

Chairperson of Insurance firms

27 November 2013

Re: Examination of Sales Incentives paid to Direct Employees of Insurance Companies

Dear Sir/Madam

The Central Bank of Ireland (the Central Bank) recently completed a themed inspection into sales incentives paid to direct employees of life insurance companies subject to the Consumer Protection Code. 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. We would like to take this opportunity to thank the firms involved for their co-operation during this inspection.

The purpose of this letter is to provide feedback in relation to the areas of concern identified by the Central Bank following the themed inspection. While this body of work related to incentive schemes of life insurance companies, the Central Bank considers the risks identified and associated recommendations to be applicable to all financial service providers, and has extended its supervisory work to look at remuneration arrangements of banks and investment firms.

A key focus of the Central Bank is to ensure that consumer protection and a customer focused culture is at the forefront of regulated entities practices, particularly when developing and implementing sales practices and remuneration arrangements. The Consumer Protection Code already imposes requirements on firms to ensure that their sales force act in the best interests of consumers when providing advice and recommendations on suitable and appropriate financial services/products. However the structure of remuneration arrangements has a substantial influence on the behaviours of relevant staff, and the potential to drive poor practices where incentive schemes are short term and

aligned to inappropriate measures. Therefore it is important that firms ensure that their internal culture is aligned to consumer interests. Firms should particularly consider the effectiveness of their sales quality monitoring, and inherent or implied conflicts of interest in the design, operation and approval of incentives schemes and monitoring processes, including sufficient independence between the sales function and staff conducting sales quality monitoring.

The inspection was conducted in two parts –

- a desk-based analysis of the remuneration policy, incentive schemes and sales quality monitoring of each firm,
- an analysis of the actual remuneration paid to sales staff and sales managers, and onsite inspections of a selection of firms.

The work specifically tested *Consumer Protection Code 2012 provisions 3.31 and 3.32*, which state:

*‘Where a **product producer** distributes its products to **consumers** through an intermediary and pays commission to an intermediary based on levels of business introduced, the **product producer** must be able to demonstrate that these arrangements:*

- a) do not impair the intermediary’s duty to act in the best interests of **consumers**; and*
- b) do not give rise to a conflict of interest between the intermediary and the **consumer**.’*

*‘A regulated entity must ensure that its remuneration arrangements with **employees** in respect of providing, arranging or recommending a product or service to a **consumer**, are not structured in such a way as to have the potential to impair the **regulated entity’s** obligations:*

- a) to act in the best interests of **consumers**; and*
- b) to satisfy the suitability requirements set out in Chapter 5 of this Code’*

The Central Bank also considered the following chapters of the Consumer Protection Code 2012 in conducting this review:

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

Key findings from the Desk Based Review and Onsite Inspections are as follows:

Incentive Schemes:

1. 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 a substantial focus on the achievement of short term sales in order to earn variable incentives.
2. While some firms have built qualitative metrics into their incentive schemes, none were considered to be used sufficiently in order to have a meaningful impact on the payment (or deduction) of variable incentives.
3. Most firms reviewed do not make sufficient use of penalties or other deterrents, other than the claw back (reduction) of the initial commission earned on a sale, to prevent or mitigate against poor sales-related behaviours. Where firms found a consumer had suffered a financial loss as a result of poor selling practices, only one firm inspected imposed a fine over and above original commission earned on the relevant staff member. In the most extreme cases however, firms stated that staff could be subject to termination. Firms considered this to be a sufficient threat; however the Central Bank believes the potential to use penalties or deterrents to be a good tool to deter poor sales behaviour, particularly for circumstances where termination may not be warranted.
4. Claw back / deduction of variable remuneration was not applied to all incentives paid to sales staff, and tended to be imposed only on the initial commission earned on a product sale. In some cases, it did not apply to all sales staff, and where it was imposed as a result of a cancellation or reduction in policy, it was subject to a time limit such as only in the first year or two of the product life. When the claw back period imposed by firms is too short it could negate the use of claw back as a means of discouraging inappropriate sales behaviours or encourage a short term sales mind-set in order to earn commission. The Central Bank believes that there should be no limitation on the claw back period where instances of poor sales-related behaviour are found in sales staff.

Sales Quality Monitoring:

5. A key mitigant in relation to the risk that incentive schemes may encourage poor sales behaviour by sales staff is for firms to have a robust, varied and well managed sales quality monitoring function. The Central Bank noted that firms recognised the importance of the monitoring function, and in general identified good practices. However some weaknesses

were identified in the course of the onsite inspections that will be addressed separately with relevant firms.

