Public Consultation: Impact of Sales Incentives on the Sale of Consumer Credit Products

Response to Public Consultation received from Central Bank of Brazil

FinCoNet
INTERNATIONAL FINANCIAL CONSUMER PROTECTION ORGANISATION

Appendix 1 – List of Questions

This Appendix compiles the 'Necessary Pre-conditions of the Regulatory Framework' and the 'Guidance to Supervisors on the setting of standards in the field of Sales Incentives and Responsible Lending' and the questions asked on each, for ease of reference.

Necessary Pre-conditions of the Regulatory Framework

a. Having one or more oversight bodies that are explicitly responsible for consumer protection in relation to consumer credit (referred to in the Report as a 'primary regulator' though please note that the Guidance in this Consultation Paper focuses on the role of the supervisor);

b. The scope of the supervisor(s)' jurisdiction being comprehensive of the various sales channels that might be employed to sell credit; and

c. Affording the supervisor(s) with a range of appropriate supervisory and enforcement powers and the resources to exercise those powers.

1. Do you agree that a. to c. above are necessary pre-conditions of the overarching regulatory framework if supervisory initiatives are to be effective in the field of sales incentives and responsible lending?

   Yes.

2. Are there any other pre-conditions that you consider necessary for supervisory initiatives to be effective in the field of sales incentives and responsible lending?

   Taking into account that legal environments and institutional frameworks differ widely across countries, we would say the listed pre-conditions are already adequate.

3. Do you have any other comments related to these pre-conditions?

   The Central Bank of Brazil (BCB) does not license and directly supervise bank agents ("correspondentes no país"). However, Resolution CMN 3,954 of February 24, 2011, states that financial institutions must ensure that their agents comply with laws and regulations, including as it comes to adequate client treatment and integrity, reliability and secrecy of transactions. Thus, supervisory actions are aimed at evaluating the adequacy of the controls implemented by the institutions to ensure compliance.

A. Guidance on Appropriate Oversight

Supervisors should include in their approach to responsible lending the assessment of whether sales incentives encourage lending practices that are not in the best interests of the individual consumer or consumers generally.

This should include the oversight of:

- all types of consumer credit products and sales channels within the supervisor's remit;
- incentives to staff and credit intermediaries who sell consumer credit products; and
- incentives offered to consumers to promote a credit product or otherwise incentivise a consumer to borrow.

4. Do you agree with this Guidance on Appropriate Oversight?

   Yes.

5. If you do not agree with this Guidance on Appropriate Oversight, please identify the specific aspects you do not agree with and explain why.

   There are no comments.

6. What challenges and opportunities do you consider relevant for the implementation of this Guidance on Appropriate Oversight? We welcome in particular information based on your experience or examples.

   A challenge for supervisors is to detect sales incentives that are applied, but are not provided or clearly expressed in financial institutions´ policies.

   The adoption of the proposed approach can result in reducing over indebtedness of credit borrowers.

7. Do you have any other comments related to this Guidance on Appropriate Oversight?

   The Supervision Manual of the Central Bank of Brazil provides procedures for assessing the management of sales incentives, including means of performance evaluation and compensation of employees, as well as controls and preventive/corrective actions carried out in cases of misconduct by employees.

B. <u>Guidance on Cross Selling</u>

Supervisors' oversight should seek to ensure that sales incentive schemes do not encourage the cross-selling of credit products without a proper consideration for the needs of the consumer.

8. Do you agree with this Guidance on Cross Selling?

   Yes.

9. If you do not agree with this Guidance on Cross Selling, please identify the specific aspects you do not agree with and explain why.

   There are no comments.

10. What challenges and opportunities do you consider relevant for the implementation of this Guidance on Cross Selling? We welcome in particular information based on your experience or examples.

    A challenge for supervisors is to detect cross-selling and to differentiate it from forced cross-selling ("venda casada"), which, in the case of financial institutions, is the practice of offering a particular service only on condition that the customer buys some other service(s).

11. Do you have any other comments related to this Guidance on Cross Selling?

    Law 8,078 of September 11, 1990, known as the Consumer Defense Code - CDC states that consumer protection in Brazil is under responsibility of the National Consumer Defense System (SNDC). One of the articles of this Law refers to cross selling.
    The National Bureau of Consumer Protection (SENACON), coordinator of the SNDC, is responsible for receiving, analyzing, evaluating and examining complaints to the CDC presented either by representative entities, legal person of public or private law or individual consumers as well as apply the penalties enumerated in the CDC.
    The CDC explicitly classifies compulsory cross-selling as a misconduct.

