Production Incentives: Protecting the Consumer
plus Compliance Checklist for Production Incentives

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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 take 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 on 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.

In this article, I will explore the various kinds of risks associated with production incentives and offer an action plan to assist with identifying and mitigating such risks. Importantly, I conclude the article with a checklist, entitled Compliance Checklist for Production Incentives, which provides some helpful guidelines to creating production incentive plans.

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:

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- 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;

- 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

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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 corrective 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;

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- 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

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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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COMPLIANCE CHECKLIST FOR PRODUCTION INCENTIVES

Production Incentives: Protecting the Consumer*

CATEGORY	ACTION ITEMS
SYSTEMS	☐ System solution is capable of collecting the right kind of information to allow proper risk management ☐ Audit procedures are established to review effectiveness and appropriateness of system solution ☐ System solution allows identification of the following (where relevant) o The types of products and services o Individual high risk staff members (i.e., sales pattern, fear of disciplinary action) o Sales staff who are achieving high sales volumes and the products they are selling o Patterns in individual sales activity (i.e., spikes before any target cut-off dates) o Effects of product promotions and sales campaign o Claim repudiation of rates and/or cancellation rates o If claw-backs are permitted by law, the levels of claw backs for individual sales staff

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MONITORING	☐ In addition to routine monitoring and checking that sales are carried out according to the firm's sales guidelines, risk-based monitoring processes are also in place: • Where there is an indication of impermissible selling or higher risk of impermissible selling, additional monitoring is put in place • Additional scrutiny of high-performing sales staff ☐ Monitoring is consistent with sales and bonus strategy (i.e., loan products with highest sales and loan products which attract large commissions as opposed to monitoring riskier products only) ☐ During the monitoring process, more weight is given to mistakes in the sales process than to administrative errors • Root causes of issues are analyzed (i.e., cancellations) ☐ Where relevant, monitoring also includes areas such as complaints handling, claims processing, mortgage arrears and customer retention (viz., risks to consumers from incentive schemes may also arise in these areas)
CONFLICTS OF INTEREST	☐ Clear strategy to manage and mitigate conflicts risks if firm answers Yes to any of the following questions: • Does the supervisor of sales staff also receive incentive payments based on the volume of sales made by those staff? o If so, does the supervisor of sales staff also carry out business quality monitoring of his/her own sales staff? o Any other conflicts risks? • Independent quality checking of supervision assessments

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INAPPROPRIATE BEHAVIOR	☐ Institution has considered the types of inappropriate behaviors that might occur as a result of the firm's incentive plans, taking into account the types of loan products being sold and the methods of distribution
	
	☐ Suitable training is in place, among other things, to ensure that staff, supervisors and management understanding the meaning and practice of "impermissible sales" and "failure to deliver fair outcomes for consumers"
	
	☐ Organization actively assesses what is being said to customers, for example, by using the following controls:
	
	• Mystery shopping
	• Contact sample consumers after sales (testing outcomes (i.e., correct information was given) and not simply customer satisfaction)
	• Record telephone calls
	• Monitor telephone calls
	• Record face-to-face sales conversation for later review
	
	☐ Past business sampling to identify if any systemically impermissible sales have occurred because of higher risk features in incentive schemes
	
	☐ Output of controls:
	
	• Management reviews output of controls
	• Results are placed into individual training and competency monitoring
	• Indications of non-compliance are escalated and acted upon on a timely basis
	
	☐ Emphasis on poor quality performance: action is taken
	
	• Staff is aware of and reminded of consequences of compliance failures
	• Individual performance assessments based on both quantitative (financial) and qualitative (non-financial) factors (i.e., qualitative factors include compliance with regulation, internal procedures, market conduct standards, business retention rates, and number of complaints upheld)
	• Qualitative factors affect remuneration of sales manager and advisers
	    o staff removed from bonus scheme or bonus significantly reduced if quality standards are not met
	    o Incentive payments already received are clawed-back or off-set against future incentives (i.e., for poor outcomes or if consumers cancel)
	• Disciplinary measures
	• Additional training given to staff with persistent compliance failures

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CULTURE OF COMPLIANCE * * Terminology developed by Jonathan Foxx, Managing Director, Lenders Compliance Group. See article entitled "Creating a Culture of Compliance" (National Mortgage Professional Magazine, February 2014)	☐ Management has clear answers to the following: • In what way does the institution have a culture of putting customers first? • Are incentive plans aligned to the goals of the organization?
RISK CALIBRATION	☐ Institution identifies, assesses, and documents specific features of its incentive plans that might increase the risk of impermissible selling (see below, RISK ACCELERATORS)
INCENTIVE POLICY & IMPLEMENTATION	☐ Management has clear understanding of how incentive plans operate and how they meet regulatory requirements, with outline of same approved and in a written outline ☐ Criteria used by institution to assess performance of relevant staff are accessible, understandable, and in writing ☐ Relevant staff are clearly informed at the outset of: • the criteria used to determine their remuneration • steps and timing of their performance reviews
INCENTIVE PLAN OUTLINES	☐ Plans are not overly complex ☐ Institution considers all relevant factors when designing am incentive plan: • Role performed by relevant person • Type of loan products offered • Methods of distribution ☐ Institution uses features in its incentives plans that reduce the risk of impermissible selling, for instance: • Emphasis on sales quality: qualitative criteria included in calculation of remuneration • Claw backs • Variable remuneration: ○ References used in calculation of variable remuneration of staff are common across loan products sold ○ Ratio between variable and fixed income reflects desired conduct of employees to act in the best interests of