6. The Central Bank also noted that firms did not perform sufficient regular reviews of the quantum of remuneration paid, in advance of the payment of variable incentives to sales staff, in order to identify possible trends in poor sales-related behaviours. Where firms conducted such monitoring it tended to be after the incentives had been paid to staff and in many cases on an annual basis only.

Conflicts of Interests & Governance:

7. Conflicts of interest were found in that many Sales Managers were assigned sales related targets and were awarded substantial variable incentives based on the performance of those sales staff that they supervise against such targets, however Sales Managers also had a role in sales quality monitoring, indicating that complete independence did not always exist in the monitoring process. However it must be noted that all firms reviewed had a sales quality monitoring function that operated separate to the Sales Department where the key responsibility for monitoring sales quality was managed. Those charged with governance did not consider such incentivisation and monitoring crossover to be a conflict or risk in the sales process.

The main risks identified from the themed inspection in relation to sales incentive schemes are set out in the appendix, along with what the Central Bank has identified and expects as best practice. The Central Bank requires the firm to immediately consider the risks and best practice identified and to review its relevant remuneration arrangements in light of these and take any remedial action necessary during 2014. The Central Bank expects firms to make changes to sales quality monitoring and governance structures as soon as possible rather than waiting for a full review of any such scheme.

Any firm specific issues identified during this inspection are subject to separate engagement by the Central Bank with the individual firms concerned.

The Central Bank is continuing its work on this topic in 2013/2014 on investment firms and credit institutions, and may update the contents of the Appendix when concluded. This appendix will also be updated on an ad-hoc basis as risks and best practices emerge. Firms will be notified of any such changes.

The contents of this letter should be considered in conjunction with any other relevant remuneration regulations and / or guidelines.

The Central Bank will have regard to the contents of this letter, or any other guidance issued by the Central Bank in relation to the application of the Consumer Protection Code in assessing firms' future compliance with the provisions of these regulations.

Should you have any queries in relation to the contents of this letter, please contact Ms Jennifer Bohan at jennifer.bohan@centralbank.ie .

Yours sincerely



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Inherent Risks and Best Practice in Sales Incentives

The Board and senior management of firms must ensure that their remuneration arrangements encourage the right behaviours in sales staff, sales managers and those charged with the governance of such arrangements. This is necessary in order to ensure they meet their legal obligation under the Code to act in the best interests of customers in all their dealings and it is essential to this that a strong culture of meeting these obligations is maintained.

The Central Bank is aware that incentive schemes are utilised by firms to encourage mainly short term performance and remunerate sales staff and sales managers accordingly. However poorly designed sales incentive schemes can carry risks to consumers. Therefore the Central Bank expects Financial Service Providers to ensure that consumer needs and objectives are served in the sales process and thus incentive schemes should not be designed to encourage short term volume selling or a sales focused culture to the detriment of consumer needs.

Inherent Risks in Incentive Schemes

The incentive schemes in scope relate to **all staff** involved in the sales process, for example sales staff and sales managers, when selling financial products such as insurance, investment, credit and pension products directly to consumers. Incentive schemes are used by firms as a means of rewarding staff for achieving sales 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 potential income, rather than to meet the needs of the consumer. Thus below is a non-exhaustive summary of the inherent risks in incentive schemes which may:

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

Firms should review their incentive scheme structures and arrangements in light of the risks highlighted below, and attempt to remove or mitigate these risks. The best practice set out later will assist in the mitigation of these risks.

Risks Inherent in Components of Incentive Schemes
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 to receive a regular income. Thus, without any element of fixed salary, sales staff may try to sell products to earn commissions in order to meet their own financial commitments rather than to meet the needs of consumers.

Lack of Qualitative Metrics in Incentive Schemes

An over-focus on the achievement of sales volumes in incentive schemes, whether to award financial or non-financial incentives, coupled with an insufficient focus on qualitative metrics in the design and composition of incentive schemes can encourage a culture focused on the achievement of sales, potentially to the detriment of the consumer. While it is recognised that firms operate in a competitive landscape with a focus on achieving new business, if qualitative metrics do not have a sufficient weight in order to have a meaningful impact on the payment or deduction of variable incentives, they are considered to be an ineffective measure.

Insufficient use of Lapse / Persistency Metrics

The 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 calculate lapse / persistency rates for sales staff, not all firms 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.

Accelerator Features

The Accelerator feature can occur in many forms and essentially awards higher levels of incentives with the achievement of higher sales volumes. It may also include the ability to step up current or future earnings by reaching or exceeding targets leading to an enhancement in the value of commission 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.