    Although the BCB has no legal mandate to deal with this issue specifically, the Supervision of Conduct:

    - reports to SENACON instances of violations of the CDC by financial institutions;

- checks whether selling practices complies with Resolution CMN 3.694, with forbids the offer of services which are not suitable to the needs of the clients ; and
- emphasizes, in moral suasion meetings, that the adoption of this practice raises their exposure to legal risk and image risk.

C. Guidance on Consumer-focused Culture

Supervisors' oversight should take into consideration the role that sales incentives play in setting the culture within firms providing or distributing credit products.

This should include the oversight of:

- variable remuneration arrangements which can encourage sales staff and credit intermediaries to focus on the achievement of sales volume at the expense of consumers' best interests; and
- the extent to which incentive arrangements which are poorly designed from the perspective of protecting the best interests of consumers can act as an obstacle to other consumer protection measures, such as advisory or disclosure requirements.

12. Do you agree with this Guidance on Consumer-focused Culture?

    Yes.

13. If you do not agree with this Guidance on Consumer-focused Culture, please identify the specific aspects you do not agree with and explain why.

    There are no comments.

14. What challenges and opportunities do you consider relevant for the implementation of this Guidance on Consumer-focused Culture? We welcome in particular information based on your experience or examples

    We have noticed that an increasing number of institutions are considering, when evaluating performance of its employees and agents, indicators regarding quality of sales such as:

    - Amount of loans canceled in relation to those granted in a given period;
    - Amount of services canceled in relation to services sold in a given period;
    - Amount of complaints received by the Ombudsman and other complaint channels.

    Besides, some institutions have begun to monitor the cancellation of certain products by clients so that this product will not be offered again to the client for a certain period of time.

15. Do you have any other comments related to this Guidance on Consumer-focused Culture?

    Besides variable remuneration, supervisors should consider:

    (i) the non-financial sales incentives defined by institutions such as acknowledgement by managers and colleagues, and
    (ii) the follow-up practices of cases of misconduct.

    Although there is no specific legislation on this subject, **Consequence Management** is demanded from financial institutions through moral suasion meetings. The rationale behind is that administrative measures must be taken by the institution whenever misconduct is identified.

D. Guidance on General Duties and Specific Responsibilities:

Supervisors' oversight of responsible lending should include both general obligations on the firm to act in the best interests of the consumer and more detailed requirements on sales incentives.

The following are examples of the types of restrictions that could be placed on sales incentives:

- banning the payment of specific types of incentives where the risks arising from the incentive cannot be managed in a manner that protects the best interests of consumers;
- placing limits or other restrictions on the types of incentives that can be granted;
- limiting the variable component of an individual's remuneration (e.g. as a proportion of total remuneration); and
- requiring that incentives be disclosed to the consumer.

16. Do you agree with this Guidance on General Duties and Specific Responsibilities?

    Partially

17. If you do not agree with this Guidance on General Duties and Specific Responsibilities, please identify the specific aspects you do not agree with and explain why.

    Instead of placing limits or other restrictions on specific incentives (restrictions which can be circumvented), requiring appropriate corporate governance on those incentives would be more effective. In addition to this, any incentive must be connected to Consequence Management.

18. What challenges and opportunities do you consider relevant for the implementation of this Guidance on General Duties and Specific Responsibilities? We welcome in particular information based on your experience or examples.

    Resolution 3,921 of November 25, 2010, which rules about compensation of FI managers, applies only to executive officers and members of the Board of Directors. Despite this limitation, Supervision:

    • checks whether the variable remuneration of employees takes into account the number of complaints and other aspects of conduct; and

    • encourages institutions, through moral suasion meetings, to consider these aspects in both calculation of variable remuneration and career development of its employees.

19. Do you have any other comments related to this Guidance on General Duties and Specific Responsibilities?

    There are no comments.

E. <u>Guidance on Oversight of Different Sales Networks</u>

The sales incentives of all those involved in the selling of credit products, from front line sales staff involved in direct sales to credit intermediaries, should be subject to appropriate standards and supervision.

