered to be inappropriate when providing ‘needs-based advice’ to clients.

Furthermore, a requirement for sales staff to justify themselves by generating revenue in excess of a predefined amount, such as a multiple of salary, in order to remain viable and ultimately in employment is considered to be inappropriate and likely to increase the risk of selling based on the needs of the firm rather than the consumer.

Disproportionate Rewards for Marginal Sales

Multiple incentives may be awarded to sales staff based on the same bundle of product sales. For example, a product sale may pay an initial commission but the same sale may also generate a credit to the seller, that counts towards an additional variable payment such as a quarterly bonus, annual enhancements etc. One sale could also generate future incentives to the individual over all or part of the life of the product through the payment of renewal commissions and annual management fees, for each year of the product life. Thus, where remuneration structures include multiple layers of incentive payments, qualitative metrics should be used as a substitute for sales measures / layering of similar incentives.

Non-Financial Competitions, Promotions and Incentives based on Sales

The use of non-financial incentives such as subsidised trips, promotion opportunity, titles such as

'Top Seller', 'Top Pension Seller', the distribution of leagues tables and targeted product campaigns to promote, reward or incentivise staff may encourage poor sales behaviours and possible consumer detriment if the performance metrics are based on the achievement of sales volumes / revenue generation only.

Management and Controls

Claw back Policy and Insufficient use of Deterrents / Penalties

A 'claw back' function is commonly used to deduct / reduce incentive payments on cancelled or reduced business; however the level of effectiveness depends on the length of the claw back period and whether the claw back impacts the payment or reduction of all incentives linked to the sale. Other than in cases where consumers exercise their rights to change their mind about a product during a cooling off period the use of a 'claw back' mechanism is considered to be an insufficient deterrent to poor sales related behaviours where it does not reduce or remove all other linked incentive payments, and merely removes commission on a sale that has been refunded or cancelled.

If a penalty is imposed in addition to the claw back of the original incentive payment for instances of poor sales-related behaviours (e.g. mis-selling), a threat of an actual loss over and above the cancellation of business exists to deter poor behaviour.

A lack of sufficient dis-incentives or deterrents in incentive schemes, performance management systems or disciplinary policies for front office sales staff may increase instances of mis-selling or other poor sales-related behaviours, particularly in incentives where business retention measures such as persistency are not linked to the payment of incentives.

Use of Thresholds / Targets – Individual or Collective

The practice of setting sales targets or minimum threshold levels provides a requirement to hit or exceed predefined sales levels in order to earn or unlock incentives. Performance against targets can provide the ability to earn higher or enhanced incentives by meeting or exceeding targets set. 'Indirect targets' can also exist in the form of minimum threshold levels whereby an incentive would not be unlocked unless a set threshold is met in a period.

A practice of setting unrealistic targets to be achieved by sales staff may be adopted by firms in order to encourage higher sales levels, as may be evidenced by rewarding below target levels (as well as above).

Also a collective target focus may exist, whereby incentives are only unlocked on an 'all or nothing' basis for a collective score against targets, rather than on an individual seller basis. Such a situation raises the risk of a constant, group focus on selling at all times and potential to put pressure on individuals within the qualifying group to perform so that all staff entitled to such a group type incentive receive it – no one individual may want to be the reason for the group not qualifying for the incentive.

The use of targets may not always carry financial incentives, and may instead be linked to other factors such as the overarching goals of the firm or the performance management evaluation process, whereby staff may receive poor performance management ratings impacting career

