



HONG KONG MONETARY AUTHORITY
香港金融管理局



FINAL REPORT

Focused Review on Incentive Systems of Front Offices
in Retail Banks

May 2022

Kiel Advisory Group

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FOREWORD

Sound bank culture is underpinned by an appropriate incentive system that induces desired behaviours at all levels. This is why we have been encouraging banks to focus on incentive systems as one of the three fundamental pillars in their culture efforts. Since the HKMA initiated the Bank Culture Reform in 2017, we have been working with banks to launch and review the progress of various culture initiatives. Overall, it is encouraging to see the intensive attention and efforts that have been made by banks on the culture fronts in the past few years. Notwithstanding the good progress made, culture reform remains an unfinished task and efforts need to continue.

Against this backdrop, we have taken an important leap, with the support of an external consultant, to commence a Focused Review on the incentive systems of front offices in 20 retail banks in March 2021. This is a very large scale industry-wide culture exercise ever conducted in the Hong Kong banking and financial industry, and is also the first of its kind to hear the inner voice of the front office staff who meet with bank customers on a daily basis. Various activities have been undertaken during the course of the review, including the first-ever industry-wide employee survey encompassing all frontline staff of the participating retail banks, focus group discussions, individual interviews as well as document reviews, in order to gauge perceptions of these staff on their banks' incentive systems and culture, as well as customer and conduct outcomes. By doing so, we have been able to get a better picture on how incentive systems are implemented, and shape the perception and hence behaviour of frontline staff in reality, and whether some incentive practices are, or are not, working as intended on the ground.

Building on the interim insights shared with the industry in November 2021, we are pleased to see that the review now bears fruit with insightful results. This Final Report of the review highlights four key observations, reflecting the major common challenges in relation to incentive systems of front offices. Riding on these key observations, the review has identified six guiding principles of incentive design for reinforcing good customer and conduct outcomes, including:

- (i) Clear prioritisation of customer outcomes;
- (ii) Development of an aligned system;
- (iii) Focusing on intrinsic motivators;
- (iv) Wise use of technology;
- (v) Close connection between leaders and staff; and
- (vi) Minimising potential misconduct and mis-selling behaviours.

The review has also identified 17 sound incentive practices implemented by banks which reflect the above six guiding principles and help address the various challenges in relation to the incentive systems of front offices.

We trust that this Final Report provides meaningful and valuable inputs to banks for their continuous culture enhancement efforts. We encourage banks to make reference to the observations of the review, and consider the six incentive design principles and the sound industry practices identified when designing their own incentive systems, taking into account their positioning in the industry as well as their desired culture, values, and behavioural standards. We also encourage banks to continue their culture efforts in tandem with their initiatives on incentive systems in reinforcing good customer and conduct outcomes.

We would like to express our gratitude to the 20 retail banks and their staff for their active participation in and full support to this important culture initiative. We trust that the completion of this review has set another important milestone in our bank culture reform journey, and will bring bank culture development in Hong Kong to new heights. Looking ahead, we will work with the industry closely in continuing their investment in culture efforts so that we can safeguard good and sustainable customer and conduct outcomes.

Arthur Yuen

Deputy Chief Executive

Hong Kong Monetary Authority

EXECUTIVE SUMMARY

As part of the ongoing effort to promote sound culture in the banking sector, the Hong Kong Monetary Authority (HKMA) conducted a Focused Review on the incentive systems of front offices in the sale and distribution of banking, investment, and insurance products of 20 retail banks (hereafter referred to as the 'Focused Review'). With a view to identifying industry-wide insights and incentive practices, and to aim for better alignment of bank staff's incentive systems with customer's interests, the Focused Review explored a number of areas of incentive systems of front offices, including how incentive systems are designed and implemented, what effect the incentive systems have on behaviour and cultural norms in front offices, and ultimately the types of incentives and related behaviour that may minimise potential misconduct and mis-selling practices.

This report provides the findings of the Focused Review undertaken by the Banking Conduct Department of the HKMA with the support of an external consultant, Kiel Advisory Group. It includes a range of observations and insights on common incentive practices noted across the industry and highlights the type of practices more commonly associated with better perceived customer and conduct outcomes. The review identifies six principles that banks are encouraged to consider when designing their incentive systems, with an aim to reinforce sound behaviour and minimise any potential misconduct and mis-selling behaviours. It also provides a range of sound practices that reflect these principles for sharing and reference by the industry.

This review collected a comprehensive set of information about incentive systems of front offices in retail banks, including financial and non-financial incentives that influence the behaviour of frontline staff across the industry. To understand the effect of incentives on staff behaviour and motivation, the review conducted an industry-wide staff survey; focus groups and interviews with staff of the 20 retail banks to gather their perspectives on the incentives they are rewarded with, their behaviour in response to incentives, and their perceptions of customer interactions and outcomes at their bank; as well as document reviews in relation to incentive systems of front offices covering various characteristics of incentive systems including the types of financial and non-financial incentives, performance assessment, application of rewards, and consequences for poor outcomes.

Importantly, as discussed in Section I of the report, the review highlighted that staff in some banks perceived better customer and conduct outcomes than others, and that those with better perceived outcomes displayed certain characteristics in relation to their incentive systems. Specifically, better perceived outcomes were more often observed in banks with more customer-oriented incentives, less focus on achievement of financial targets, and more emphasis on bank culture and values.

To explain these differences in incentives and outcomes in more detail, Section II of the report describes four common challenges the review observed in banks in relation to the way incentive systems drive frontline behaviour and customer outcomes.

- A. Understanding customer outcomes.** Incentive systems may not fully reflect 'good customer outcomes'. Specifically, frontline staff often understand good customer outcomes to be customer satisfaction. While customer satisfaction may be a component of a good outcome, others such as providing information that helps customers to make decisions and products that meet the customer's needs were less prominent. Performance metrics for frontline staff often reflected the focus on customer satisfaction.
- B. Aligning staff behaviour.** Some common incentive practices may unintentionally push staff to prioritise business objectives over customer outcomes. Incentive schemes, performance criteria and calculations often reward frontline staff for their financial performance more than their non-financial performance. In certain banks cultures, social factors also contribute to a focus on revenue and sales through status associated with financial performance achievements and pressure from managers to meet business targets.
- C. Motivating frontline staff.** Currently, incentive systems in many banks generally emphasise financial incentives, but in fact, other types of rewards may also be effective at motivating good customer outcomes. In particular, many staff appreciate non-financial rewards such as recognition from supervisors and satisfaction in serving customers, but these non-financial elements are less featured in incentive systems. Banks can also influence the conduct of frontline staff through rewards and penalties, however, the review found that penalties for poor conduct are far more prevalent than rewards for good conduct. When examining the overall incentives provided to staff, the review found limited differentiation in rewards based on non-financial performance which in turn limits how much non-financial performance encourages staff to deliver good customer outcomes.
- D. Effective influence of systems.** Some factors may impact the effectiveness of incentives designed to reinforce a focus on good customer outcomes. Even when incentive systems encourage good customer outcomes, banks need to be aware of possible conflicting objectives perceived by frontline staff, for example for sales and revenue. Some banks have taken steps to explore and adopt technology such as Regtech solutions in an effort to help the bank manage conduct priorities more efficiently and effectively. Frontline staff also tend to perceive rewards for good customer outcomes as less transparent and less consistent. Furthermore, banks that address these factors may still find that shifting the behaviours of frontline staff to improve customer outcomes takes time.

Although these challenges and the practices contributing to them were relatively common across the industry, the review also observed a range of sound industry practices. These practices may provide important information about the design of sound incentive systems. Section III of the report outlines six guiding principles for incentive design to reinforce good customer and conduct outcomes for banks to consider when seeking to address common challenges shared by the industry.

The principles include: (1) clearly prioritising good customer outcomes; (2) developing an aligned system of customer-focused incentives and cultural practices; (3) leveraging non-financial rewards and the intrinsic motivations of staff; (4) using technology wisely to overcome implementation risks and challenges; (5) connecting staff and leaders for better oversight, feedback and assessment; and (6) minimising the chances of misconduct and mis-selling behaviours occurring. To illustrate these principles and provide a reference for banks seeking to apply them to their own incentive systems design, Section III also includes a range of sound incentive practices the review observed across industry.

Culture is set and owned by banks, underpinned by appropriate incentive systems that induce desired behaviours at all levels. Banks are encouraged to make reference to the industry themes and observations identified in this review and consider the six principles to reinforce good customer and conduct outcomes which could form the basis of design of incentive systems that may address the common challenges shared by the industry. The individual practices shared in this final report may not always be suitable or effective for every bank. However, banks may consider whether each of the practices is suitable and effective when designing and adopting in their own incentive systems, taking into account their positioning in the industry as well as their desired culture, values and behavioural standards. Further, it is also clear from this review that banks are encouraged to continue their efforts in promoting a sound bank culture, given the integral role it plays alongside sound incentive systems, in reinforcing good customer and conduct outcomes.

