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Production Incentives: Protecting the Consumer

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Production incentives have been around since the dawn of modern capitalism. They are not going anywhere. Incentives have been called sales incentives, sales bonuses, compensation bonuses, and takes into account any additional remuneration that tends to be transactionally based. All such incentives can be grouped into business objectives where a transaction may be tied to certain benchmarks, met by employees or service providers, the achievement of which leads to an increase in wage or reward for the party achieving the stated goal. For the sake of discussion, let's call forms of such economic inducement, collectively, as "incentives."

Typical incentives include cross-selling, where sales or referrals of new products or services are pitched to existing consumers; sales of products or services to new customers; sales at higher prices where pricing discretion exists; quotas for customer calls completed; and collections benchmarks.

Some of these incentives are very complex in the way they are achieved and applied, whether optionally or required. The incentive challenge is one of the usual conundrums arising when money and capital formation meet: the opportunity for harm to the consumer. Obviously, incentives offer a way to further enhance revenue for the seller of services and products. Indeed, in our market economy, an incentive can reveal the economic interest of market participants in a particular service or product, which is extrapolated from consumers' responses to the offerings. Like so much in finance, incentives are not inherently good or bad, but how they are applied makes them so!

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The Consumer Financial Protection Bureau ("Bureau") has decided to weigh in with guidance on production incentives. I am going to provide my reading of the Bureau's most recent bulletin on this topic, entitled "Detecting and Preventing Consumer Harm from Production Incentives" (Bulletin 2016-03, November 28, 2016, hereinafter "Bulletin"). It is an interesting read, because it endeavors not only to compile guidance that the Bureau had provided in other contexts but also draws attention to the Bureau's supervisory and enforcement experience in which incentives contributed to substantial consumer harm. Importantly, the Bulletin offers some actions that supervised entities should take to mitigate risks posed by incentives.

RISKS

The most obvious risk of incentives to the consumer is a sales program that includes an enhanced economic motivation for employees or service providers to pursue overly aggressive marketing, sales, servicing, or collections tactics. These kinds of incentives are and always have been features of sales tactics that do not meet regulatory scrutiny. Consequently, it is the case that the Bureau has taken enforcement action against financial institutions that have expected or required employees to open accounts or enroll consumers in services without consent or where employees or service providers have misled consumers into purchasing products the consumers did not want, were unaware would harm them financially, or came with an unexpected ongoing periodic fee.

One or more regulatory violations may be triggered as a result of such incentives. To name but a few of the more salient regulatory frameworks that can be violated, impermissible incentives can cause violations of unfair, deceptive, and/or abusive acts or practices (UDAAP) (Dodd-Frank Act, §§ 1031 & 1036(a), codified at 12 USC §§ 5531 & 5536(a), the Electronic Fund Transfer Act (EFTA), as implemented by Regulation E (15 USC § 1693 et seq.; 12 CFR Part 1005); the Fair Credit Reporting Act, as implemented by Regulation V (15 USC § 1681-1681x; 12 CFR Part 1022); the Truth in Lending Act (TILA), as implemented by Regulation Z (15 USC § 1601 et seq.; 12 CFR Part 1026); and the Fair Debt Collection Practices Act (15 USC § 1692-1692p). And to this the Bureau itself notes that violations can stir up public enforcement, supervisory actions, private litigation, reputational harm, and potential alienation of existing and future customers.

Although not meant to be comprehensive, here are some impermissible incentives that surely trigger regulatory violations:

- Opening Accounts: sales goals that encourage employees, either directly or indirectly, to open accounts or enroll consumers in services without their knowledge or consent, which may result in improperly incurred fees, improper collections activities, and/or negative effects on consumer credit scores;

- Benchmarks: sales benchmarks that encourage employees or service providers to market a product deceptively to consumers who may not benefit from or even qualify for it;

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- Terms or Conditions: paying compensation based on the terms or conditions of transactions (such as interest rate) that encourages employees or service providers to overcharge consumers, to place them in less favorable products than they qualify for, or to sell them more credit or services than they had requested or needed;
- Tiered Compensation: paying more compensation for some types of transactions than for others that were or could have been offered to meet consumer needs, which could lead employees or service providers to steer consumers to transactions not in their interests; and
- Quotas: unrealistic quotas to sign consumers up for financial services may incentivize employees to achieve this result without actual consent or by means of deception.

ACTION PLAN

As I have often said, the evaluation of risk is just the first step to mitigating it. Sometimes, it is the easiest step! When dealing with incentives, the risk to the consumer – and *mutatis mutandis* to the financial institution – is mitigated through effective controls. Some people seem to balk at internal controls, as if their implementation is reflective of a personal bias. It is not. It is just the way to establish a means by which to regulate behavior that is lawful and acceptably fair to all market participants. Too many regulations can stifle financial opportunities; but too few regulations can cause the market to explode.