progression, or incur disciplinary actions, including the loss of their job, should their performance against targets be less than expected. This element of the use of targets may carry as much encouragement to mis-sell as those carrying a financial implication. The linking of targets to unlocking incentives based on the goals of the firm rather than the needs of the client cannot be considered to be acting in the best interests of the client. Thus the practice of setting sales targets or minimum threshold levels is ultimately seen as a means of driving performance which can be at odds with the requirement to provide advice to consumers based on their own financial needs and individual circumstance. *(Although it must be noted that targets can be used positively, for example, when related to quality measures such as minimum compliance quality testing results or customer service scoring targets linked to unlocking variable remuneration.)*
Insufficient use of Lapse / Persistency Metrics
The use of a lapse / persistency measure is considered to be an important indicator of whether sustainable or 'quality' business is being sold or indeed if mis-selling or poor sales-related behaviours may be occurring. While firms may calculate lapse / persistency rates for sales staff, not all firms review the results and link a persistency measure to the awarding of all / part of variable remuneration, or to its reduction / cancellation. If an incentive scheme links persistency / lapse metrics to the payment or deduction of incentives, 'quality business' is being encouraged.
Inadequate Trend Analysis
While firms may regularly monitor and review trends in financial information such as commission related revenue for purposes such as payroll accuracy or budget forecasting, a lack of regular and consistent reviews of key trends such as persistency / lapse rates, number of sales related complaints, significant reward payments to eligible staff members etc. is a flaw in the sales quality monitoring function, as key trends related to compliance, the sale of products and by certain staff may go unnoticed.
Monitoring of Materiality of Incentives Paid
Incentive schemes may carry the ability to generate substantial amounts of variable remuneration, such as up to, in excess of and multiples of fixed salary. Firms did not appear to place much emphasis on regular monitoring of trends in remuneration awarded for instances of possible enhanced selling patterns as a motivation to increase earnings, particularly in cases where sales staff were earning material amounts of total remuneration relative to their peers. Thus the amount of potential incentives achievable by individuals, particularly when the awarding of incentives is based on sales volume metrics with no cap on earnings, is considered to be a risky component of incentive schemes. Thus paying multiples of fixed salary to sales staff based on performances in volume selling may cause poor consumer outcomes.
Inadequate use of Equity Components in Variable Remuneration Arrangements
While it is considered to be beneficial for firms to incorporate an element of linking the interests of staff in receipt of variable remuneration to the long term interests of the firm and / or the client, the use of an equity deferral option may not be an adequate mitigant if used ineffectively, such as by failing to build a sufficiently long deferral period into the process or no mandatory participation level, whereby any variable earnings above a pre-defined threshold are automatically deferred to the equity option component for future payment (after the deferral period). If such equity components are not subject to a clawback / 'malus' provision for possible future sales related issues, the potential deterrent is diminished.,

Governance, Oversight and Monitoring
Complexity of Incentive Schemes
Highly complex incentive schemes can make the task of monitoring the payment of incentives and the identification of poor sales behaviour patterns / trends difficult for those involved in the process due to insufficient training and / or understanding of the scheme. Highly complex incentive schemes thus pose a risk of non-detection of mis-selling motivations by sales staff, particularly if this key data is not reviewed in conjunction with sales quality monitoring results.
Informal Awarding of Incentives (Discretionary Bonus / Awards)
Where firms use a discretionary type bonus or award system to incentivise sales staff and do not formally link the awarding of such a discretionary award to pre-defined measures such as sales quality metrics, customer service levels, compliance and regulatory issues, performance appraisal results etc, a culture may arise whereby sales staff consider the main determination of such a discretionary award to be related to revenue generation or sales achievements. While it is recognised that firms may not pay such awards unless the firm itself is sufficiently profitable and also that sales staff may not be contractually entitled to such payments, the risk of encouraging a culture focused on achieving sales / revenue exists unless the factors affecting the awarding of discretionary bonus are clearly defined by the firm and equally understood by sales staff.
Ineffective Performance Management Systems and the link to awarding incentives
While performance management systems, such as a balanced scorecard type approach, may include an element of sales quality metrics as a performance objective, if the majority of other metrics used are based on sales or financial objectives, the effectiveness of the sales quality element can be diminished leading to little or no impact on sales behaviours. Where firms do not formally link performance management systems with qualitative metrics and no other deterrents to poor sales related behaviours are utilised, an increased risk of poor practices exists. Therefore, a performance management approach to managing sales quality behaviours is not considered to be an efficient tool unless a sufficient weight is placed on sales quality measures in order to have a meaningful impact on the reduction, suspension or removal of incentives and thus to encourage the right behaviours in the objectives set for relevant staff involved in the sales process that may ultimately lead to unlocking all or part of variable remuneration.