GLOSSARY OF TERMS

TERM	DEFINITION
Accelerator	A variable remuneration arrangement whereby a higher rate of reward is earned with higher levels of staff performance (e.g., a higher percentage of commissions after a sales target or tier is achieved).
Business/financial outcomes	Any outcomes that deliver profit to the bank, such as revenue from the sale of products and provision of services, cross-sales, and referrals.
Business/financial targets	Business objectives set by the bank, relating to the sale of products and provision of services, cross-sales, and referrals.
Customer and conduct outcomes	Generally, customer and conduct outcomes are practices that impact the treatment of customers. • Good outcomes: business practices that ensure that customers receive fair treatment and fair outcomes. • Poor outcomes: business practices that do not ensure that customers receive fair treatment and fair outcomes, such as misconduct and mis-selling.
Fixed remuneration	The guaranteed level of monetary reward paid to staff, typically comprising base salary and fixed allowances.
Incentive systems	Formal and informal structures used by banks to motivate and shape behaviour (e.g., performance management, remuneration).
Intrinsic motivation	A person's drive to engage in an activity because it is inherently satisfying (e.g., enjoyment from providing helpful advice to customers).
Multiplier	A method of assigning additional weight to a performance factor (e.g., revenue) by multiplying it in the calculation of an overall performance rating or variable incentive amount.
Net promoter score	A metric typically in the form a single survey question asking customers to rate the likelihood that they would recommend a company, product, or service to a friend or family member.
Variable remuneration	The level of monetary reward paid to eligible staff, and may include periodic discretionary bonuses and performance-based incentives such as sales commissions.



| INTRODUCTION

BACKGROUND

Incentives are a critical driver of human behaviour. In the financial sector, incentives are a highly visible feature of the environment. Banks are rewarded for achieving positive outcomes for their customers, shareholders, employees, and other stakeholders. There are also disincentives (penalties or consequences) that motivate banks to avoid adverse outcomes. At a basic level, banks tend to pursue objectives they are rewarded for, and avoid activities that might lead to negative consequences.

To achieve good bank-level performance, banks generally develop strategies for motivating staff to apply their skill and energy in support of the bank's objectives. The types of things that motivate staff are varied. Some sources of motivation are outside the direct control of banks (e.g., the degree to which an individual is intrinsically motivated by status or achievement). However, there are many rewards that banks can offer to help motivate their staff. These rewards can be tangible, such as fixed remuneration for meeting role requirements, or bonuses for meeting specific targets. They can also be intangible, such as pride in solving a customer's problem or praise from a supervisor for meeting development goals. As with banks, incentives can also function to discourage individuals from undesirable behaviour (disincentives). Having a bonus reduced due to compliance breaches is an example of a disincentive.

Although the basic concept of rewards and penalties is reasonably straightforward, in practice, there are many details and choices involved in operationalising incentives. A few choices that banks face include: What types and mix of incentives should they offer? How should good

performance be defined? What level of reward should apply for different levels of performance? What kinds of disincentives should a bank apply? How should incentives and disincentives be combined?

To deliberately use incentives as a motivational tool, banks need to make decisions on each of these issues. Sometimes the 'right' answer is not easy to see, and the effect of incentives on individual and group behaviour can be counter-intuitive. The cost of making poor decisions about incentive design can also be profound¹, ranging from under-utilisation of talent, to poor customer outcomes such as mis-selling. Hence, it is important for banks to approach the issue of incentive design with care.

THE FOCUSED REVIEW

The Focused Review is part of the HKMA's ongoing effort to promote sound culture in the banking sector. With a view to identifying industry-wide practices and an aim for better alignment of incentive systems of bank staff with bank customers' interest, the HKMA appointed an external consultant, Kiel Advisory Group, to assist in the Focused Review. Specifically, the Focused Review examined the front office incentive systems of 20 retail banks in Hong Kong, including how incentive systems are designed and implemented, how they affect behaviour of frontline staff, and ultimately how they influence customer outcomes. We are particularly interested in the role of incentives in minimising potential misconduct and mis-selling behaviour in the sale and distribution of investment, insurance, and banking products.

The Focused Review aims to understand the effect of incentives on front office behaviour. The external consultant, using their expertise and experience in conducting reviews of this nature, applied behavioural science to analyse the perceptions and behaviours of frontline staff in the selected retail banks.

Behavioural science techniques reflect a range of key principles, which are key to the methodology used for this review, including:

- ▶ **Evidence-based.** Conclusions are based on valid and reliable data.
- ▶ **Objective.** Techniques are employed to reduce bias and ensure a balanced perspective.
- ▶ **Neutral.** The approach is primarily inductive, that is, designed to understand the current reality from a variety of perspectives, especially from frontline staff.
- ▶ **System-oriented.** The approach recognises the system of influences on behaviour and seeks insights that reflect this context.
- ▶ **Confidential.** Ensuring that staff feel comfortable contributing their perceptions and experiences to the review is an important way for us to gather honest insights.

OVERVIEW OF DATA COLLECTED

Over the course of the Focused Review, we collected a comprehensive set of information, from a range of data sources, including both quantitative and qualitative data, and both objective occurrences and subjective perceptions. This comprehensive set of data was then collated and analysed to form the final observations and insights. See below for an overview of the types of data collected and analysed.

SURVEY		Anonymous online survey, inviting all frontline staff from the 20 retail banks	50 QUESTIONS, INCLUDING: • 5-point rating scale • Open-ended responses • Demographics
INTERVIEWS		One-on-one discussion between bank staff and interviewer	300 SESSIONS Participants included frontline sales staff and supervisors, staff from other functions (such as compliance, complaints management, quality assurance, human resources, rewards and compensation, performance management), and senior leaders from retail banks.
FOCUS GROUPS		Facilitated discussions with groups of frontline staff of the same level of seniority	60 SESSIONS Activities included anonymous poll, text chat, and verbal discussions used to reveal shared mindsets and perceptions. Participants included frontline sales staff involved in selling general banking, insurance, and/or investment products.
DOCUMENT REVIEW		Systematic collection and analysis of documents provided by retail banks	20 INCENTIVE SYSTEMS OF RETAIL BANKS Information and documents provided by banks in relation to incentive systems of front offices.

PARTICIPATION

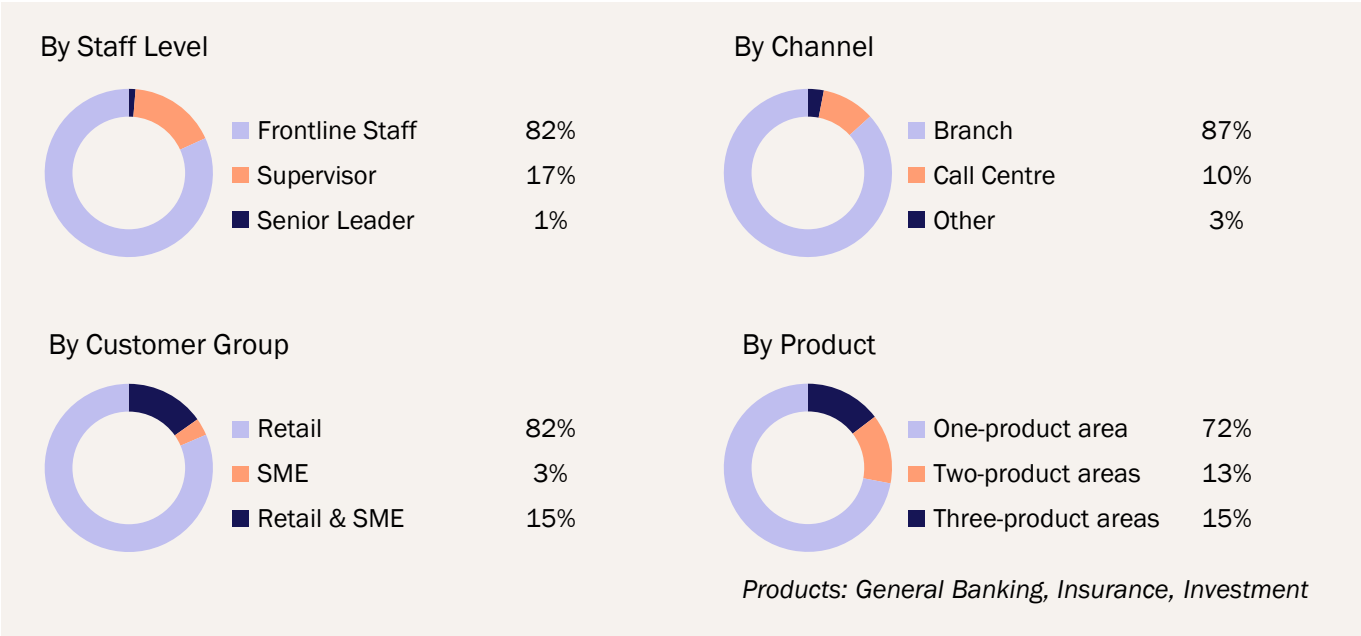
We would like to thank the selected banks for their active engagement and cooperation throughout the course of this Focused Review, resulting in high participation rates throughout the review process. Participation in any of the activities of the Focused Review was voluntary and anonymous (i.e., no identifiable information was collected).

SURVEY

25,112
STAFF INVITED

17,559
STAFF PARTICIPATED

70%
RESPONSE RATE



INTERVIEWS

300
STAFF PARTICIPATED

Frontline Staff and Supervisors	160
Other Functions	120
Senior Leaders	20

FOCUS GROUPS

564
FRONTLINE STAFF
PARTICIPATED

UNDERSTANDING THIS REPORT

Detailed analyses were conducted on various sources of data collected, using both quantitative and qualitative analysis methods where appropriate. Insights or observations presented in this report were drawn by triangulating findings from the various data sources. The data displayed are intended to help readers better understand the insights. Conclusions should not be made from single points of data.

SURVEY DATA

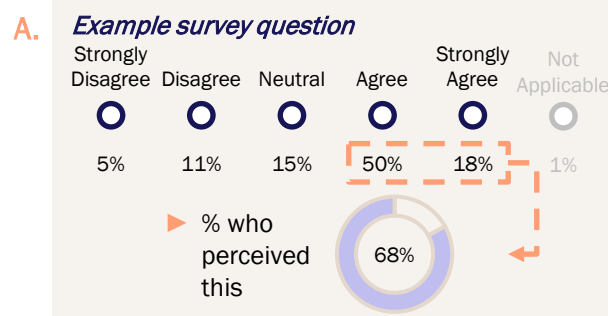
- ▶ The survey gathered industry-wide staff perceptions about their banks, in relations to incentive practices, bank culture, individual motivations, and customer and conduct outcomes. Staff rated their level of agreement to each statement provided. See illustration A on the right.
- ▶ We also examined relationships between various factors of interest, to see whether responses to one set of questions (e.g., specific type of incentive practice) were associated with responses to another set of questions (e.g., perceived customer outcomes). See illustration B on the right.