The standards set and the approach to their supervision should:

- apply consistently across the channels through which a given credit product is sold; and
- include, as well as sales staff and credit intermediaries (and their practices), the overall architecture of a given sales network. This should include taking into consideration:

• the propensity for a practice restricted or prohibited in one area to migrate to another; and

• the importance of non-sales functions and management practices to the effective operation of controls in this area (as set out further below in Guidance G. on Monitoring).

20. Do you agree with this Guidance on Oversight of Different Sales Networks?

    Yes.

21. If you do not agree with this Guidance on Oversight of Different Sales Networks, please identify the specific aspects you do not agree with and explain why.

    There are no comments.

22. What challenges and opportunities do you consider relevant for the implementation of this Guidance on Oversight of Different Sales Networks? We welcome in particular information based on your experience or examples.

    The BCB regulation on sales networks states that agents are the only third party channel financial institutions can use for sales.

    Resolution 3,954 of February 24, 2011, provides that bank agents act on behalf and under the guidelines of the contracting FI, which takes full responsibility for the services provided to customers and users by the contractor. In addition to this, it ensures integrity, reliability, security and confidentiality of transactions carried out by the contractor and also compliance with legislation and regulations relating to those transactions.

    Furthermore, this resolution provides that the contracting institution must adjust internal control systems and internal audit in order to monitor customer services activities through agents and establish a plan of quality control, taking into account among other factors, demands and complaints of customers and users.

    Thus, Supervision assesses: (i) adequacy of controls of institutions on its agents; (ii) whether it is based on complaints of customers and users, (iii) the quality control plan that the institution adopts, (iv) penalties applied by the institution in case of misconduct.

23. Do you have any other comments related to this Guidance on Oversight of Different Sales Networks?

    All sales channels should be regulated and supervised in the same way to prevent regulatory arbitrage in this respect.

F. <u>Guidance on Oversight and Governance</u>

Supervisors' oversight of product oversight and governance of credit products should include an assessment of incentives comprised in credit products.

This should include the oversight of:

- the role, if any, that incentive arrangements play in how credit products are designed;
- the relationship between incentives and how consumers are targeted;
- the relationship between the scale of the target market and volume of sales rewarded by the incentive scheme; and
- the scope and strength of firms' product oversight and governance arrangements.

24. Do you agree with this Guidance on Oversight and Governance?

    Yes.

25. If you do not agree with this Guidance on Oversight and Governance, please identify the specific aspects you do not agree with and explain why.

There are no comments.

26. What challenges and opportunities do you consider relevant for the implementation of this Guidance on Oversight and Governance? We welcome in particular information based on your experience or examples.

Assessing corporate governance in the context of different kinds of institutions and apply the requirements on a proportionate basis is challenging. Even when the institutions are similar in terms of activities and size, governance structures and institutional culture have to be taken into account.

27. Do you have any other comments related to this Guidance on Oversight and Governance?

To be effective, governance should involve senior management and should establish guidelines for sales incentives. Implementation of effective internal controls is also a way to ensure governance in credit products.

Supervisory actions are mainly based on Resolution 3,694 of March 26, 2009 and Resolution 4,433 of July 23, 2015.

Resolution 3,694 of March 26, 2009, regulates sales of products and provision of services by institutions authorized to operate by the BCB and states that institutions must assure: (1) Adequacy of products and services offered or recommended to the needs, interests and objectives of clients and users (suitability), and (2) Provide all the necessary information which could lead to free choice and decision making to customers, including explicit rights, obligations, costs and penalties (transparency).

Resolution 4,433 of July 23, 2015, provides about establishment of the Ombudsman by financial institutions, which, besides being the ultimate channel for customers and users, the Ombudsman should seek solution to the matters.

Thus, Supervision assesses corporate governance in relation to the process of management customers and users demands of financial products and services sold through all service channels of financial institution, with regard to its quality, effectiveness and compliance with current regulations, as well as solving matters, including the root-cause of the problem.

G. <u>Guidance on Monitoring</u>

Supervisors' oversight should include an assessment of firms' arrangements for monitoring the operation of incentives within their firm.

