White Paper

Conduct Risk

When incentive compensation and culture are poorly aligned

Watson Financial Services

IBM

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Introduction

Businesses and their regulators are increasingly focused on controlling the risk that employees will put self-interest before their customers' best interests. From financial services to telecommunications, cautionary tales have proliferated recently about incentive compensation strategies gone awry. The result has been an increase in resources devoted to what has come to be called **conduct risk**.

Conduct risk is focused squarely on customer-facing employees, and it refers to employee behavior that takes place at the intersection of customer interest and organizational culture. When compensation strategy and culture are in harmony, incentive pay reflects a proper balance between corporate strategy and financial results, in which positive customer outcomes are the primary goal. When compensation and culture are poorly aligned, however, employees may begin to behave in risky ways to benefit themselves rather than put customers first.

Just as weeds crop up in cracks in the sidewalk, risky behaviors take root when there is a gap between a company's stated values and the rewards and penalties that flow from pursuing incentives. If the culture says ethics matter, but the reality is that sales quotas matter more, employees may struggle to balance personal interest and customer trust. If the message from management is "goal achievement is the top priority," employees may regard incentive pay as an exercise in the survival of the fittest and lose sight of the customer.

Of course, most companies want and need a high-performance culture, and incentive compensation is an established and effective tool that results-driven organizations can utilize. But a process of recalibrating sales targets and related incentive pay to achieve desired behaviors toward customers is clearly under way in highly regulated industries. To catch ethical lapses, fix flaws and cracks in incentive pay systems, and promote individual accountability, companies need to find the right tools and deploy them effectively.

For example, **sales performance management solutions** can play an important role in helping companies understand conduct risk in a n immediate and intuitive way so that they can manage risk before it reaches crisis levels. These solutions can be used to track performance and incentive results at various levels of the sales organization to quickly identify risk hot spots.

Meanwhile, **surveillance insight solutions** that use advanced technologies such as speech to text and natural language analysis to monitor employee-related activities can be used to examine structured and unstructured data, including emails, chat transcripts, voice recordings, customer complaints, and trade data. Surveillance can provide a leg up in detecting and reacting to risky behavior.

By harnessing appropriate solutions, companies can gain the insights to be effective at mitigating conduct risk and strengthening corporate culture, ethics, integrity, accountability, and compliance.

Fallout from banking scandals

The intensifying focus on conduct risk can be traced to a 2016 scandal in which a large U.S. bank's employees created 3.5 million unauthorized customer accounts.[1] The entire industry was shaken by the news that thousands of bank employees, under pressure to meet sales quotas and reap incentive pay, had secretly created deposit, checking, and credit card accounts without customers' knowledge.

When the behavior was uncovered, regulators intervened forcefully. The company paid fines totaling $185 million and suffered reputational damage; the CEO and other senior executives were forced out; and incentive pay was clawed back. The company was subsequently hit with a $1 billion fine for mishandling consumer home and auto loans and insurance fees. Regulators limited the bank's activities, and private litigation ensued. Regulators ratcheted up standards for sound risk management, ethical behavior and compliance. A company once considered a trailblazer in driving the profitability of customer relationships is paying the price for having taken the concept too far.[2]

Banks and other financial institutions felt the ripples of the customer-abuse scandal—notably in the form of a regulatory review of sales practices at dozens of large and midsized banks. Also, the U.S. Consumer Financial Protection Bureau quickly took aim at incentive compensation programs, saying that, "despite their potential benefits, incentive programs can pose risks to consumers, especially when they create an unrealistic culture of high-pressure targets." [3]

The customer-abuse scandal was clearly a tipping point toward increased regulatory focus on banks' conduct toward customers. However, concern that retail and business customers were not being treated fairly had been building throughout the financial crisis and in its immediate aftermath.