INTERVIEW AND FOCUS GROUP VERBAL RESPONSES

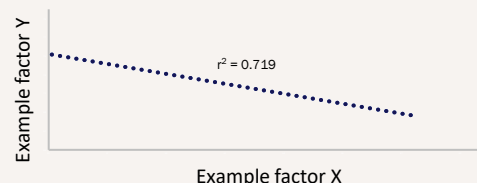
- ▶ Verbal responses from interview and focus group sessions were captured and then analysed to identify themes in the responses to specific topics. See illustration C on the right.
- ▶ Quotes were identified from various sessions to provide examples of staff perspectives and lived experiences. See illustration D on the right. Conclusions should not be made from any single quote alone.

DOCUMENT REVIEW DATA

- ▶ Documents received were analysed to identify similarities and differences across the banks on various areas of interest (e.g., incentive practices, performance appraisal processes, and so on). Illustration E on the right shows one type of visualisation used to present these similarities and differences.
- ▶ Quantitative data were also obtained through the information requests (e.g., remuneration, performance scores, and so on). Statistical analyses were conducted, for example, to examine the relationships between factors of interest, similar to what was conducted for survey data. See illustration B on the right.

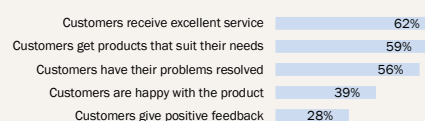


- B. ▼** There is a negative relationship between example factor X and factor Y, that is, a higher value in one factor is associated with a lower value in the other.



C. Example interview question

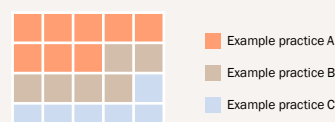
- ▼ % who indicated these response themes:



- D.** "Example content ... example content ... example content."

💡 Minor edits denoted by "..." have been made to improve readability. No identifiable information is included in any quote to maintain anonymity.

- E. ▼** Number of banks that use the following practices:





SECTION I: OVERALL OBSERVATIONS

OVERALL OBSERVATIONS

INTRODUCTION

The Focused Review collected a broad set of data on incentives that motivate frontline bank staff, and how these influence sales behaviour. This range of information allowed us to examine some key questions, including:

1. Can banks incentivise both customer outcomes and business outcomes?
2. Do different incentive practices carry associated conduct risks, or protect against risks?
3. What role does bank culture play?

The survey conducted with front office staff across the industry provided a robust basis for examining these questions. Specifically, we surveyed staff about the way they perceive incentives, culture, and customer outcomes at their banks, and examined the pattern of responses among banks to see how different incentives and cultural characteristics influenced perceived customer outcomes. Note that the survey involves perceptions of staff, which may sometimes differ from the actual practices and situations in banks. On the right is a summary of the characteristics we examined to understand drivers of better perceived outcomes.

This section provides an overview of the key observations and insights arising from the review before we dive deeper into specific industry-wide themes and observations in more detail in Section II.



Customer-focused incentives

These systems were characterised by the balanced assessment of staff performance, and a focus on rewarding staff for achieving good outcomes for customer and penalising staff for poor outcomes for customers.



Business-focused incentives

These systems were characterised by perceived pressure on staff to achieve business objectives, performance assessments that focused mainly on business outcomes, and rewards for staff based largely on business performance.



Workplace norms that reinforce conduct

Bank culture was characterised by how staff viewed the behavioural norms at their banks around accountability, speaking up or raising issues, demonstrating values and articulating purpose, risk appetite, and competence.



Perceived customer outcomes

Perceived customer outcomes were determined by staff perception of how their bank treated their customers, and how satisfied customers were with the bank.

FOCUSING ON CUSTOMER OUTCOMES

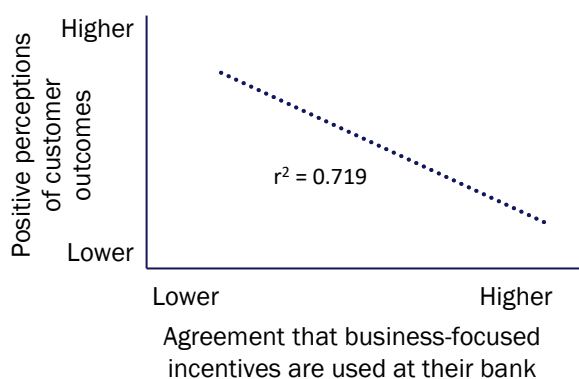
INCENTIVISING STAFF TO ACHIEVE CUSTOMER AND BUSINESS OBJECTIVES

First, the Focused Review noted that banks need to satisfy multiple objectives, and this dynamic clearly shapes incentive systems. In particular, banks need to meet commercial objectives, and at the same time, they also need to ensure their customers receive good outcomes, and uphold high standards of conduct and compliance. Incentives are a way for banks to influence the efforts of staff towards these multiple objectives. Designing incentive systems in a way that clearly communicates and influences staff behaviour in alignment with the desired balance in objectives can be complex and challenging.

The review highlighted that all banks incorporate both financial and non-financial objectives. However, the relative weighting of rewards for financial versus non-financial differed across banks

in important ways. Our analysis found that when staff perceived that incentives were more focused on achievement of business targets, they also perceived less positive customer outcomes. When incentives emphasised a balanced focus on customer outcomes, on the other hand, staff generally perceived better customer outcomes. However, there were some exceptions. For example, in a bank with business-focused incentives, the survey also indicated positive staff perceptions of customer outcomes. Finally, some banks with customer-focused incentive practices also had practices that were business-focused, that is, one focus does not preclude the other. These results provide information about the way business-focused incentives could be combined with customer-focused incentives to strengthen perceived customer outcomes.

Negative relationship between business-focused incentives and perceived customer outcomes²



- ❖ When banks have incentives that are more focused on business performance, staff are more likely to perceive less positive customer outcomes.

Customer-focused incentive practices can lead to better perceived customer outcomes³



Measuring staff performance against a balanced set of customer and business outcomes



Requiring staff to deliver good customer outcomes to receive a promotion



Penalising staff for actions that cause poor customer outcomes



Praising staff for treating customers fairly

INDUSTRY-WIDE THEME A: UNDERSTANDING CUSTOMER OUTCOMES

Theme A explores in more detail how incentives help staff understand the balance between business-focused and customer-focused priorities. Specifically, it highlights two key industry-wide observations that suggest incentive systems may not fully reflect what good customer outcomes entail.

1. Good customer outcomes are often understood as customer satisfaction
2. Staff are measured on metrics that reflect the common understanding of good customer outcomes

HIGHER-RISK INCENTIVE PRACTICES

PRACTICES THAT MAY OVER-EMPHASISE FINANCIAL OBJECTIVES

Second, analysis conducted as part of the Focused Review revealed that regardless of whether a bank's overall incentive system is collectively more focused on customer or business outcomes, certain practices were consistently associated with weaker perceived customer outcomes. Specifically, when incentive systems create a frequent reminder to staff about the consequences of not meeting targets, they seem to send a strong message to staff about the crucial importance of commercial goals. Although most banks include customer-focused objectives within staff incentive systems, it is possible that practices like ranking and pressure from supervisors may create a day-to-day emphasis

on business targets that 'drowns out' other dimensions of performance evaluation.

The analysis did note that, despite this overall pattern where certain practices were more likely to be associated with weaker perceived outcomes, there were a small number of banks with relatively sound perceived customer outcomes that also used these practices. This suggests there may be ways to mitigate the risk of these approaches to some extent, and also that banks with such practices could achieve even better customer outcomes if they avoided the use of these practices.

When staff observed the following practices ...



Focusing performance reviews mostly on business targets



Pressure from supervisors to meet business targets



Ranking staff based on sales and/or revenue



Letting go staff who don't meet their business targets

... they were less likely to perceive positive outcomes for customers⁴

INDUSTRY-WIDE THEME B: ALIGNING STAFF BEHAVIOUR

Theme B examines in more detail some of the subtle but common ways that incentive practices may indirectly lead staff to prioritise their effort on financial objectives over customer outcomes. We highlight three ways that incentives for financial achievement are often disproportionately salient, and the opportunities to leverage the role of social factors to more effectively bolster perceived benefits of non-financial achievement.

1. Incentives often reward financial performance more than non-financial performance
2. Many staff feel pressure from their supervisors to meet business targets
3. Social factors also play an important role in incentives

BANK CULTURE

INTERACTION OF INCENTIVES AND CULTURE

Finally, the review highlighted that incentives often reflect and reinforce broader bank culture, creating a shared understanding of ‘the way things are done’ at a bank. How staff are rewarded, communication between staff and leaders, and the way change is managed all shape staff perceptions of what is valued by leaders and peers.

Further, this shared understanding (or ‘culture’) itself has a direct influence on perceived customer outcomes. The cultural traits we examined in the

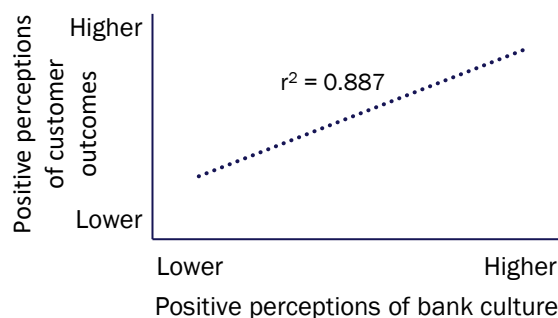
industry-wide survey included a range of qualities such as diligence, honesty, ethics and continuous improvement. Our analysis found that when staff perceive these kinds of norms in their bank, they also perceive better customer outcomes.