5. Good Practice v. Poor Practice

In order to assist firms in understanding potential risks and what is considered to be acceptable structures in remuneration arrangements, the Central Bank has set out what it considers to be examples of good and poor practices, as follows:

Good Practices
Sufficient use of Quality Measures: The use of an annual Performance Management Process to set out a significantly high weighting of key quality objectives for sales staff linked to determining or unlocking variable remuneration. Such a system could be used in whole or in part for determining / unlocking variable remuneration, for example, an overall performance score / category could be linked to unlocking certain levels of variable remuneration paid to staff. Likewise, a poor scoring could reduce / eliminate entitlement to all or part of variable remuneration in a period under review. ***Penalties or Deterrents for Poor Sales Related Behaviours:*** In assessing sales staff performance and evaluating metrics used in a period, such as, sales related compliance issues, inadequate service levels provided to consumers, failure to appropriately evidence and document client circumstances when recommendations are made, appropriate penalties or deterrents should be used by firms to ensure that the right behaviours are encouraged in sales staff, while actively discouraging behaviours that may lead to poor customer outcomes. Examples may include clawback of all bonus / commission earned on a case where an unsuitable sale occurred plus the imposition of a penalty over and above clawback, such as a fine relative to the cost of upholding the complaint against any future bonus entitlement. Serious breaches may require penalties such as removal from entitlement to variable remuneration for a suitable period of time, e.g. 1 quarter, 1 year etc. or removal from the role. One firm reviewed had a practice of reducing the payment of variable incentives in a month by 50% for a quality assurance score below 80%, with enhanced monitoring conducted on the individual in the following month. If the individual scored below 80% again in the following month, entitlement would be removed in full until such a time as scores are at an acceptable level (greater than 80%), with the caveat that should a third instance of below 80% quality assurance be recorded, the individual's suitability for the role will be assessed. These poor scores also had an impact on the variable remuneration payments to their managers accordingly. ***Adequate Fixed Salary Payments:*** The payment of an appropriate fixed salary mitigates the personal need for sales staff to have to sell in order to earn variable remuneration that could otherwise be required to supplement an insufficient regular income to meet personal commitments. ***Use of Deferral Payments:*** Deferral of payment of variable remuneration, whether through the use of share participation programmes or capping earnings in a period and deferring payment to a future date (e.g. 2 years on for exercise of shares / payment for any variable income over €20,000 per annum) is considered to reduce the risk of a short term mindset in sales staff and align the interests of staff to the longer term interests of the firm.

Linkage of Persistency Type Measures to Allocation / Unlocking Incentives:

While many firms calculate persistency / lapse rates for sales staff members, this measure may not be widely linked to the allocation or unlocking of incentives. One firm reviewed linked the unlocking of incentives to a Balanced Scorecard with individual's persistency performance making up a possible one third of sales staff members variable remuneration payments. This is considered to be a positive measure as firms are monitoring whether sales staff are writing quality business, i.e. business that was appropriate to the consumer and hence stays on the books, but also the metric not only rewarded staff for a good persistency performance, it reduced incentives paid where the persistency metric was below an acceptable level. For non-insurance products, firms could use a similar measure to persistency, such as sustainability of a loan for credit purposes, as a means of measuring whether sales staff were selling 'quality business' to consumers.

Variety of Monitoring Methods Used:

One firm had a robust and varied approach to reviewing sales through a number of channels, from varied sales file sampling, mystery shopping exercises, post-sale 'welcome calls' for all new business, manager 'sit-ins' on sales meetings and taping and reviewing of sales interviews for sales conducted over audio-visual portals. Thus a wide variety and consistent level of testing was conducted on sales staff.

Poor Practices

Layering of Incentives Inappropriately:

One firm allocated several different types of incentives to sales staff for performance against the same bundle of sales, for example a basket of sales to clients paid an initial commission on the sale, but also counted towards the payment of a quarterly and annual bonus entitlement, as well as additional promotions such as 'Top Seller' titles, qualification for trips abroad etc. Such a layering of incentives for the same portion of product sales is considered to be an inappropriate reward mechanism.