Incentive Bias between Products

Products may carry different rates of commission and other incentives, whether the products are similar and substitutable products or not. The associated risk to consumers is the facility for sales staff to recommend the product carrying the greatest incentive to a client rather than matching the most suitable product to the client need. 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 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 such as: a 'product mix' percentage, minimum sales thresholds, sell 'X' number of life assurance products or the running of targeted product sales campaigns to unlock commission / bonus / equity participation / non-financial incentives are considered to be inappropriate when providing 'needs-based advice' to clients. Instead these requirements can be seen to encourage sales 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 initial commission but the same sale may also generate a credit to the seller, which when cumulated with all other credits provides 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 incentive payments, qualitative metrics should be used as a substitute for sales measures.

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. 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 feed into a reduction or removal of 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 serious 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 sales staff may increase instances of mis-selling or other poor sales-related behaviours, particularly in incentive schemes where business retention measures such as persistency are not linked to the payment of incentives.

Use of Thresholds / Targets

The practice of setting targets or threshold levels provides a requirement to hit or exceed predefined sales levels in order to earn or unlock incentives. 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 targets higher than expected to be achieved by sales staff may be adopted by firms in order to encourage higher sales levels, and thus a practice of setting unrealistic targets, as may be evidenced by rewarding below target levels (as well as above). The use of targets may not always carry financial incentives, and may instead be linked to other factors such as the performance management evaluation process, whereby staff may receive poor performance management ratings impacting career progression, or incur disciplinary actions 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. 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.

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 quantum 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.

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.

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 Life Seller', the distribution of leagues tables and targeted product campaigns to promote, reward or incentivise staff may encourage mis-selling and possible consumer detriment if the performance metrics are based on the achievement of sales volumes only.

Ineffective Performance Management Systems linked to awarding incentives

While performance management systems, such as a balanced scorecard, 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. 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 link or encourage the right behaviours in objectives set for relevant staff involved in the sales process.

Best Practice

Firms must comply with the principle, as set out in the Consumer Protection Code, 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. 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.

Firms are expected to regularly review incentive schemes for all staff involved in the sales process, such as sales staff and sales managers, 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,

These reviews should link qualitative metrics into the payment of variable incentives and are expected to include the design, operation and the associated monitoring/governance, with sign off by the board, or appropriate board subcommittee,

In conducting reviews of their remuneration arrangements, firms should have particular regard to the non-exhaustive list of best practice below:

- I. A sufficient weight must be placed on the use of qualitative metrics in the determination, allocation and unlocking of variable incentives so as to have a meaningful impact on whether variable incentives should be paid or not. For example, linking payments to a number of relevant factors such as persistency / lapse rates, sales quality monitoring performance, customer satisfaction / complaints, education and training, compliance issues etc.
- II. Incentive scheme 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.
- III. 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 disincentive built into a cancellation of such a policy. 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 incentives for instances of poor sales-related behaviours should not be subject to a limited time period.

- IV. Claw back should impact all 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 incentives may be adequate here.
- V. Those charged with governance should ensure that in the design of incentive schemes 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 and controls.
- VI. Conflicts of interest should be eliminated in (a) the reporting structures and (b) components of variable incentives paid to those responsible for monitoring sales staff, for example, sales managers should not receive substantial variable incentives based on the achievement of sales volumes by the sales staff that they supervise. Instead the composition of their variable incentives should encompass a significant weight of other performance requirements.
- VII. In designing remuneration 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, can be considered to increase the potential risk to consumers of mis-selling practices, product bias should be removed unless there is sufficient justification for applying such product bias and the associated risks can be managed accordingly.
- VIII. 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. Consideration should be given to whether a practice of rewarding above or below targets / thresholds has the potential to increase the risk of mis-selling to consumers, and mitigate this risk appropriately.
- IX. The practice of paying multiple incentives (in addition to an initial commission payment) based on the same bundle of sales / 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.
- X. The monitoring, controls and review process around the payment of sales incentives 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. 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.

- XI. An appropriate time lag should exist between new business being written, and the associated payment of incentives. This should not occur before the first premium / new product payment has been received from a consumer.
- XII. Staff conducting the sales quality monitoring process should be independent of the sales team (including sales managers). 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 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.
- XIII. The results of sales quality monitoring should be regularly reported to Senior Management and those charged with governance for analysis and review.
- XIV. The sales quality monitoring process should be robust and matched to the risks of the associated incentive schemes 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 and post-sale 'Welcome Calls'.
 - 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.
- XV. Finally firms are reminded to ensure that all documentation issued to clients and maintained on client files meets the requirements of the Consumer Protection Code, particularly related to the 'Knowing the Consumer' requirements and 'Statement of Suitability'. 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.