These findings support the idea that alongside sound incentive practices, banks also need to maintain momentum in their culture efforts to sustain and continue improving customer outcomes.

These cultural norms ...

- ✓ Being honest about mistakes
- ✓ Giving and receiving feedback
- ✓ Clear social norms related to ethics and compliance
- ✓ Sharing ideas about how to meet customer needs
- ✓ Responsiveness to problems
- ✓ Desire to uphold the banks reputation
- ✓ Day-to-day discussion about bank’s values

... are positively related to better perceived customer outcomes⁵



- ❖ In banks where staff perceive positive cultural norms (see left), staff are also more likely to perceive more positive customer outcomes.

INDUSTRY-WIDE THEME C: MOTIVATING FRONTLINE STAFF

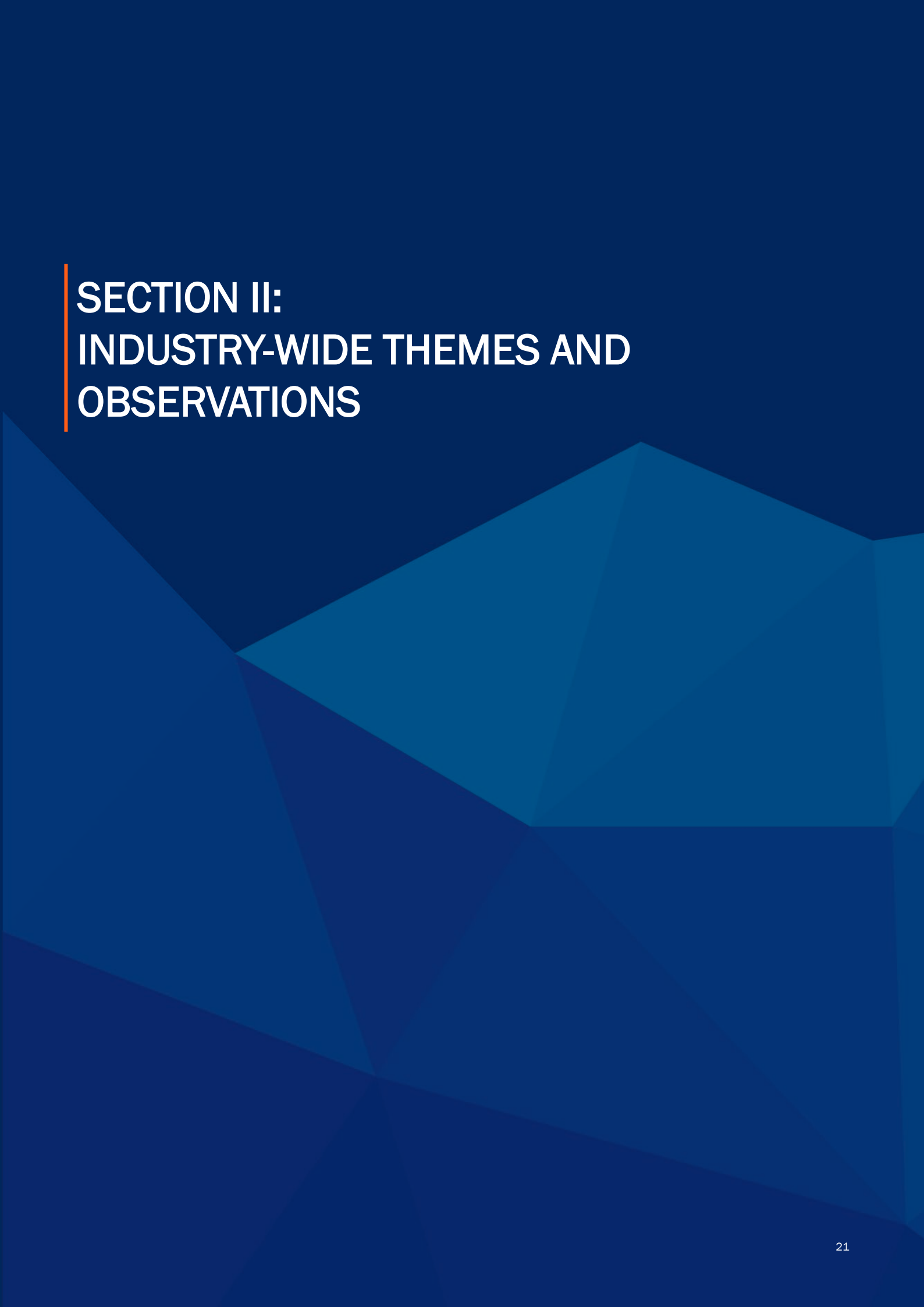
Theme C takes a closer look at the practices banks use to motivate staff to focus on customer outcomes.

1. Penalties do not inspire a focus on good conduct as effectively as rewards
2. There is limited differentiation of incentive levels for non-financial performance
3. Non-financial factors are often effective at motivating good conduct

INDUSTRY-WIDE THEME D: EFFECTIVENESS OF INCENTIVE SYSTEMS

Theme D examines some common factors within bank environments that may impact the effectiveness of incentive systems designed to encourage staff to focus on customer outcomes.

1. Conflicting objectives may impede the effectiveness of incentive systems
2. Rewards for non-financial factors are often perceived as less transparent
3. Incentives for good conduct are less consistently awarded
4. Benefits from incentive changes can take time to emerge



SECTION II: INDUSTRY-WIDE THEMES AND OBSERVATIONS

INTRODUCTION

INDUSTRY-WIDE THEMES AND OBSERVATIONS

Through the Focused Review, four main themes were identified. These themes reflect the major industry observations and insights drawn from the different sources of data collected and analysed during the review, from all of the participating banks. A summary of our findings is provided below, and each theme will be further explored in detail in this section of the report.

Themes

Key Observations



A. HOW ARE CUSTOMER OUTCOMES COMMONLY UNDERSTOOD?

Incentive systems may not fully reflect 'good customer outcomes'

1. Good customer outcomes are often understood as customer satisfaction
2. Staff are measured on metrics that reflect the common understanding of good customer outcomes



B. DO INCENTIVES ALIGN STAFF BEHAVIOUR TO THE GOAL OF GOOD CONDUCT?

Some common incentive practices may unintentionally push staff to prioritise business objectives over customer outcomes

1. Incentives often reward financial performance more than non-financial performance
2. Many staff feel pressure from their supervisors to meet business targets
3. Social factors also play an important role in incentives



C. DO INCENTIVES MOTIVATE FRONTLINE STAFF?

Incentive systems generally emphasise financial incentives when other types of rewards can be used more effectively to motivate good customer outcomes

1. Penalties do not inspire a focus on good conduct as effectively as rewards
2. There is limited differentiation of incentive levels for non-financial performance
3. Non-financial factors are often effective at motivating good conduct



D. WHAT FACTORS MAY IMPACT THE INFLUENCE OF INCENTIVE SYSTEMS?

Some factors may impact the effectiveness of incentives that are designed to reinforce good customer outcomes

1. Conflicting objectives may impede the effectiveness of incentive systems
2. Rewards for non-financial factors are often perceived as less transparent
3. Incentives for good conduct are less consistently awarded
4. Benefits from incentive changes can take time to emerge

UNDERSTANDING CUSTOMER OUTCOMES



Insight

Incentive systems may not fully reflect 'good customer outcomes'

KEY OBSERVATIONS

1. Good customer outcomes are often understood as customer satisfaction
2. Staff are measured on metrics that reflect the common understanding of good customer outcomes

Incentive systems play several roles. They are a way to motivate employee efforts towards certain objectives by offering rewards for their achievement. They also provide an implicit message to staff about what their leaders value.

In both cases, what banks understand as good customer and conduct outcomes is key. When banks understand what constitutes good customer and conduct outcomes, they have a good basis for designing incentives that reward appropriate behaviours, and these rewards communicate to staff what is expected from them.

Good customer outcomes can be broadly described as *business practices that ensure that customers receive fair treatment and fair outcomes*. This was the definition provided to participants during the survey undertaken as part of this Focused Review, and survey questions sought to cover specific drivers of good customer outcomes, which are reflected in the HKMA's *Treat Customers Fairly* principles (see right).

PRINCIPLES FOR GOOD OUTCOMES

The HKMA worked with the banking industry in developing the Treat Customers Fairly (TCF) Charter which all the retail banks in Hong Kong had signed up to in 2013. This demonstrates the industry's commitment not only to treat customers fairly but also foster a stronger culture towards upholding fair treatment of customers at all levels of banks, and at all stages of their relationship with customers. The Charter incorporates TCF principles that reflect important dimensions when it comes to achieving good customer outcomes.⁶ Of interest for this Focused Review are those TCF principles which cover the following themes:



Customers should be provided with **accurate and sufficient information** before, during and after the point of sale



Customers should **understand** all the information provided to them regarding the product or service



Customers should have reasonable channels to make **complaints and seek redress**



Products and services should be **designed** and provided to **meet customer needs**

Other TCF principles incorporated in the Charter cover themes such as not imposing unreasonable barriers on customers to switch banks, and providing reasonable access to basic banking services for the public.