Payment of Incentives when Quality Issues Exist:

Failing to stop or reduce incentive payments to sales staff when a quality issue is found, such as incorrect advice being given to clients or where information gathered and recorded on the client file is not in line with the recommendation made, was a weakness found in some firms. While one firm reduced the commission credit allocated to staff members for such instances, they failed to factor the issues into the quality assessments attributed to staff members that triggered a further variable remuneration payment to the staff members in question. Thus in this case while the staff member had their associated sales commission reduced by the commission attributed for these sales, the issues identified did not factor into the 'quality assessment' element of the individual's performance and they were paid the associated, substantial incentive for performance to an 'expected standard'. The firm had presented this structure as a positive component of its variable remuneration arrangements, however on closer examination the process was found to be flawed. Another firm split the determination of variable remuneration equally between sales and customer service performance, however a poor customer service performance had no impact or bearing on unlocking the other element of variable remuneration payable, namely sales related.

Use of Collective Targets & Thresholds to Unlock Collective Incentives:

It was common for banks to impose collective targets on branches whereby high minimum threshold performance levels were required in order to unlock incentives for staff on an all or nothing basis. Within these targets, product bias may occur, whereby higher weights were applied to some products over others, e.g. higher weights applied to credit products, and within credit products higher weights applied to mortgage lending over other types of credit. Thus regardless of the consumer need, minimum collective levels of performance against these targets and product types would be required by branch staff in order to unlock the same incentive for all staff in a similar role. Such measures pose a risk that staff have a constant focus on sales and may push products to meet these targets in order to unlock the collective incentive for everyone in the branch, whether the customer need is met or not, particularly where sales levels against one product type are low, close to a period end or to the levels required to unlock incentives. There is a further risk at Senior Management / Governance level that by incorporating product bias into target setting practices, greater risks can be imposed, such as driving the needs of the bank / firm over the need of the consumer. The Central Bank is concerned that such practices may have fed into the recent credit bubble, and does not want a repeat of such issues. Therefore banks / firms must ensure that such practices are eliminated or the potential risk sufficiently mitigated, including setting high product specific targets and / or linking them to unlocking variable remuneration payments in sales staff.

Inappropriate use of credit targets

The Central Bank understands that in order to measure the performance of branches that target levels are set across a number of categories in order to measure the branch performance. An area of particular concern relates to the allocation of credit / lending related targets imposed upon either individuals or branches i.e. assigning target credit / lending levels in respect of products such as mortgages, loans and credit cards, which ultimately can impact whether variable remuneration payments will be made to the staff members concerned. Within these targets, product bias may occur, whereby higher weights are applied to some products over others, e.g. higher weights applied to mortgage lending over other types of credit. However, the Central Bank is of the opinion that the assignment of target sales levels in respect of credit / lending products to be a potentially risky practice.

Thus removal of credit / lending targets from the performance framework in conjunction with improved checks and balances and an increased focus on quality behaviours, it is anticipated that sales staff will not be incentivised / remunerated based on the value of credit they issue but by ensuring that consumers are being provided with facilities that are not beyond their means and where they have demonstrated sustainability regarding repayment capacity.

Ineffective Monitoring and Controls:

While one firm had extensive processes in place to monitor Management Information (MI) the data reviewed was not wholly linked to a risk based approach to reviewing sales related risks. Instead the data focused on revenue generation and performance against targets that were focused on budgetary and financial forecasting, rather than the identification of possible mis-selling risks. Another firm did not adequately record sales related issues found in the sales quality monitoring processes in the MI reporting to senior management if the issue was resolved in the month / period of reporting. Thus these issues were not logged as having occured and subsequently resolved in the review period, and instead an inaccurate and misleading picture was recorded and presented on sales related issues in the firm, which may lead to inadequate resolution mechanisms.