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	clients (i.e., bonus is limited to a lower proportion of basic salary) ○ Variable remuneration is paid out in several payments over a period, in order to take into account long-term results ○ Capped or decreasing incentives (i.e., bonuses are capped or reduced when sales volume approaches a certain level or bonus is limited to a lower proportion of basic salary) ○ Policy on payment is flexible and, where appropriate, includes possibility of not paying any variable remuneration
APPROVALS	☐ Management approves incentive plans with input from risk management and compliance functions ○ Drafts such approvals guidelines into the plan design and incentive policies reviews ☐ Compliance function verifies that institution's remuneration practices comply with federal and/or state regulatory guidelines, including applicable employment law ☐ Compliance personnel have access to all relevant documentation
REVIEWS	☐ Frequent and effective department and function reviews of written remuneration policies and incentive plans and related controls ☐ Internal and/or external testing and audit to determine compliance with policies and procedures, with results of same given to management
REPORTING LINES	☐ Appropriate and transparent reporting and chain of command lines to assist in timely escalation of problems
CONTROLS	☐ Controls are established to identify and mitigate increased risks
OUTSOURCED ENTITIES	☐ Ensure that outsourced entities apply controls and arrangements to mitigate risks that, at minimum, are at the same level as the institution's own risk tolerance
GOVERNANCE GROUP	Where appropriate, institution has a formal governance group (reporting to the remuneration committee or senior management) that ensures incentive plans are consistent with the firm's remuneration policies

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GROUPS	☐ Appropriate remuneration policies are not circumvented at individual or group-wide level (i.e., use of off-shore or outsourced entities) ☐ Affiliates to have the group remuneration policy applied and the requirement of subsidiaries to take into account local responsibilities (viz., based on risk profile and regulatory environment)

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RISK ACCELERATORS	EXAMPLES OF SIGNIFICANT INCREASE OF IMPERMISSIABLE RISK
DISPROPORTIONATE REWARDS FOR MARGINAL SALES (Target/goal triggers an increase in earnings which is much higher than the normal rate at which incentives accrue.)	☐ Retrospective accelerator: level of incentives earned for all sales in a period, rather than just the sales above target, increases once a target is reached ☐ "First past the post" competition bonus (i.e., first 25 sales people to reach the target earn a "super bonus") ☐ Locked-in enhanced commission: once a target is met, sales people are locked in to an enhanced commission for the next year
STEPPED PAYMENTS	☐ Higher rate of incentive applies to sales over a target
INAPPROPRIATE INCENTIVE BIAS BETWEEN PRODUCTS (Even higher risk where incentives are different for substitutable products)	☐ Sales people are biased towards loan products with higher commissions attached
VARIABLE SALARIES	☐ Staff moves between salary bands or tiers depending on their performance against sales targets
INAPPROPRIATE REQUIREMENTS FOR DETERMINING STAFF ELIGIBILITY FOR INCENTIVES	☐ Incentive payments are accrued but not paid unless a minimum target is met for each of several types of loan products (i.e., bonus paid only if a percentage of the sales person's clients have purchased certain services or products, such as an insurance product)
BONUS ABOVE THRESHOLDS	☐ Once a target is met, staff receive bonuses on each sale above the target
CAMPAIGNS OR COMPETITIONS	☐ Product-specific or volume-based competitions designed to increase sales

Compliance Checklist for Production Incentives is meant to be suggestive, rather than comprehensive. Each financial institution should evaluate its incentive plans in accordance with federal and state guidelines, and applicable employment law, as well as ensure these are reflective of its size, complexity, and risk profile. Information contained herein is not intended to be and is not a source of legal advice.
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This "Compliance Checklist for Production Incentives" accompanies a White Paper and Article, entitled "Production Incentives: Protecting the Consumer," by Jonathan Foxx, President & Managing Director of Lenders Compliance Group, published in the January 2017 edition of National Mortgage Professional Magazine. Information contained in this article is not intended to be and is not a source of legal advice. The views expressed are those of the author and do not necessarily reflect the views or policies of Lenders Compliance Group, Inc., any governmental agency, business entity, organization, or financial institution. Lenders Compliance Group, Inc. makes no representation concerning and does not guarantee the source, originality, accuracy, completeness, or reliability of any statement, information, data, finding, interpretation, advice, opinion, or view presented herein.
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