INDUSTRY INSIGHT A

UNDERSTANDING CUSTOMER OUTCOMES

OBSERVATION 1: GOOD CUSTOMER OUTCOMES ARE OFTEN UNDERSTOOD AS CUSTOMER SATISFACTION

The Focused Review found varying understanding of customer outcomes. For example, many leaders and frontline staff viewed customer outcomes in terms of customer satisfaction and providing excellent service. On the other hand, staff in Compliance and Human Resources (HR) roles were more likely to emphasise meeting customer needs to deliver good customer outcomes. While these

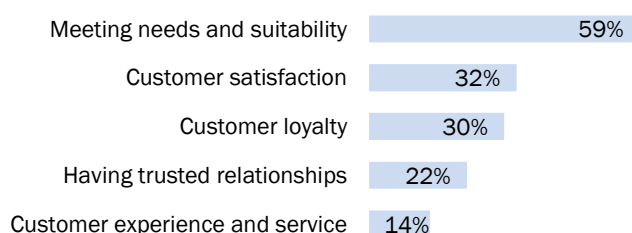
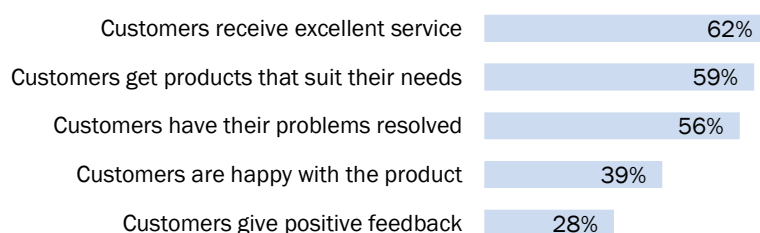
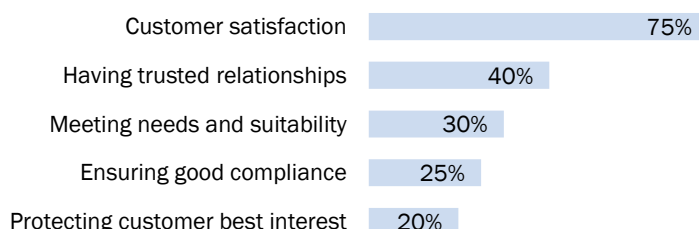
views are related, they emphasise different priorities. In addition, since frontline staff are those impacted by the incentive systems we examined, a main focus on customer satisfaction may suggest that their incentive systems may not necessarily drive the desired staff behaviour for achieving good customer outcomes.



UNDERSTANDING OF CUSTOMER OUTCOMES AT DIFFERENT LEVELS

Key elements staff mention when defining 'good customer outcomes'

▼ Percentage of interviewees who indicated each of these top five themes



INDUSTRY INSIGHT A

UNDERSTANDING CUSTOMER OUTCOMES

OBSERVATION 2: STAFF ARE MEASURED ON METRICS THAT REFLECT THE COMMON UNDERSTANDING OF GOOD CUSTOMER OUTCOMES

The effectiveness of incentives in motivating staff to focus on customer outcomes is closely related to the way these outcomes are operationalised – that is, the metrics staff are measured on in order to determine rewards and consequences. In turn, the choice of which metrics to use is closely related to the common understanding of good customer outcomes in banks.

The Focused Review found that banks often

evaluate staff performance in relation to customer satisfaction and compliance. An advantage of these metrics is their quantifiable nature. However, the review also observed several common scenarios where a main focus on these metrics reinforced a common understanding of good customer outcomes that may inadvertently overlook the fundamental principles of good customer and conduct outcomes.

Relevant
metricsSituations staff
describedExamples of good outcomes this
situation can undermine⁷Ideal
situations

i. KEEPING CUSTOMERS HAPPY

Satisfaction focus

Customer satisfaction, complaints, compliments, net promoter score

Time pressure

Staff feel customers are not satisfied when sales procedures take a lot of time, so staff feel this pressure to speed up the process

Providing complete information

Nearly one-in-seven bank staff who participated in the survey indicated that they do not have full confidence in providing complete information in all circumstances

Focus on customer
interests

Staff explain to customers that procedures are necessary to protect their interests



ii. FOCUS ON PROCESS VERSUS OUTCOMES

Process focus

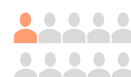
Quality assurance, call monitoring, mystery shopper results

Forgetting principles

Banks use deductions to focus staff on good conduct, but they are sometimes based on process compliance, overlooking key principles

Ensuring customers understand

More than one-in-ten bank staff who participated in the survey indicated that they do not have full confidence in ensuring customers understand the products they buy in all circumstances

Focus on customer
outcomes

Banks focus on rewarding staff who check customer understanding of products

ALIGNING STAFF BEHAVIOUR



Insight

Some common incentive practices may unintentionally push staff to prioritise business objectives over customer outcomes

KEY OBSERVATIONS

1. Incentives often reward financial performance more than non-financial performance
2. Many staff feel pressure from their supervisors to meet business targets
3. Social factors also play an important role in incentives

The concept of nudging was popularised by economist Richard Thaler in 2008. It describes how positive reinforcement and indirect suggestions can shape the decisions and behaviours of individuals and groups, especially when in relation to finance.

Although the Focused Review did not specifically seek to examine nudging, a number of observations suggest that the theory provides a useful way of explaining how some common incentive practices may shape behaviour of frontline staff in unexpected ways.

This subsection provides three ways that various incentive mechanisms used by a number of banks may influence staff to prioritise their efforts on financial objectives over customer and conduct outcomes.

WHAT IS 'NUDGING'

Nudging good behaviour⁸

Staff behaviours are often influenced by a range of different factors. Incentives are one type of mechanism that drive staff to exhibit desired behaviour – sometimes directly, such as rewarding specific achievements, or indirectly in a way that is not always immediately obvious to frontline staff. This type of indirect influence is often referred to as *nudging* and, while subtle, can have notable implications on staff behaviour. For example, banks may use certain incentive practices to nudge staff towards business objectives such as:

- Having a high volume of competitive mechanisms that aim to increase sales efforts (e.g., sales competitions, staff ranking, sales leader boards)
- Having frequent updates on staff sales achievements to boost staff attention on achieving targets (e.g., daily email updates, digital apps where staff can track their own performance)

In contrast, other incentive practices may be used to nudge staff towards more positive, customer-oriented behaviours, such as:

- Communication from senior leaders celebrating and/or rewarding good behaviour
- Having systems that provide prompts during the sales process, reminding staff to check for customer understanding

INDUSTRY INSIGHT B

ALIGNING STAFF BEHAVIOUR

OBSERVATION 1: INCENTIVES OFTEN REWARD FINANCIAL PERFORMANCE MORE THAN NON-FINANCIAL PERFORMANCE

The review found that high-earning frontline staff received similar performance ratings on non-financial dimensions to their average-earning peers (see Theme C). Similarly, when we analysed the effect of financial versus non-financial performance ratings on incentives, we found that financial performance had a much stronger effect on frontline staff earnings. In short, frontline staff earn more by performing better on financial dimensions, not non-financial dimensions.

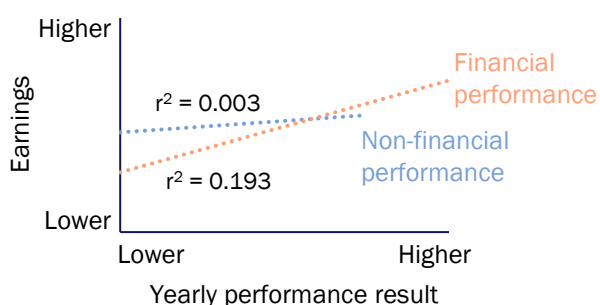
From one perspective, these results suggest high earners are meeting expected requirements, as per their bank's performance assessment process. However, there are also possible side-effects to this pattern. First, it suggests some banks may not be offering sufficient room for their staff to excel (beyond minimum requirements) on non-financial

performance dimensions. In comparison, some banks provide a much broader scope for performance (and subsequent reward) on financial performance dimensions. Second, it suggests to frontline staff that their remuneration is really only influenced by their financial performance. For those wishing to earn above average remuneration, additional effort in conduct or compliance will not be rewarded in the same way as additional effort to achieve financial objectives. Finally, as the survey and discussions with staff indicated that supervisors place pressure on them to achieve business targets linked to financial incentives, staff may perceive that their leaders value financial performance more than non-financial performance – thus implying staff should prioritise their effort accordingly.



FINANCIAL PERFORMANCE SCORES IMPACT INCENTIVES MORE THAN NON-FINANCIAL

- ▼ Analysis of relationship between sales staff annual earnings and financial and non-financial performance scores for that year^{9,10}



- ❖ The analysis indicated that on average, non-financial performance, regardless of results, does not have a material impact on staff earnings. However, financial performance shows a much stronger positive relationship with staff earnings.

IMPLEMENTING BALANCED SCORECARDS – POSSIBLE PITFALL



Many banks have introduced balanced scorecards which measure staff performance across a broad range of metrics, specifically covering both financial and non-financial aspects of performance. However, if not implemented appropriately, use of balanced scorecards may not be able to achieve the full desired effect. In an example, we noted that the gross incentive payment amount for a bank is determined solely based on financial performance. The scorecard result, comprising a balance of financial and non-financial performance, is then used as a percentage multiplier to adjust the final payout. This means that, although performance scores includes a balance of financial and non-financial factors, the incentive payment amount is still largely based on financial performance.

INDUSTRY INSIGHT B

ALIGNING STAFF BEHAVIOUR

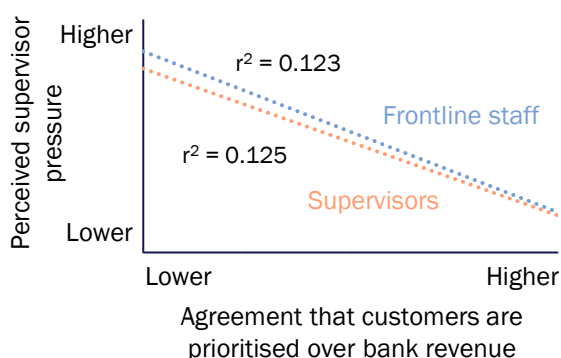
OBSERVATION 2: MANY STAFF FEEL PRESSURE FROM THEIR SUPERVISORS TO MEET BUSINESS TARGETS

In their day-to-day work, supervisors play an important role in directing staff work effort by monitoring performance against key performance indicators (KPIs), improving staff sales performance, and encouraging them to meet targets in tactical incentive programs. In many instances, frontline staff perceive such source of pressure: 48% of participants in the survey overall perceived that supervisors place pressure on staff to achieve business targets. However, some important differences among banks were observed in relation to pressure. First, as the Focused Review's Interim Report¹¹ highlighted, supervisor pressure was a factor we observed more often in

banks with lower perceived customer outcomes. Further analysis of this issue revealed that some frontline staff perceived more pressure from supervisors than their supervisors perceived, and that when both groups perceived less pressure, bank staff were more likely to indicate that customer outcomes were prioritised over bank revenue. Good communication and understanding between management and staff may help frontline staff understand that while business objectives are important, customer outcomes should always come first, therefore reducing pressure to achieve financial results at all costs.