6. Guidelines on Variable Remuneration Arrangements - Best Practice

Firms must comply with the principles set out in the applicable rules and regulations such as the Consumer Protection Code and the Markets in Financial Instruments Directive, to act in the best interest of the consumer and also to ensure a culture of acting in the best interests of consumers is developed and maintained, by providing suitable and appropriate advice and recommendations to consumers. Firms are also reminded that maintenance of complete and accurate documentation in respect of the Knowing the Consumer, Statement of Suitability, retention of records and suitability and appropriateness are essential to meeting these requirements. These behaviours should be fostered in the design and operation of remuneration arrangements and the Central Bank sets out below what it considers to be best practice in this area. This best practice should be reviewed in conjunction with, not in lieu of, other related materials such as the European Securities and Markets Authority 'Guidelines on remuneration policies and practices (MiFID)' as applicable to investment firms authorised under these regulations and credit institutions when providing MiFID services. Firms should review their variable remuneration structures, target setting practices and performance management processes in light of the risks highlighted in section 4 and Good v. Poor Practices in Section 5, and remove or mitigate these risks. In the course of reviewing prior variable remuneration arrangements, should a widespread historical issue be identified, firms are required to investigate such issues in full, take corrective action and where consumers are found to have suffered a loss / detriment, to redress consumers appropriately.

Scope

While the work was conducted on the banking, insurance and investment firm sectors, the Central Bank considers the guidelines to be applicable to all financial service providers when remunerating staff for selling products or services to retail clients / consumers. Thus the guidelines are applicable to the banking, insurance and investment firm sectors initially, and engagement with the remaining sectors will follow in 2014. The variable remuneration arrangements in scope relate to rewards to all staff involved in the sales process for a firm, for example sales staff, pensions managers, client facing front office staff and the associated sales managers, when providing investment advice, portfolio management and selling financial instruments such as insurance, investments, credit and pension products directly to consumers, whether staff are employed or self-employed (e.g. tied agents). Furthermore, in complying with Code Provision 3.31, Product Producers should take the associated risks and best practice highlighted in these guidelines into consideration.

For clarity, these guidelines relate to all forms of variable remuneration paid / offered to staff involved in selling or providing recommendations to consumers / retail clients.

Guidelines on Variable Remuneration Best Practice:

1. **Governance:**
    - Those charged with governance should ensure that in the design of variable remuneration arrangements all possible sales and suitability-related risks to

consumers inherent in variable remuneration arrangements are considered and sufficiently eliminated or mitigated to an acceptable level through measures such as adequate and robust deterrents, monitoring of trends in sales metrics and controls.

- Those charged with governance must ensure that the structure of applicable variable remuneration arrangements is aligned with sales staff providing consumers with suitable products, services and recommendations.
- The onus is on the board / those charged with governance to conduct regular assessments of variable remuneration arrangements to ensure that they are fit for purpose and conducive to fostering a culture focused on needs based selling.
- Such reviews should include variable remuneration arrangements for all staff involved in the sales process in order to identify and eliminate or sufficiently mitigate elements that may encourage, in order to earn a variable incentive, behaviours in staff such as:

  (a) the potential to mis-sell or
  (b) to act contrary to the best interests of consumers.

2. <u>Use of Quality Measures:</u>

- A sufficient weight must be placed on the use of qualitative metrics in the determination, allocation and unlocking of variable remuneration so as to have a meaningful impact on whether variable remuneration should be paid or not. For example, linking payments to a number of relevant factors such as compliance issues, persistency / lapse rates / repayment history, an individual's sales quality monitoring performance, customer satisfaction / complaints, education and training etc. The Central Bank would expect at a minimum 50% of the factors linked to unlocking variable remuneration to be qualitative metrics.

3. <u>Inclusion of Penalties / Deterrents and Clawback:</u>

- Variable remuneration structures should have sufficient deterrents built into them in order to discourage or penalise poor sales-related behaviours, for example, penalties, reductions or loss of variable payments for a specified period. Such deterrents should be in addition to any claw back imposed on the commission earned for a sale, when poor behaviours warrant it. All relevant staff should be aware of the existence and operation of such deterrents in order for the process to be effective.
- When utilising a claw back mechanism, the claw back period should be of a sufficient duration and appropriate to the product being sold, for example, some products are not subject to claw back unless within the initial 'cooling off' period, meaning there is no dis-incentive built into a cancellation of such a product. For longer term products, the impact of mis-selling may not be detected or discovered for a longer period of time and thus the impact of claw back in such cases would be dependent on the length of time for which a claw back policy is applicable to sales staff. Thus claw back of remuneration for instances of poor sales-related behaviours should not be subject to a limited time period.