The U.S. Consumer Financial Protection Bureau opened its doors in 2010, a direct response to subprime lending abuses and the global financial crisis in the U.S. Between 2008 and 2013, U.S. banks paid billions of dollars in fines for misleading customers about the risks of subprime mortgage loans.[4] Meanwhile, trading and rate-setting scandals had rocked big banks around the globe. Starting in 2010, the UK took steps to split off conduct regulation from prudential regulation on grounds that banking regulators had failed to act in customers' best interests. The UK government created the Financial Conduct Authority in 2013 to protect the interests of consumers.[5]

This cascade of events added up to a growing desire for improvements in banking culture and accountability. By 2014, Barclays Bank Chairman Sir David Walker, a veteran financial regulator, was calling for standardized metrics to help quantify how individual employees lived up to organizational values.[6]

It was that same year that the term "conduct risk" gained traction. The Financial Stability Board, made up of the Group of 20's finance ministers, helped to establish the concept in 2014, when it published guidance describing the foundations of a sound risk culture. The guidance, designed to educate banks and their supervisors, identified "conduct risk control" as an element of effective risk governance.[7]

In Canada, the Office of the Superintendent of Financial Institutions and the Financial Consumer Agency of Canada are increasingly focusing on financial firms' processes for handling and responding to customer complaints as they prioritize compliance, conduct, and operational risks.[8]

A conversation about connection between incentive compensation, culture, and conduct is now well under way in the global banking system. Regulators are paying keen attention to how organizations ensure fair treatment of customers. There are also business imperatives at play: Fair treatment drives customer loyalty, which in turn can confer competitive advantages.

In Canada, spotlight on telcom sector

It is not only financial organizations that need to concern themselves with conduct risk, because the potential conflict between sales incentives and customer trust is not limited to fiduciary responsibilities. Any organization with a sales force has the potential to stumble – as well as the ability to strengthen its reputation by seeking ways to improve outcomes for customers. From finance and insurance companies to car manufacturers and technology vendors, attention to conduct risk is rising. In Canada, the impact has been most keenly felt by telecommunications firms.

Conduct risk came into sharp relief in Canada in late 2017, when the Canadian Broadcasting Corporation produced several investigative reports examining sales practice abuses among internet, television, and wireless providers.[9, 10]

Several companies were reported to be using high-pressure tactics to sell telecom customers unwanted products. Meanwhile, some employees complained of pressure to achieve sales targets by “upselling” customers. They described how rewards could be attained by offering customers more costly internet service options, failing to disclose how multi-year contracts work, and withholding information about promotional prices. Within months, consumer protection organizations and telecom consumers were calling for a public inquiry.[11]

Over time more than 200 past and present employees of telecom companies stepped forward to describe pressures to mislead customers in order to hit sales targets.[12] Canada’s federal government intervened on June 14, 2018, ordering an investigation.[13] The government directed the Canadian Radio- television and Telecommunications Commission (CRTC) to complete an investigation by February 28, 2019, and asked the CRTC to identify “feasible and effective ways to strengthen or expand the scope of existing consumer protections.”[14]

Were there early warning signals in Canada’s telecom industry, as there were in global banking? In fact, there were. Concern over customer mistreatment had been percolating since at least 2015. At the end of that year, Canada’s independent watchdog for telecommunications customers, issued a report on trends in complaints. The Commission for Complaints for Telecom–Television, had identified grievances about missing or misleading information in customer contracts as customers’ top concern for 2014-15.[15, 16]

Corporate culture

Regulators are paying keen attention to how organizations ensure fair treatment of customers. Efforts to mitigate conduct risk are getting serious focus from banking regulatory agencies in Australia, Canada, Hong Kong, the Netherlands, the UK, and the US. Business imperatives are also at play. Fair treatment drives customer loyalty, which in turn confers competitive advantages. A focus on corporate culture is a unifying element that runs through all these efforts.

While sales performance and related incentive pay can easily be measured; corporate culture by its very nature is an elusive quantity, both hard to define and constantly evolving. It is often outlined in motivational language in a company's code of conduct, and executives speak of it in inspiring tones. But in the end, employees color in the details of corporate culture through their actions.

Corporate culture matters because "you can't make rules to cover everything and you can't monitor everything that goes on, particularly in larger companies," said Julie L. Williams, managing director and director of the domestic advisory practice of Promontory, an IBM Company. "There are other things you have to rely on to keep things stable and operating with integrity." [18]

John C. Williams, president and CEO of the Federal Reserve Bank of New York, described the dilemma regulators and business practitioners' face when trying to instill and implement corporate culture.