Varied perceptions of pressure

- ▼ Analysis of relationship between perceived supervisor pressure to meet business targets and perception that customer outcomes are prioritised over bank revenue¹²



- ❖ Less pressure from supervisors to meet targets may support prioritisation of customer outcomes. Staff, at both frontline and supervisor levels, who agreed that there is pressure from their supervisors to meet business targets, were less likely to agree that fair customer outcomes are prioritised over bank revenue.

Pressure can be unintended

- ▼ Examples of scenarios that staff described as creating pressure

Reminders



Frequent reminders from managers about sales or incentive targets may push staff to place more attention and priority on sales activity.

Monitoring progress



Excessive monitoring of sales performance from supervisors may result in frontline staff feeling anxious about meeting expectations.

Coaching



Supervisors may try to support or coach staff to achieve their targets, but pushing too hard can create pressure on staff to be more aggressive.

INDUSTRY INSIGHT B

ALIGNING STAFF BEHAVIOUR

OBSERVATION 3: SOCIAL FACTORS ALSO PLAY AN IMPORTANT ROLE IN INCENTIVES

The review found that incentive systems often leverage social or interpersonal factors as a source of motivation for staff by using team-based targets and rewards, encouragement by direct supervisors, public recognition and visible performance ranking of staff. Socially-based incentives can be very powerful at fostering team spirit and building morale. They can also channel competitive energy towards collective objectives, and ensure the accomplishments of high achievers are celebrated.

Interestingly, while the review noted that banks currently leverage the motivational power of socially-based incentives to reward staff for financial achievement, particularly for short-term tactical incentive programs, their use is far less embedded and prevalent for rewarding non-financial performance. Given the powerful motivational effect of approval from peers and public recognition, banks could apply these types of incentives more widely in relation to conduct and

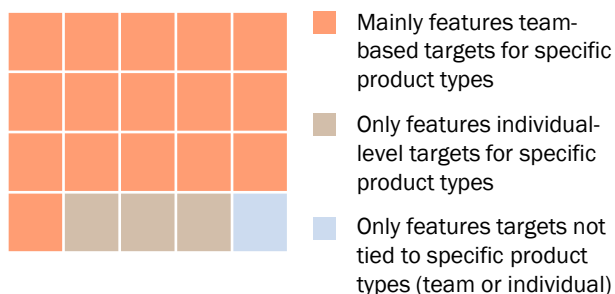
compliance achievements.

Finally, given the strong effect of socially-based incentives on behaviour, the review also observed possible risks, especially when these kinds of incentives are applied in the context of sales targets, and particularly when tied to specific products. When staff are under social pressure to achieve business targets for certain products, this may lead to poor customer outcomes. Just like individual incentives for financial objectives, the pursuit of team-based incentives can create significant pressure on staff to achieve them. We heard that less experienced staff in particular, feel pressure to contribute to team-based incentives in an effort to avoid disappointing colleagues. Given the widespread use of team-based short-term incentive programs to reward achievement of financial objectives, banks should be conscious of managing the risks associated with their use in the context of high-risk products.



TEAM TARGETS AND OTHER SOCIAL FACTORS INFLUENCE STAFF BEHAVIOUR

▼ Types of targets used for short-term tactical incentive programs



- ❖ Team-based targets, particularly those tied to specific products, are a feature in many banks. For example, for short-term tactical programs, which all banks offered, the majority of banks set team-based targets as well as individual-level targets, that are product-specific.

▼ Social factors that influence staff

% who perceived this¹³



- ❖ These factors all create sales pressure on staff, which could increase the risk of poor behaviours.

MOTIVATING FRONTLINE STAFF



Insight

Incentive systems generally emphasise financial incentives when other types of rewards can be used more effectively to motivate good customer outcomes

KEY OBSERVATIONS

1. Penalties do not inspire a focus on good conduct as effectively as rewards
2. There is limited differentiation of incentive levels for non-financial performance
3. Non-financial factors are often effective at motivating good conduct

Research on incentives and their role in motivating employee behaviour continues to evolve in academic and applied communities in behavioural science, regulation, and ethics disciplines. This review sought to explore and extend aspects of this research within the specific context of frontline staff of retail banks in Hong Kong.

Three general research findings examined in the Focused Review included the influence of reward versus penalties on behaviour, financial versus non-financial rewards on behaviour, and base pay versus performance-based incentives on behaviour.

This subsection shares common approaches banks use to motivate achievement of good customer and conduct outcomes amongst frontline staff, and practices that may be effective in achieving these objectives.

KEY RESEARCH FOR MORE INSIGHTS



In recent years, researchers have sought to shed more light on the topic of motivating staff. Below, several insights relevant to the current theme have been summarised in snapshot, to provide greater context and useful further reading:

- **Reward versus punishment.** From a neurological perspective, rewards are more effective than punishments at *motivating* behaviour. The opposite is true (i.e., punishments are more effective) for *detering* behaviour.^{[14](#)}
- **Self determination theory.** External pressures (e.g., extrinsic rewards, punishments, or fear) are effective at motivating short-term behaviour (quantity) but can reduce performance quality and overall engagement. This is because focus shifts from the activity itself to the consequences.^{[15](#)}
- **Financial compensation and meeting psychological needs.** Financial compensation is effective – but its motivational impact is determined by the way it symbolically meets psychological needs (feelings of ownership or autonomy; being valued, respected, included; and experience of success, mastery, and growth) at work.^{[16](#)}

INDUSTRY INSIGHT C

MOTIVATING FRONTLINE STAFF

OBSERVATION 1: PENALTIES DO NOT INSPIRE A FOCUS ON GOOD CONDUCT AS EFFECTIVELY AS REWARDS

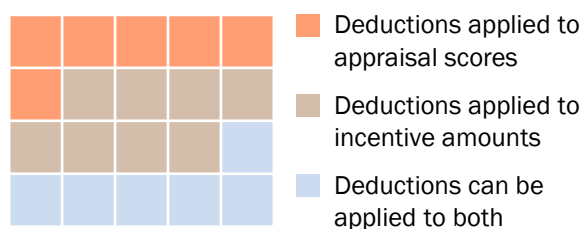
As discussed in the previous subsection, the common understanding of good customer outcomes often focuses on satisfaction, and therefore measures used to evaluate staff may not necessarily drive the desired staff behaviour for achieving good customer outcomes. However, this review observed that, all selected banks assess frontline staff on some measures of non-financial performance, in addition to financial performance. This consideration of non-financial performance – including, for example, compliance, customer satisfaction, and adherence to bank values – represents a significant evolution of frontline incentive systems over the past decade.

Generally, performance on non-financial measures are also incorporated into discretionary incentives and/or annual bonus calculations for staff.

However, the review found clear differences in the mechanisms used to reflect financial and non-financial performance in incentives. Specifically, unlike achievement of financial objectives, which is generally recognised using monetary rewards, non-financial performance is often incorporated into incentive calculations via penalties for poor performance. As a source of motivation, negative reinforcement (that is, penalties) does not carry the same influence as positive reinforcement (that is, rewards). Although penalties may focus staff attention on meeting minimum standards, they do not necessarily motivate staff to exert discretionary effort on achieving good customer outcomes. Banks are thus encouraged to pay attention to when evaluating the potential impact of their incentive systems.

Penalties for poor compliance are common

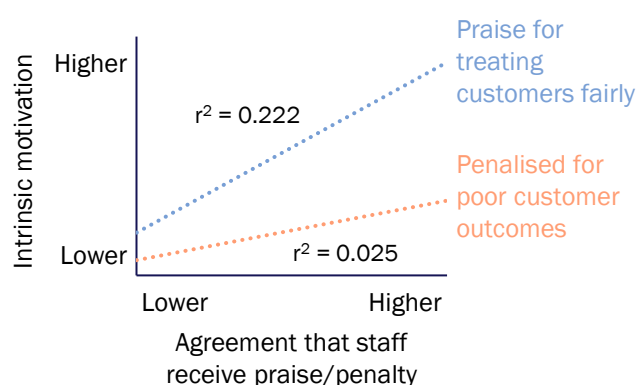
▼ Use of deductions across banks in the industry



- ❖ All banks apply deductions to penalise errors and non-compliance. Some deductions are applied to performance appraisal scores (e.g., 10% subtracted from the total appraisal score), which often also impact the incentive payment amount. Some deductions are applied directly to incentive amounts (e.g., a dollar value subtracted from the incentive amount). Most banks use one of the two types of deduction methods, although some banks use both methods.

But penalties may not foster intrinsic motivation

▼ Analysis of relationship between motivation, praise and penalties¹⁷



- ❖ Staff who agreed that they **receive praise** for good customer outcomes also tended to indicate **higher intrinsic motivation** to contribute to good customer outcomes, to team objectives, and to bank reputation. Conversely, staff who agreed that they are **penalised** for poor customer outcomes were **less likely to also indicate higher intrinsic motivation**.