This oversight should include consideration of the following:

- ensuring that firms have measures and procedures in place to adequately and effectively monitor the implementation of incentive schemes so as to avoid poor outcomes for consumers;
- that the governance structure includes appropriate alert systems within the firm to detect high risk situations as they emerge and address them appropriately;
- that financial and non-financial reward arrangements and practices include qualitative metrics by which staff are rewarded, such as quality of service, complaints analysis or loan performance over a period of time;
- that there is proper support and priority for control functions whose input goes towards any qualitative scoring affecting staff incentives. This should include having reward arrangements for staff in control functions that are sufficiently independent of the arrangements for sales staff and credit intermediaries to secure the independence of these control functions; and

– that firms periodically review the efficacy of their policies and procedures in this regard.

28. Do you agree with this Guidance on Monitoring?

    Yes.

29. If you do not agree with this Guidance on Monitoring, please identify the specific aspects you do not agree with and explain why.

    There are no comments.

30. What challenges and opportunities do you consider relevant for the implementation of this Guidance on Monitoring? We welcome in particular information based on your experience or examples.

    It is part of the general governance arrangements and the challenge is to encourage specific focus on these issues by the board and senior management.

31. Do you have any other comments related to this Guidance on Monitoring?

    According to Resolution 2,554 of September 29, 1998, the institutions licensed by the BCB should have internal controls focused on activities developed by them and compliance with laws and regulations applicable to them.

    Thus, institutions must identify internal and external factors that may adversely affect the achievement of the objectives of the institution and monitor these activities, so that it can evaluate whether the institution's objectives are being achieved. Internal audit is part of the internal control system of the institution.

H. Guidance on Disclosure

Disclosure to consumers of incentives received by a salesperson can be beneficial for the protection of consumers' best interests. These benefits include promoting education and a healthy level of skepticism and self-reliance which may encourage consumers to take extra measures such as shopping around or seeking a second opinion.

The approach of supervisors to disclosure as a protection for consumers should take into account:

– that it should always be seen as complementary to (and not a substitute for) the other tools to mitigate poorly designed incentive arrangements, such as those listed in the other FinCoNet Guidance to Supervisors on the setting of Standards in the field of Sales Incentives and Responsible Lending;

– the propensity for disclosure to have perverse behavioural effects such as inappropriately increasing the level of trust a consumer places in the salesperson, and giving the salesperson a sense of moral licence (having disclosed their conflict) to disregard their duty to continue acting in the best interest of the consumer; and

– the need for it to provide a meaningful opportunity for the consumer to understand, interrogate and challenge the incentive arrangement disclosed.

32. Do you agree with this Guidance on Disclosure?

    Partially.

33. If you do not agree with this Guidance on Disclosure, please identify the specific aspects you do not agree with and explain why.

Financial products and firm practices are often opaque in spite of disclosure requirements, and cognitive biases on the part of consumers can also constitute a substantial barrier to a considered, informed decision. There are other ways in which firm incentives can be managed (governance, monitoring, internal controls, moral suasion meetings) that the BCB considers more effective than disclosure.

34. What challenges and opportunities do you consider relevant for the implementation of this Guidance on Disclosure? We welcome in particular information based on your experience or examples.

    The requirements or encouragement to institutions consider different aspects, including misconduct, and sales incentives may be quite complex, which make it hard to explain to the public. In this context, their disclosure might lead to confusion and misunderstanding.

35. Do you have any other comments related to this Guidance on Disclosure?

    In Brazil there is no specific regulation on disclosure of sales incentives to the general public.

I. <u>Guidance on Promotional Incentives to Consumers</u>

Supervisors' oversight should include consideration of the benefit of promotional incentives offered to consumers versus the cost of the credit product.

This oversight should consider:

- whether the benefit is significantly outweighed by the cost of the credit;
- whether specific disclosures or warnings are required for misleading incentives; and
- when to prohibit or restrict this practice on the grounds that the apparent benefit of the promotional incentive is in fact illusory.

36. Do you agree with this Guidance on Promotional Incentives to Consumers?

    Yes.

37. If you do not agree with this Guidance on Promotional Incentives to Consumers, please identify the specific aspects you do not agree with and explain why.

    There are no comments.

38. What challenges and opportunities do you consider relevant for the implementation of this Guidance on Promotional Incentives to Consumers? We welcome in particular information based on your experience or examples.

    Promotional incentives are part of the issue of suitability, so supervisors face the same challenges related to identifying whether or not they suit the consumer's needs and are aligned with their best interest.

39. Do you have any other comments related to this Guidance on Promotional Incentives to Consumers?

    There are no comments.