"Often in finance there's a tendency to disregard what can't be quantified. But just because it's hard to measure doesn't mean we should ignore it or downplay its importance," he said in a June 18 speech.[19]

The power of Observation

In banking, telecommunications and other industries, improper incentives can backfire, harming customers, putting companies at high risk, and eroding trust and confidence. "The record from the crisis and more recent years shows just how powerful incentives can be in driving firms and individuals to do things that are imprudent and/or unethical," William C. Dudley, president and CEO of the Federal Reserve Bank of New York, has said.[20]

The ability to observe behavior carefully, using rich information, robust tools, and visualization technology, can be critical in helping companies understand how incentive pay is working in practice. Making data visual transforms it into information, and good information is the foundation of insight.

All IBM Sales Performance Management and Surveillance Insight tools can be customized to monitor individual and business units to ensure their adherence to culture and conduct standards. Clients can also work hand in hand with Promontory, an IBM Company, to develop risk profiles to complement the Sales Performance Management and Surveillance Insight tools, and to ensure that appropriate regulatory considerations have been integrated into all facets of managing sales incentives and performance.

IBM Sales Performance Management is a robust database tool that can provide companies with nuanced insights into their sales performance metrics and related variable compensation programs. Using comprehensive analytics, Sales Performance Management can be adapted to provide views that are tailored to the requirements of different team members, including compliance and risk management. Front-line workers can check in on their goals and bonuses; team leaders and regional managers can look across their entire rosters to look for outliers or overall patterns at any level of the organization that may be associated with risky behavior.

By looking for outliers, managers using Sales Performance Management can see if any employee is performing at unexpected levels or receiving outsized incentive payouts – and then dig deeper to understand why.

IBM Surveillance Insight for Financial Services searches for risky and noncompliant behavior as it monitors all employee-related activity – not just limited to the "known" sales team or to those receiving incentive pay. Surveillance Insight sweeps in information from emails, chat transcripts, voice recordings, customer complaints, and trade data. By taking a holistic approach to risk detection, Surveillance Insight is able to identify even sophisticated misconduct.

Promontory, an IBM Company, is a global leader in regulation, compliance, and risk management. Promontory's draws on deep experience in forensic reviews to work with companies to identify potential conduct issues through analysis of internal data. Even midsize banks face regulatory expectations to monitor potential misconduct using their existing data. For example, account opening data, compliances, and internal ethics reporting can be harnessed to identify potentially systemic issues. Banks of all sizes can benefit from broadly reviewing incentive compensation programs. Promontory is highly skilled in implementing appropriate schemes.

Conclusion

The corporate culture landscape is shifting, and the need to do the right thing for consumers is ascendant. In banking and telecommunications as well as other high-performance, sales-driven cultures, companies are refocusing on achieving fair, equitable, and positive outcomes for customers. Putting customer needs first while supporting the company's reputation and financial well-being is an important initiative, and it has significant implications for incentive pay.

Understanding how incentive pay is affecting and motivating employees is a critical step toward harnessing it for good. Intelligent tools that provide access to rich data can help companies catch problems early, fix flawed incentive pay schemes, and promote individual accountability.

Most critically, incentive pay must mesh with culture. Failure to recognize this is at the very heart of conduct risk. Variable pay works best when it is aligned with a real code of ethics – not a code that employees pay lip service to, but one that reflects organizational values, goals and aspirations. Conduct risk can be minimized if incentive pay and organizational goals are squarely aligned behind the idea that customers come first.

William C. Dudley, president and CEO of the Federal Reserve Bank of New York, had this to say about culture and conduct risk:

> " As I see it, an organization's culture gets into trouble when it equates "what is right" with what is legally permis- sible, and when "what is wrong" becomes viewed as what is legally impermissible. A proliferation of rules—followed by the gaming of these rules—can be ultimately self-defeating. The end result may not only be a loss of trust, but also over time a more burdensome regulatory regime than would otherwise be the case."[21]
>
> — William C. Dudley
> President and CEO of the Federal Reserve Bank of New York

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