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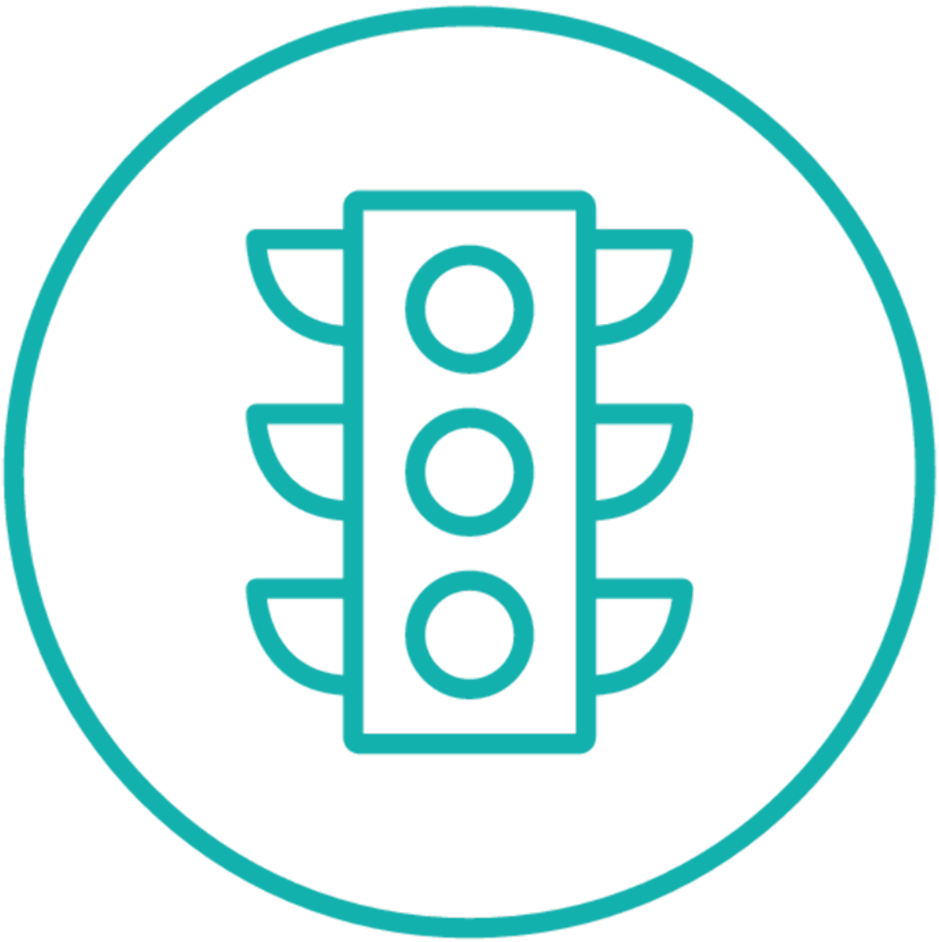

Steering toward responsible incentives

Getting incentive-based sales practices under control

CENTER *for* REGULATORY STRATEGY AMERICAS

Like other businesses, financial services organizations, such as banks, credit unions, investment advisers, and broker-dealers, rely on sales to boost profits. But focusing on achieving financial targets may foster the wrong behaviors. In response, regulatory agencies have sharpened their focus on banking sales practices that might lead to real or perceived misconduct where incentive compensation is concerned. Therefore, for banking sales, the time to act is now.

Regulators expect each organization to have an enterprise-wide framework to identify and manage abusive business practices. Such a framework doesn't replace the compliance and risk structures already in place, but it is a necessary complement to them.

A strong culture that promotes ethical behavior and conduct of employees can help prevent unfair, deceptive, or abusive practices. True risk management brings together all of an organization's human-, technology-, and analytics-based activities to form an "early warning system" that can find the seeds of trouble and keep them from taking root in the first place.

Built-in GPS: Conduct, culture, and ethics

The need to hit a revenue or sales volume target might create conflicts of interest for employees or the firm overall. Organizations need a clear view of the potential behaviors that could lead to misconduct. The first step is to have a clear conduct risk taxonomy. The second step is to proactively mitigate the identified risks. An organization can't control what it doesn't know. That's why it's important to be aware of risks that may have an impact on your organization. Anyone who has spent any time in a large, complex organization knows the grapevine usually outpaces the hotline.

Ethics are the values that guide the way people make judgment calls. Consider driving: People see "65 MPH" signs on the highway every day, even as many of them are doing at least 70 MPH. A long aggregation of individual experiences has given them a sense of what behaviors will or won't get them in trouble. Where rules present an incomplete safeguard, ethics can help buttress good behavior.

Documenting what good employee behaviors look like and logging customer complaints are among the baseline inputs to a system of ethical monitoring. Other factors may include pockets of anomalous activity, such as spikes in the customer complaints or calls to an internal hotline. That's why it's crucial to never discount the importance of hiring the right people in the first place.

Three lines, one mission: Governance and controls

Explicit rules and codes of conduct and ethics can help align incentive compensation sales behaviors with legal and ethical standards, and tone from the top is a necessary component. Recent industry activity tells us that top-down imposition of standards isn't enough. Organizations need to implement a robust governance structure and implement controls to mitigate conduct risk and reinforce culture.