- Furthermore, claw back should impact all variable incentive payments made in respect of a sale, rather than just the initial commission component being reduced by the cancellation / reduction. A proportional reduction in remuneration may be adequate here.

4. **Managing Performance:**
   - If linking the determination or unlocking of variable remuneration to a formal performance appraisal / performance management process, firms must ensure that the process is robust, including the use of a sufficient weight of qualitative objectives in the process in order to have a meaningful impact on the payment or deduction of variable remuneration, for example, if multiple sections are used a poor score / failure in the qualitative objectives should sufficiently reduce or remove entitlement to variable remuneration that may be earned on objectives not related to quality.
   - This will only be an effective tool if the right behaviours are set out in the process and known by staff, and are not contradictory to other objectives set such as related to targets or minimum sales threshold levels. Furthermore, it is questionable if someone obtaining a low overall performance appraisal score should receive any element of variable remuneration as a reward, particularly when related to sales.

5. **Managing Conflicts of Interest and Risky Components of Incentive Schemes:**
   - Conflicts of interest should be eliminated in (a) the reporting structures, (b) the sales quality monitoring functions and (c) components of variable remuneration paid to those responsible for monitoring sales staff, for example, sales managers should not receive substantial variable remuneration based on the achievement of sales related targets or volumes by the sales staff that they supervise if they have a key role in the sales quality monitoring process. Instead the composition of their variable remuneration should encompass a significant weight of other performance requirements.
   - In designing remuneration and / or targets associated with different products consideration should be given to whether there is a product bias in their structure. Given that the existence of product bias, particularly in similar or substitutable products, is considered to increase the potential risk to consumers of mis-selling practices, product bias should be removed from remuneration arrangements.
   - Firms must not set targets or thresholds that require staff to meet the needs of the firm or its sales staff rather than the needs of the consumer / client. If setting targets or thresholds, milestones other than those based on sales volumes should also be used, such as x meetings in a period, customer satisfaction metrics / feedback, persistency / lapse rates, etc. These milestones should have a sufficient weight in order to have a meaningful impact on the calculation of variable remuneration. Sales volume / revenue targets should not exceed 50% of all targets set for sales staff to ensure sufficient balance of quality related measures is achieved. Consideration should be given to whether a practice of rewarding above or below targets / thresholds and the use of collective targets and thresholds for

unlocking incentives has the potential to increase the risk of mis-selling to consumers, and remove / mitigate this risk appropriately.

- The practice of paying multiple incentives (in addition to an initial commission payment) based on the same bundle of sales / revenue / new business written should be eliminated or reduced to an acceptable level. Instead qualitative components should make up a significant portion of variable remuneration metrics.
- Furthermore, multiples of fixed salary should not be paid to sales staff based on performances in volume selling.