INDUSTRY INSIGHT C

MOTIVATING FRONTLINE STAFF

OBSERVATION 2: THERE IS LIMITED DIFFERENTIATION OF INCENTIVE LEVELS FOR NON-FINANCIAL PERFORMANCE

The Focused Review observed that banks measure staff on non-financial performance using a variety of methods. Some banks use directly quantifiable measures (such as quality assurance results, net promoter scores, and number of complaints or compliments), while others use more qualitative measures (such as 3 or 5-point scales, with different performance standards for each point). Qualitative ratings are usually determined by branch managers or supervisors based on direct observations of staff and/or other information such as feedback from customers and compliance staff. All banks used sampling check to determine whether penalties would be applied as part of the non-financial performance assessment.

However, regardless of the methods used, the review observed limited variation across staff for scores on non-financial performance, especially compared to variation in financial performance. Patterns like this are commonly due to:

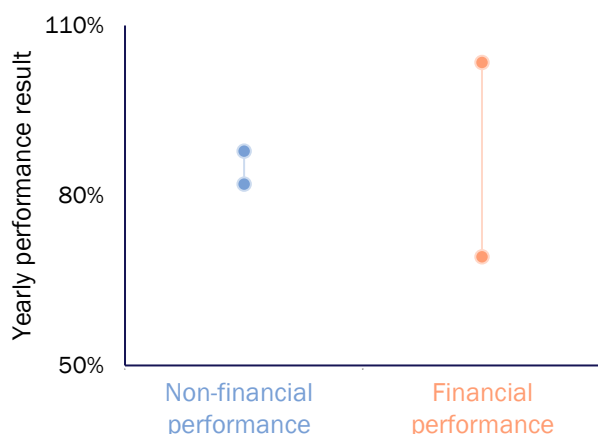
1. Exception-based measures – that is, measures where the majority of staff are expected to get the same result (e.g., pass versus fail), and exceptions are rare.
2. Central tendency bias – a common tendency for managers to award staff a ‘mid-point’ rating – for example, a ‘3’ on a 5-point scale.
3. Leniency bias – in some contexts, a tendency for managers to avoid awarding low ratings, therefore scoring everyone towards the upper end of a rating scale.

When staff perceive little difference in their performance evaluation regardless of achievement or effort, it reduces motivation for both good and poor performers. In addition, as the insights in the next subsection highlights, there can be further implications when staff observe this pattern applying mainly in relation to non-financial performance.



THERE IS MINIMAL DIFFERENTIATION ON NON-FINANCIAL PERFORMANCE

- ▼ Annual performance results on financial versus non-financial dimensions, for top and average earning sales staff [9.18](#)



- ❖ This analysis illustrates that for **non-financial performance**, there is not a great deal of difference in the average performance scores between top and average earners (88% for top earners, 82% for middle earners). The range of scores that distinguish between top and average earners on **financial performance** is a lot higher (103% for top earners, 69% for middle earners).

Note: comparisons were not made to low-earning peers since we observed that these cases are often related to non-performance-related circumstances, such as reduced work hours, new hires, or returning from extended leave.

INDUSTRY INSIGHT C

MOTIVATING FRONTLINE STAFF

OBSERVATION 3: NON-FINANCIAL FACTORS ARE OFTEN EFFECTIVE AT MOTIVATING GOOD CONDUCT

Over many years, the remuneration of staff in the financial sector has placed a heavy emphasis on financial compensation, in particular sales-based incentives. However, in recent years, the requirements of bank staff have shifted, as customer, regulatory, and shareholder expectations have created a more balanced and comprehensive set of objectives for frontline staff. At the same time, a range of social and generational changes are creating a different mixture of benefits that staff are seeking from their work. While most staff still highly value financial rewards, more staff are also showing a desire for meaningful work and professional development to achieve good

customer outcomes. Our discussions with staff revealed that more staff are motivated by other non-financial factors over maximisation of monetary rewards. As a result of this rapidly changing landscape, traditional incentive models may not motivate staff in the same way they used to. However, they also revealed an important pattern – factors that are increasingly motivating for staff, are closely aligned to drivers of good conduct: a more balanced approach to sales-based incentives, a focus on the purpose of serving customer needs, improved competence and professional development to support a long-term career in the banking sector.



FINANCIAL INCENTIVES ARE NOT THE ONLY FACTOR THAT MOTIVATES STAFF BEHAVIOUR

▼ Influence of intrinsic motivators for staff in their work

Intrinsic motivators at work	Survey result ¹³
Feeling responsible to uphold the bank's reputation	91%
Finding it rewarding to achieve customer outcomes	90%
Being motivated by team objectives	83%
Finding their job meaningful	76%
Progressing career with current organisation	76%

- ❖ The majority of staff indicated that they were intrinsically motivated to achieve good outcomes for customers, their bank, and/or their team.

▼ Main reasons why staff try to avoid defects or mistakes

Top 5 reasons to avoid defects	Poll result ¹⁹
Customer loses trust	39%
Negative impact for customer	35%
Deductions from incentive	8%
Reduces appraisal rating	8%
Impacts incentive eligibility	5%

- ❖ Over 70% of staff cited concern for customer outcomes and relationships as the main reason to avoid defects or mistakes.

EFFECTIVENESS OF INCENTIVE SYSTEMS



Insight

Some factors may impact the effectiveness of incentives that are designed to reinforce good customer outcomes

KEY OBSERVATIONS

1. Conflicting objectives may impede the effectiveness of incentive systems
2. Rewards for non-financial factors are often perceived as less transparent
3. Incentives for good conduct are less consistently awarded
4. Benefits from incentive changes can take time to emerge

Banks implement a variety of incentives and disincentives (or penalties) to foster desired behaviour within staff. In practice, these strategies are only part of what shapes employee behaviour. As several themes in this report highlight, the behaviour of staff is often influenced by a combination of factors, and some may not be obvious to bank leaders. An awareness of these factors can help banks make appropriate adjustments to incentive strategies to make them more effective.

In particular, in certain situations, systems designed to positively influence staff behaviour may actually disincentivise staff from prioritising their efforts to achieve good customer outcomes. The following set of observations highlights ways that staff may feel their efforts to deliver and/or be rewarded for delivering good customer outcomes may be hindered. While these challenges are relatively common across the industry, some banks have identified ways to adjust their systems to address and/or reduce their effect on staff motivation.

INFLUENCES ON EFFORT

The link between success and effort

Researchers^{20,21} have shown that when people lack confidence in their ability to influence the outcome of a situation, they eventually lose motivation to try. This phenomenon, which is sometimes called 'learned helplessness', has been discussed by others²² in relation to the important cultural challenge for many workplaces of encouraging staff to 'speak up' about risks and concerns. It is also relevant for other behaviours that banks may wish to reinforce in staff. In the context of this review, some examples of learned helplessness might include:

- No longer putting in effort to achieve sales targets that are seen to be excessively high and unattainable
- Reduced motivation to achieve rewards due to opaque incentive systems, making it unclear how their efforts are rewarded
- Blindly following complex policies and processes, instead of providing feedback or suggestions for improvement

INDUSTRY INSIGHT D

EFFECTIVENESS OF INCENTIVE SYSTEMS

OBSERVATION 1: CONFLICTING OBJECTIVES MAY IMPEDE THE EFFECTIVENESS OF INCENTIVE SYSTEMS

Bank staff need to perform their role with a number of different objectives in mind. As outlined throughout this report, three objectives in particular are commonly reinforced via frontline incentive systems: achievement of financial results, customer satisfaction, and compliance with regulatory requirements. In striving to achieve good customer outcomes, however, frontline staff may encounter instances where these key objectives can seem to conflict.

The review observed a range of situations where staff may feel they need to achieve conflicting

objectives. Navigating such situations may be more difficult for frontline staff than leaders realise. Further, staff perceptions about these situations interact with incentive systems to shape behaviour in ways that may be unexpected. In particular, qualitative ratings can be seen as subjective or unclear to staff (detailed in observation D2), they may lead staff to prioritise their effort on performance dimensions they feel are more transparent, short-term and straight-forward: specifically, keeping customers happy in the short-term, and achieving sales.



SITUATIONS WHERE STAFF PERCEIVED CONFLICTING OBJECTIVES



Staff meeting short-term targets versus focusing on customer needs

“With monthly or quarterly target, staff may need to push products, despite not suited, to meet their target.”



Leaders focusing on performance versus protecting staff engagement

“[Leaders] should make staff happier at work and not just chasing on the target to make staff depressed.”



Underperforming staff struggling to meet sales targets versus maintaining sales quality

“The complaints we receive that [are] substantiated are [for staff] who are barely hanging on in the bank.”



Staff following process to get incentives versus making an effort to adhere to the spirit of rules

“If staff think they are treated unfairly, then they will do things you don't want to see.”

Difficulties managing these tensions may create instances of poor conduct



Nearly **one-fifth** of bank staff who participated in the industry-wide survey **observed potential conduct risks** in their bank in relation to achieving performance requirements or business objectives.²³

INDUSTRY INSIGHT D

EFFECTIVENESS OF INCENTIVE SYSTEMS

OBSERVATION 2: REWARDS FOR NON-FINANCIAL FACTORS ARE OFTEN PERCEIVED AS LESS TRANSPARENT

Traditionally, many banks calculated performance-based incentives purely based on sales-related data. In most cases, this is a very direct and transparent method, which is easy for staff to understand. As banks have moved towards more comprehensive calculations – taking into account other dimensions of performance, such as compliance, customer satisfaction, and values – many staff perceive the calculation of their incentive payment amounts to be less transparent. This perception may be due to various factors, including increased complexity in calculations, use of qualitative measures (e.g., supervisor ratings versus sales data), and staff's lack of familiarity with non-financial measures.

It should not be assumed that transparent incentive calculations ensure good customer outcomes. However, when staff can clearly see how their behaviour is linked to rewards, there is more chance that they will strive to exhibit conduct required to achieve them. Conversely, if staff cannot see how their behaviour impacts their incentives, it may undermine the motivational value of those incentives.

As banks assess frontline performance more holistically, continued efforts to communicate incentives in a way that ensures clarity and transparency will be important to maximise the role incentives play in reinforcing good conduct.