> Incentive-based compensation is the gas pedal that powers sales performance. But have you checked your brakes?

The "three lines of defense" approach to the daily conduct of business doesn't emerge without hard work. Organizations typically struggle to operationalize key controls and the related oversight that each line of defense uses to identify, monitor, and mitigate risks. Appropriate delineation of roles and responsibilities on the governance, ownership, and execution of key controls is paramount.

The first line, the business units themselves, is accountable for risks inherent in day-to-day operations. What phone scripts are people using? How do call-in, call-out, and walk-in procedures vary? How are employees held accountable, and what kinds of behaviors are rewarded? What do employees consider to be normal levels of sales volume and velocity, and how do those achievements influence compensation?

Compliance policies and procedures originate predominantly within the second line of defense. But they succeed or fail on the front lines, where training supports sales practices with real examples of conflicts, ways to treat customers fairly, and paths for escalating concerns.

If detecting issues is the first duty of the first line, reacting to them is the next logical step. Some issues will begin and be resolved entirely within the first line. Some issues may be escalated to management or board committees. Others will carry over to the

A four-part framework: The first and second lines			
Governance policies, procedures, and controls	Risk assessment, quality assurance testing, and monitoring	Training and awareness	Escalation triggers, reporting, protocols, and pathways

risk management and compliance functions. This is one reason the interaction between first and second lines needs to be smooth; the organization can't afford the delay and disconnect of a siloed relationship.

The second line of defense, the risk management function, must build complementary oversight and execution activities to support whichever functions the first line is taking ownership of. Specifically, it should perform dedicated risk assessment activities and monitoring to identify activities that may be detrimental to consumers, then direct more targeted reviews where needed. For example, if a risk assessment is performed dynamically enough, it can identify the types of transactions an organization would want to monitor and assess, such as new deposit accounts opened and closed within a short duration, consumers with multiple deposit or savings accounts, or consumer accounts with the same address and different names.

The third line of defense, the internal audit function, serves as the board's eyes and ears into where risk resides and what the organization is doing to mitigate such risks. It provides independent assurance as to whether safeguards are functioning as designed in both the first and second lines. Internal audit typically has separate board committees designed to provide independent views on risk management. And it must include personnel who have the authority and the will to challenge business activities at every level.

Seeing down the road: Data and analytics

Talk of ethics and compliance is just talk without information to drive action. An organization's compliance data regime needs to extend far beyond minimal requirements. First, it should tap into relevant sources of data to catch any misconduct that's already taking place. In addition to legal, compliance, risk management, and human resources data, business and operational metrics will also be critical. Data collection must embrace seemingly innocuous and external sources, even news and social media. It should encompass lessons from peer organizations. And it should focus on patterns and outliers. If the introduction of a new business strategy doesn't include an evaluation of potential risks, the organization isn't reading the right clues.

The tools to operate this way are becoming more powerful and commonplace: Natural language processing, machine learning, and artificial intelligence can mine high-volume data in ways a manual system can't. Visualization and other interface technologies can help decision makers interpret and act on new indicators in time to make a difference. The right insight from the right set of data can warn of trouble months ahead of time. In the regulatory cycle, as well as the news cycle, sufficient warning time adds value beyond measure.

But technical, data-driven risk sensing also requires a human element. A person still has to assess: Is this an issue? Could it become one? Analytics can augment decision making—they don't replace it.

When analytics help identify the danger of actions that appear innocuous, that can also help prevent the slippery-slope progression which often leads people off a compliant path. People are less likely to "ratchet" incrementally away from expected norms of behavior when their early steps sound an alarm. So they're less likely to violate incentive compensation guidelines when robust standards and early-detection controls are in place.

Managing within the guardrails: Ethical and compliant business processes

Neither a regulator nor a customer nor an elected official will be satisfied with answers like, "Our monitoring program caught it, but our escalation protocols didn't bring it to leadership's attention," or "We knew it was against the rules, but no one had ever been punished for it before," or "Our cultural expectations are well-documented at headquarters, but no one here knew what was going on in the branches." To outside parties, your organization is a single entity. They will hold it guilty or not at fault the way they would an individual person.

That means all the internal distinctions, interactions, and procedures that add up to an organization's culture aren't their concern. They're yours.

Common techniques in compliance analytics

- Rules-based monitoring to identify known fraud behaviors and compliance risks
- Anomaly detection to recognize potential new fraud and compliance risks
- Network analysis to identify potentially worrisome collusive activity across entities
- Text analytics to mine and sense complaints data and documents for insights
- Visual analytics/dashboards to summarize actionable results for stakeholders

Each of the three pillars that can help an organization maintain ethical and compliant business practices—the appropriate conduct, culture, and ethics framework; the governance and controls to keep the organization in check; and technological use of data and analytics—feeds off and informs the other two. If you aren't sure how well they're connected, they're not connected well enough. If you can't declare right now that your organization is managing incentive compensation within the guardrails, you have work to do.

And the first thing you'll need is a good roadmap.

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