6. **<u>Sales Quality Monitoring and Controls:</u>**

- Staff conducting the sales quality monitoring process should be independent of the sales team (including sales managers when their remuneration is linked to sales staff performance).The process should involve sufficient sampling of files in order to be meaningful, with a risk-based approach to the volume, frequency and selection of files for sampling and review. The results of this monitoring should be collated and reviewed regularly for relevant trends and possible mis-selling risks. Where a high proportion or 100% of remuneration is variable the Central Bank considers that a key mitigant to possible poor sales related behaviours is that a high portion of sales should be checked, possibly 100%, rather than random sample checking. The Central Bank expects regular independent suitability testing of product sales, investment advice and portfolio management conducted to form part of the regular sales quality monitoring plan in all firms.
- The monitoring, controls and review process around the payment of variable remuneration and sales quality monitoring should be sufficient to identify and capture the risks of poor sales-related behaviours linked to earning an incentive payment. Regular reviews of the actual variable incentives paid to sales staff should be conducted for the identification and recognition of possible mis-selling or other high risk trends and the associated actions taken. Where the individual seller has the ability to determine the amount of fees or charges imposed on the consumer, the monitoring process should consider whether this fee is acceptable. Firms should conduct such reviews in advance of paying variable incentives to individual sales staff, unless the firm can reasonably justify a less frequent review. Firms must be able to evidence conducting such reviews, and any associated actions taken.
- The results of sales quality monitoring must be regularly reported to senior management and those charged with governance for analysis and review.
- The sales quality monitoring process should be robust and matched to the risks of the associated variable remuneration and business model of the firm. The Central Bank considers good practice in this area to include a combination of:

  - ➢ Business Vetting, via file sampling, file quality checking, formalised suitability and appropriateness testing and post-sale ‘Welcome Calls’ conducted by an independent business area such as Compliance / Operations.
  - ➢ Assessment of a wide range of appropriate Management Information, at an individual, product, incentive, issues and complaints level and any other relevant information required in the sales quality monitoring process.

- Sales conversations / sales meetings assessments via call sampling, mystery shops, manager review of sales meetings and /or the use of taped audio visual reviews where firms use such technologies.

- The Central Bank is conscious of the size of a firm and the ability of smaller firms to meet some / all of the monitoring requirements, such as smaller firm's ability to adequately segregate duties including sales quality monitoring and sales manager roles and the ability to carry out the various methods of sales quality monitoring recommended (e.g. mystery shopping exercises, audio visual review, post-sale welcome calls, independent assessment of MI produced etc). In such instances, firms are required to adequately apply a proportional response, taking the associated risks in their business model into consideration and applying adequate mitigants in the resolution of such issues.

7. Client Service and Standards of Documentation:

- In setting up an account and in the subsequent services rendered, clients should understand through adequate disclosure and explanation by the firm the type of account and service level being provided, such as whether the firm will provide once off or on-going investment advice / recommendations, whether the client is receiving an 'execution only' service and / or whether the firm is providing the client with information only for them to make their own investment decisions. Firms must ensure sufficient monitoring and controls are in place to ensure that the right service level is rendered to the client, including checks to ensure that investment advice is not provided to clients where insufficient information has been obtained by the firm to be able to accurately recommend a product or service.
- Finally firms are reminded to ensure that all documentation issued to clients and maintained on client files meets the requirements of the relevant regulations, such as Consumer Protection Code and / or MiFID, particularly related to the 'Knowing the Consumer', 'Statement of Suitability', retention of records and suitability & appropriateness assessment requirements. Firms must also ensure that sufficient information is gathered, including adequate risk profiling, and documented by sales staff, where relevant, to ensure a robust assessment of a client's needs and objectives, personal circumstances, financial situation and attitude to risk in order to make a suitable and appropriate, needs-based recommendation to consumers.

7. Conclusion and Next Steps

The area of remuneration is high on the Central Bank's agenda and we will follow up with firms to ensure that Central Bank guidelines are being adhered to and the specified changes have been implemented.

Following on from the conclusion of this phase of the project, the following is required of firms:

- The Chairperson of all banking, insurance and investment firms within the scope of the Sales Incentives Review are required to report back to the Central Bank confirming that they have undertaken a review of the sales incentive / remuneration arrangements within their firms, including sales, management, governance and monitoring, and that relevant changes have been implemented by 1 January 2015.

- Firm-specific issues identified in firms reviewed will be addressed directly with these firms in the post-inspection process.

- The Central Bank will contact the remaining sectors / financial services providers to advise them of the next steps and requirements regarding the applicability and implementation of these guidelines.

- During 2015 - 2016 the Central Bank will review the implementation of these Guidelines across the relevant sectors.

- In H1 2016 all firms in the three sectors are required to have their Internal Audit function conduct a review of changes implemented in their remuneration arrangements in line with these Guidelines. The Central Bank may use the Audits as part of any follow up work.

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