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MARCH 29, 2017

CFPB Focuses on Incentive-Based Compensation Programs

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Incentive-based compensation programs have long been a focus of banking regulators, but recent actions suggest that the issue is back at the top of the regulatory watch list. Specifically, action by the Consumer Financial Protection Bureau (CFPB) has made clear that in the minds of the regulators, misaligned incentives and weak compliance controls can result in significant harm to consumers and to the reputation of the responsible institution.

Incentive-Based Compensation Is on the Agenda

In recent months, the CFPB has repeatedly highlighted incentive-based compensation programs as a topic of scrutiny by the agency. In November 2016, the agency issued CFPB Compliance Bulletin 2016-3, "Detecting and Preventing Consumer Harm from Production Incentives," which emphasized the risks associated with incentive-based compensation models in sales programs. After the bulletin's issuance, Director Richard Cordray raised specific concerns about collection activities in a January 12, 2017, speech at a CFPB Debt Collection event: "Most debt collectors are compensated based on how much they collect, which can create the kind of serious incentive problems that we have noted elsewhere in the financial marketplace." One week after the Debt Collection event, the issue was highlighted again in a CFPB lawsuit filed against a large student loan servicer and in a CFPB overdraft "opt-in" settlement with a bank whose employee performance goals were linked to "opt-in rates."

For an agency that issues very few compliance bulletins (only three were issued in 2016), the CFPB intended to send a very strong message to regulated institutions. This incentive-based compensation issue will be examined regularly. If your employee compensation programs are based on monetary incentives tied to productivity, or even if your service providers have such models, the CFPB is going to take a *very* close look at the consumer experience in its examination and enforcement interactions.

Potential Risks of Incentive-Based Compensation Programs

The CFPB bulletin notes that incentive programs can pose risks to consumers if they "create an unrealistic culture of high-pressure targets." The agency points to several situations that may generate problems in this area:

- Setting sales goals for employees that measure their productivity in opening new accounts or enrolling consumers in additional services, which could influence unauthorized enrollment or deceptive marketing.
- Compensating employees or service providers based on "the terms or conditions of transactions (such as interest rate)," which could encourage overcharging, selling customers less-favorable products or selling them more than they need.
- Compensating employees or service providers at a higher rate for certain types of transactions, which could result in steering consumers into products that are not in their best interest.

The examples provided in the bulletin are fairly broad, which may make it difficult for institutions to gauge the risk associated with their particular compensation programs. Further, the bulletin notes that agency considerations of compensation programs will be specific to the facts and circumstances of a particular situation.

CFPB Action to Date

As the CFPB noted in the bulletin, incentive-based compensation programs "have been common across many economic sectors, including the market for consumer financial products and services." Accordingly, the concerns highlighted in the CFPB bulletin translate to almost all consumer-facing financial products, making it difficult for institutions to know where to start.

In the bulletin, the CFPB notes several industries where it has already brought enforcement actions. Specifically, it made reference to its "credit card add-on matters" that were brought in the early days of the agency's public enforcement work. It also mentioned "opt-in" products, which may have similar compensation programs to the add-on products. A couple of months after issuing the bulletin, the CFPB settled a matter related to a financial institution's overdraft opt-in products. Additionally, in the ongoing lawsuit filed in federal court against the nation's largest student loan servicer, the CFPB alleges that the servicer's compensation policies "incentivized" customer service representatives to steer borrowers into forbearance when other, lower-cost, long-term options were available. And based on recent event remarks by the director, it seems these issues are also being scrutinized in collections reviews. In sum, the agency is looking at all incentive-based compensation programs, regardless of the product or service offered.

