

Client Alert

Americas FS Regulatory Center of Excellence



Retail Sales Practices and Incentive Compensation Under Heightened Scrutiny

Against the backdrop of recently publicized supervisory actions, policy makers have expressed concern that, across the financial services industry, retail sales practices and incentive compensation structures may need enhancement to prevent consumer harm. This Alert highlights specific areas where bank boards and senior executives should direct attention immediately, including monitoring and testing programs and complaints processes in addition to incentive-based compensation.

In summary

Against the backdrop of recently publicized supervisory actions, policy makers have expressed concern that, across the financial services industry, retail sales practices and incentive compensation structures may need enhancement to prevent consumer harm.

Accordingly, federal financial services regulators have announced plans to conduct industry-wide horizontal reviews of retail sales programs, encompassing cross-selling, incentive compensation, and compliance monitoring systems. Multiple regulatory agencies, including enforcement agencies, will likely be engaged in this effort. Expected areas of focus include: governance by senior management and the board of directors, accountability, and thematic reviews of consumer protection, customer consent, and

suitability/customer best interest across all retail banking and securities products.

Policy makers and regulators also have expressed keen interest in assessing the structure of incentive compensation programs, particularly with respect to the use of "risk adjustments" such as deferred compensation, forfeitures, and clawbacks in order to address failures in risk management or internal controls. For example, CFPB Director Richard Cordray has testified to Congress that "unchecked incentives and an unrealistic and uncaring culture of high-pressure sales targets can lead to serious consumer harm." 1

It is clear that compliance monitoring programs focused on detecting and preventing improper sales conduct will be under intense scrutiny in the

¹ Testimony of Richard Cordray, Director, Consumer Financial Protection Bureau before the Senate Committee on Banking, Housing and Urban Affairs, September 20, 2016.



near-term. This Alert highlights specific areas where bank boards and senior executives should direct attention immediately, including monitoring and testing programs and complaints processes in addition to incentive-based compensation.

Industry Response and Preparation

All bank and nonbank financial services companies need to take proactive measures now to assess, develop, and/or enhance their sales and customer treatment practices as well as their employee conduct programs in light of this announced regulatory focus. In this regard, KPMG is actively assisting clients with developing and implementing the following initiatives across all business operations:

- Communications with employees and customers both acknowledging regulatory attention regarding retail sales activity and encouraging the reporting of misconduct. Appropriate channels for such communications include: hotlines, whistleblowers programs, Human Resources departments, and customer complaints portals.
- Executing an assessment of the following areas in order to promote consistent, enterprise-wide application:
 - Retail sales programs, including sales targets, marketing campaigns, promotions, cross-selling opportunities, and links to incentive-based compensation programs.
 - Incentive-based compensation programs and data supporting performance awards, such as: training completion, sales volume patterns, account open/close rates, zero (low) balance/activity accounts, spikes in complaints by product or sales representative, spikes in sales volumes following product/service promotions or changes in terms.
 - Consumer consent, including policies and procedures relating to obtaining affirmative consent and retaining evidence of consent prior to a sale.
 - Complaints processing, including policies and procedures related to intake, escalation, resolution, monitoring, reporting, and analysis for customer complaints and employee allegations as well as the use of

- metrics and linkages to unfair, deceptive, or abusive acts or practices (UDAAP).
- Conduct and culture, including "tone from the top," roles and responsibilities, accountability, and alignment of the stated culture with desired behaviors.
- Monitoring and testing programs for transactions, employee surveillance, data access, and consumer complaints and employee hotlines. Consideration should be given to the scope and frequency of monitoring, metrics (KRI's/KPI's), triggers, thresholds, exception reporting, issue management, escalation, root cause analysis, and appropriate resourcing.
- Developing a business action plan based on the assessments results.

Concurrent Influences

Going forward, regulators will likely be influenced by the following related and concurrent developments:

- Horizontal reviews by the Federal Reserve Board of large bank "Conduct and Culture" programs (to be completed in 2016 and 2017). In addition, the Federal Reserve will focus on product suitability for retail and investment customers.
- The upcoming Federal Reserve Bank of New York's third invitational workshop on conduct and culture in the financial services industry. The workshop agenda features discussions on methods for measuring conduct and culture, criminal accountability, and the influence of technology. Perspectives will be provided by institutional investors, financial institution supervisors, and industry leaders.
- Ongoing work to revise Federal Reserve guidance in <u>Supervision and Regulation Letter 08-8 (SR 08-8)</u> on compliance risk management programs and oversight of large banking organizations with complex compliance profiles. The revisions are expected to focus on conduct and culture programs, the responsibilities of the board of directors and senior management, governance and controls, and the use of technology/automated solutions to comply with risk assessments, measuring and monitoring requirements.



- Pressure to release a final rule on incentivebased compensation arrangements. In June 2016, six federal regulatory agencies published a proposed rule² that would prohibit incentive-based compensation arrangements that encourage inappropriate risks by providing excessive compensation or that could lead to material financial loss. As proposed, the rule would subject large financial institutions to increasingly more strict prescriptive requirements related to the structure of their incentive-based compensation arrangements, including incentive award limits, deferral requirements, downward adjustments and forfeitures, and clawbacks. KPMG analysis³ at the time noted that the proposal signaled an intention by federal financial regulators to increase their scrutiny of these issues.
- Initial implementation of the <u>Department of Labor's fiduciary rule</u>, which goes into effect beginning March 2017. This rule redefines who is considered a "fiduciary" for purposes of retirement investment advice and expands substantially the universe of fiduciaries. Specifically, fiduciaries must guard the "best interest" of the customer, not merely assess the suitability of investment options, thus reinforcing the regulatory focus as well as public attentions on issues of customer harm, suitability, and conflicts of interest.

Conclusion

At a minimum, all financial institutions that provide products and services to retail clients must review their retail practices and incentive compensation plans relative to the recent news and policy coverage. They should, however, expand those reviews to also include, among others, internal and external complaints processing, documentation of customer consent, and monitoring and testing programs. In addition, these reviews offer financial institutions an opportunity to assess the broader impact of their

conduct and culture programs by identifying how decisions are made across the institution to meet the competing demands of multiple stakeholders.⁴ Firms should begin to build more robust target state oversight and compliance and internal audit programs based on the results of these many reviews.

Federal financial regulators are signaling an intention to increase their scrutiny of retail banking operations significantly, across a range of entities. Momentum supporting new regulatory rule-making will increase if regulators identify additional practices, including internal conduct and culture standards, that increase the risk of consumer harm. These reviews should consider whether automated approaches to internal compliance monitoring could deliver more effective mechanisms for achieving existing internal oversight goals as well as for implementing more rigorous internal processes.

Proactive attention and action to these issues now will place firms in a strategic position to promote brand value and integrity by ensuring that retail customer interests are protected.

 $\frac{https://assets.kpmg.com/content/dam/kpmg/pdf/2016/06/incentive-compensation-alert-062016.pdf$



² See 81 FR 37669, *Incentive-based Compensation Arrangements*, proposed rule, published July 10, 2016. Available at: https://www.federalregister.gov/documents/2016/06/10/2016-11788/incentive-based-compensation-arrangements

³ See KPMG Alert, Linking Compensation, Conduct, and Culture: Incentive-based compensation arrangements – Interagency notice of proposed rulemaking, June 2016. Available at:

⁴ See KPMG's Approaching the Crossroads of Conduct and Culture: Improving culture in the financial services industry, August 2015. Available at:

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