From what we have been able to determine, both from its supervisory issuances and its enforcement actions, the Bureau certainly wants to provide a means whereby a financial institution can gauge its compliance with consumer financial protection laws as it relates to incentives. This is why it has often stated - such as in issuing its "Supervision and Examination Manual: Compliance Management Review" - the importance of implementing a Compliance Management System, otherwise known by its acronym, "CMS."

Indeed, because my firm believes so strongly in ensuring that our monthly clients are fully prepared with their CMS, we developed our annual CMS Tune-up!™, which is an evaluation of a financial institution's compliance management system. We provide an executive report and a risk rating to these clients at no additional charge. It is a critical responsibility of management to set up and implement a CMS, the review of which will certainly be undertaken by both federal and state regulators.

If our CMS Tune-up!™ shows the presence of production incentives, we are going to rate the risk based on where those incentives concern products or services less likely to benefit consumers, or have a higher potential to lead to consumer harm, or reward outcomes that do not necessarily align with consumer interests, or implicate a significant proportion of employee compensation.

Thus, instituting a compliance management system, a CMS, is at the core of effective compliance with the Bureau's expectations in its supervision and enforcement of permissible incentives. Essentially, there are four components to the Bureau's conception of a viable CMS: these are (1) the oversight by the Board of Directors or

Management; (2) a ratified and comprehensive compliance program, consisting of policies and procedures, training, monitoring, and correction action; (3) a consumer complaint management program; and (4) an independent compliance audit.

Let's apply the CMS framework to a few ways and means for limiting violations arising from incentives that may trigger violations of law.

Board of directors and management oversight
Foster a culture of strong customer service related to incentives. In product sales, for instance, ensure that consumers are only offered products likely to benefit their interests.

Policies and procedures
Ensure that the policies and procedures for incentives contain:

- Employee sales/collections quotas that, if a part of an entity's incentive program, are transparent to employees and reasonably attainable;
- Clear controls for managing the risk inherent in each stage of the product life cycle (as applicable): marketing, sales (including account opening), servicing, and collections;
- Mechanisms to identify potential conflicts of interest posed for supervisory personnel who are covered by incentives but also are responsible for monitoring the quality of customer treatment and customer satisfaction; and
- Fair and independent processes for investigating reported issues of suspected improper behavior.

Training
Implement comprehensive training that addresses:

- Expectations for incentives, including standards of ethical behavior;
- Common risky behaviors for employees and service providers to foster greater awareness of primary risk areas;
- Terms and conditions of the institution's products and services so that they can be effectively described to consumers; and
- Regulatory and business requirements for obtaining and maintaining evidence of consumer consent.

Monitoring
Design overall compliance monitoring programs that track key metrics that may indicate incentives are leading to improper behavior by employees or service providers. Examples of possible monitoring metrics include, but are not limited to:

- Overall product penetration rates by consumer and household;
- Specific penetration rates for products and services (such as overdraft, add-on products, and online banking), as well as penetration rates by consumer segment;
- Employee turnover and employee satisfaction or complaint rates;
- Spikes and trends in sales (both completed and failed sales) by specific individuals and by units;
- Financial incentive payouts; and
- Account opening/product enrollment and account closure/product cancellation statistics, including by specific

individuals and by units, taking into account the terms of the incentive programs (i.e., requirements that accounts be open for a period of time or funded in order for employees to obtain credit under the program).

Corrective Action

Promptly implement corrective actions to address any incentive issues identified by monitoring reviews as areas of weakness:

- Corrective actions should include the termination of employees, service providers, and managers, as necessary, and these termination statistics should be analyzed for trends and root cause(s);
- Corrective actions should include changes to the structure of incentives, training on these programs, and return of funds to all affected consumers as appropriate in light of failed sales or heightened levels of customer dissatisfaction;
- All corrective actions should ensure that the root causes of deficiencies are identified and resolved; and
- Findings should be escalated to management and the board, particularly where they appear to pose significant risks to consumers.

Consumer Complaint Management Program

Collect and analyze consumer complaints for indications that incentives are leading to violations of law or harm to consumers in order to identify and resolve the root causes of any such issues.

Independent Compliance Audit

Schedule audits to address incentives and consumer outcomes across all products or services to which they apply, ensuring audits are conducted independently of both the compliance program and the business functions, and ensuring that all necessary corrective actions are promptly implemented.

Whether a financial institution uses our CMS Tune-up!™ or has the resources to objectively evaluate the foregoing elements of a compliance management system on its own, the CMS approach to internal control is a necessity. There must be a careful, ongoing, systemic, procedural, testable, traceable, and evaluative means by which to ensure that incentives are rigorously supervised throughout the service and product delivery process.

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