Other Financial Regulators

In April 2016, following up on an April 2011 initial proposal, a number of financial regulators, including the Office of the Comptroller of Currency (OCC), Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Securities and Exchange Commission and Federal Housing Finance Agency, issued a proposed rulemaking on incentive-based compensation arrangements. This proposal provides guidelines for how incentive-based compensation practices should work in financial institutions with $1 billion or more in assets. While this proposal focuses more on high-level employees with a fair amount of influence within an institution, the themes are consistent with the CFPB bulletin, focused on eliminating high-risk compensation models and establishing robust monitoring and governance practices.

Incentive-based compensation programs in mortgage lending have been under scrutiny for quite some time in the wake of the financial crisis. One of the first rulemaking actions taken by the CFPB was the issuance of its Loan Originator Compensation Rule. Recent False Claims Act matters brought by the Department of Justice regarding alleged violations of the Federal Housing Administration restrictions for commission-style compensation in mortgage underwriting suggest that the issue is still a top priority. While the focus on incentive-based compensation seems to have started with the mortgage lending industry, these federal actions indicate that regulators are now looking at it in a much broader context.

The CFPB's Expectations

The CFPB bulletin does not preclude institutions from using incentive-based compensation programs, but it does set some fairly strict expectations about how the programs should be structured and monitored. In addition to developing an overall strong compliance management system (CMS), the CFPB mentions seven ways an institution can best manage these potential issues:

1. **Management Oversight and Institutional Culture:** Boards and management should consider any unintended consequences of these programs that could result in consumer harm and provide adequate resources dedicated to CMS monitoring. Further, institutions should exhibit a "tone from the top" of compliance in this area, with open channels for employees to report incidents of noncompliance.

2. **Policies and Procedures:** Set transparent sales/collections quotas for employees and clear controls for managing the risk at each stage of product life (sales, servicing, collections). There should be mechanisms in place to identify potential conflicts of interest for supervisors who have compensation incentives but are also responsible for monitoring customer service.

3. **Training:** Require comprehensive training on ethical behavior, primary risk areas, terms and conditions of products offered, and regulatory and business requirements for maintaining evidence of consumer consent.

4. **Monitoring:** Design compliance monitoring programs that are capable of identifying when potential improper behavior is occurring with either employees or service providers.

5. **Corrective Action:** Promptly correct any incentive issues by identifying and resolving the root cause and escalating to executive management.

6. **Consumer Complaint Management Program:** Collect and analyze complaints for any indication that incentives are leading to legal violations or consumer harm and address any issues immediately.

7. **Independent Compliance Audit:** Routinely schedule audits focused on programs with incentive-based compensation to ensure that issues are proactively identified and dealt with.

Those experienced with CFPB exams know that having a strong CMS in place goes a long way.

Monitoring Service Providers

In several places in the bulletin, the CFPB notes that the expectations are applicable to institutions and their service providers. Pursuant to CFPB Compliance Bulletin 2016-02, "the mere fact that a supervised bank or nonbank enters into a business relationship with a service provider does not absolve the supervised bank or nonbank of responsibility for complying with Federal consumer financial law to avoid consumer harm." Both the OCC and Federal Reserve Board have recently issued similar guidance. This is significant, because certain activities that could be at risk for misaligned interests, like collections, are often outsourced. Institutions will be well-served to invest in the up-front due diligence work to ensure that the relationship they have with their service provider is one that will not create additional legal risk.

CFPB Supervision and Enforcement Outlook for 2017–2018

Institutions should expect incentive-based compensation programs to be a focus of examination work in 2017–2018, especially if there are a lot of complaints around a particular product or service. Indeed, customer complaints are at the heart of the agency's examination and enforcement work. If you, or your service provider, is offering a compensation incentive to its first-line employees based on sales/collections or anything similar, be sure to review the program with the strictest scrutiny to ensure there are no unintended consequences. Customer complaints should be reviewed as in the ordinary course of business, but should be given extra attention if they are related to products sold or funds collected by employees with incentive-based compensation.

There can be a place for incentive-based compensation programs in the future. But to pass regulatory scrutiny, any such programs must be organized, managed, questioned and audited by people with the authority to act and to avoid misalignments.

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