Differing perceptions of transparency

- ▼ Discrepancies between bank intent and staff perception on the transparency of incentives

Rating scales



Banks provide performance appraisal results to staff to indicate how they performed, but staff may not understand why they received a particular result.

Supervisor commentary



While supervisors provide explanations to justify ratings given to staff, some staff may perceive them as lacking detail and examples.

Incentive calculations



Banks communicate to staff what factors are included for incentive calculations, however, staff may not understand how these factors are calculated to determine incentive payouts.

- ❖ Although banks use a variety of practices to convey transparency, some staff may not perceive their incentive system to be transparent.

Staff tend to prefer high transparency

- ▼ Unintended effects when staff perceive a lack of transparency in incentive calculations

Rating scales



Misuse of non-transparent mechanisms in the incentive system, where some supervisors may take advantage of low transparency to continue driving a financial focus.

Supervisor commentary



Increased concerns about supervisor bias or favouritism impacting the incentive received (whether occurring in practice or not).

Incentive calculations



Reduced faith in the fairness of the incentive systems, especially if low transparency is coupled with more subjective performance assessment methods (e.g., discretionary ratings).

- ❖ While highly transparent systems are often preferred by staff, formulaic methods can lead to unwanted behaviour (e.g., staff overly focused on tracking their incentives). Banks should use a communication approach that balances transparency without excessive opportunity for short-term incentive tracking.

INDUSTRY INSIGHT D

EFFECTIVENESS OF INCENTIVE SYSTEMS

OBSERVATION 3: INCENTIVES FOR GOOD CONDUCT ARE LESS CONSISTENTLY AWARDED

As highlighted earlier in this report, the review observed that staff tend to feel rewarded for financial performance, but penalised for poor non-financial performance. This perception may be related to the mechanisms by which non-financial performance is measured and rewards are delivered.

Specifically, the review noted that rewards for financial performance tend to be delivered more frequently (at least quarterly) and capture all sales activities as the basis for calculating achievement of targets. In contrast, rewards for non-financial performance tend to be less frequent (usually

annually) and many examples of good day-to-day behaviour may be overlooked when determining rewards due to assessment methods that are more ad hoc or sample-based.

Consistency is a critical element in all forms of behavioural reinforcement. When good behaviour is not rewarded consistently, the effectiveness of incentive systems is reduced because staff are not sure what outcome to expect from their efforts. Banks could use measures of non-financial performance more wisely (e.g., positive adjustment) to motivate staff.



MEASUREMENT OF STAFF CONDUCT MAY NOT CONSISTENTLY REWARD EFFORTS

▼ Common ways banks determine rewards for financial performance

Metric	Reward basis
Overall or product revenue or sales	All transactions minus any ineligible transactions due to non-compliance
Portfolio growth	
New accounts or customer growth	
Product or service penetration	
Referrals	
Cross-sales	
Team or branch revenue or sales	Transactions allocated to team/branch

▼ Common ways banks determine rewards for non-financial performance

Metric	Reward basis
Net promoter score	For transactions that have been sampled, overall sound results will typically be part of incentive calculations
Customer satisfaction	
Call monitoring	
Mystery shopper	
Customer compliments	For outstanding instances, banks may award annual prizes, or recognise via branch-level programs or newsletters
Team or branch compliance	For branches with 100% compliance results, team awards may be given

- ❖ Compared to rewards for financial performance, which are generally based on all eligible transactions, rewards for non-financial performance may inadvertently overlook many good behaviours displayed by staff in daily work that are not captured in customer feedback, award nominations, or quality assurance sampling.

INDUSTRY INSIGHT D

EFFECTIVENESS OF INCENTIVE SYSTEMS

OBSERVATION 4: BENEFITS FROM INCENTIVE CHANGES CAN TAKE TIME TO EMERGE

An inherent challenge in incentivising good customer and conduct outcomes is that subsequent commercial benefits can take a long time to realise. For both institutions and individuals, waiting to see the positive result is less motivating than being rewarded for short-term results. As a result, there is a tendency to focus on activities with short-term versus long-term 'payoffs' ('hyperbolic discounting'). Given innovations often require investment of time, cost and talent to develop and implement, banks may consider it challenging to adopt technologies, such as Artificial Intelligence and Machine Learning, to improve the efficiency and effectiveness of conduct risk management and compliance outcomes. Despite the challenge, the review found some banks that embraced these technologies found early benefits that support good customer and conduct outcomes.

The review also observed that when banks introduce changes to incentives or performance monitoring systems, frontline staff often perceive anxiety and resistance to changes – for example, due to concern about their capability to meet new requirements and changes to their incentive payment amounts. Similarly, bank management also attach importance to talent retention, motivation and performance when contemplating changes to incentive methods that have been in place for many years. Adoption of new practices is challenging, and implementation issues associated with new practices can be obstacles to rapid improvement. Banks need clear purpose, commitment to new strategies, and trust from their staff that changes to incentives will lead to better results for all stakeholders.

All banks have introduced changes

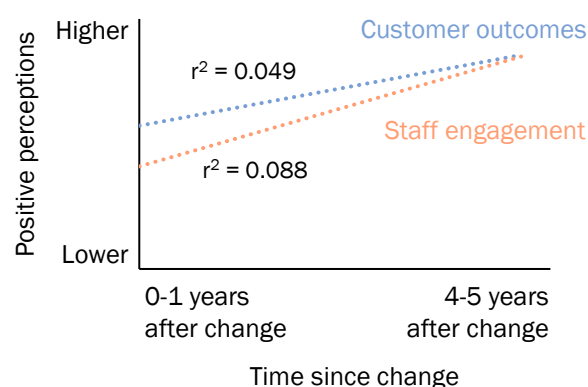
- ▼ All banks in the review have made significant changes to their incentive systems in the past five years

Incentive mechanisms that we observed banks implement in recent years included:

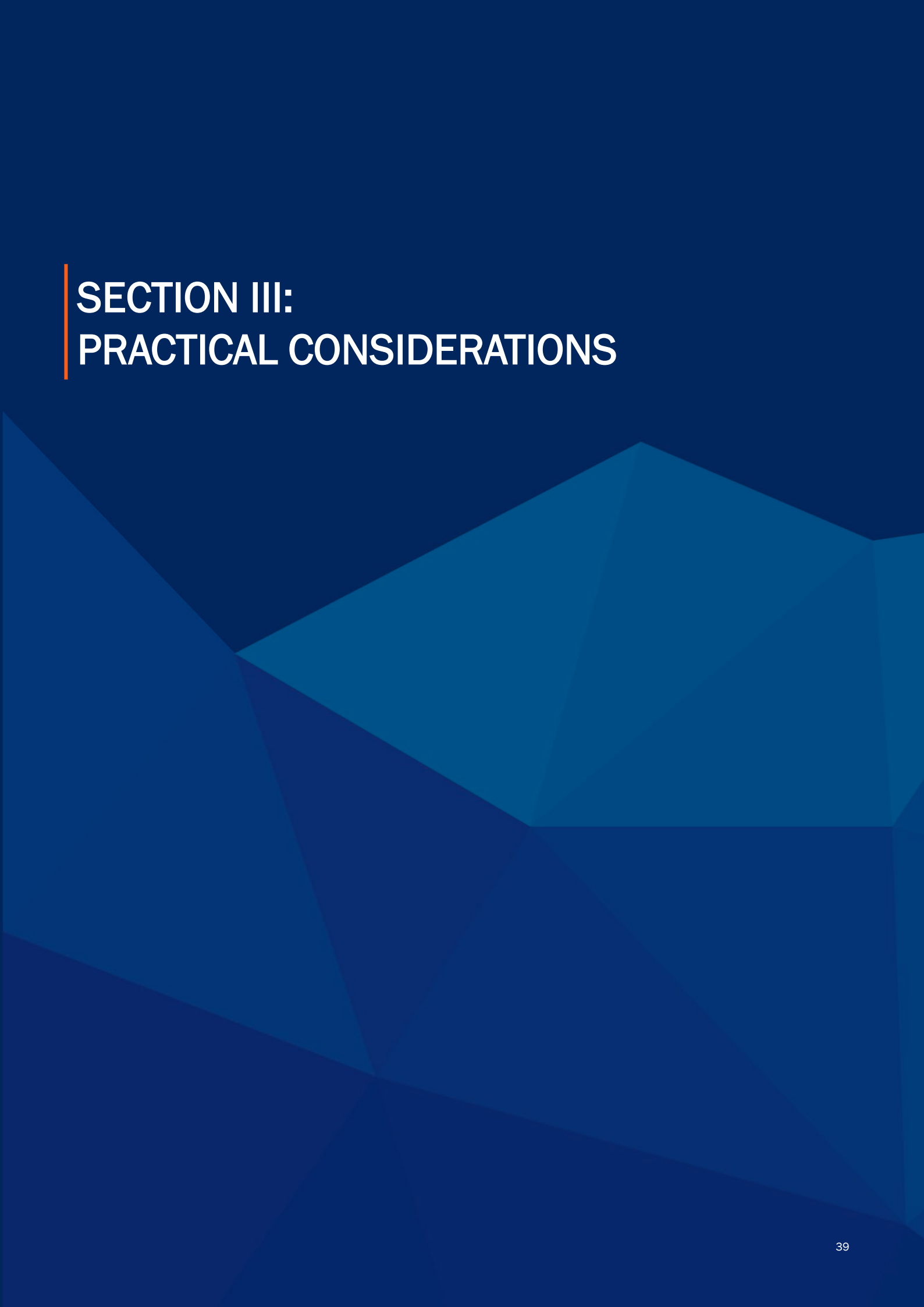
- ✓ **Non-financial focus introduced in performance assessment**, such as introducing non-financial KPIs, adopting a matrixed scorecard, and assessing values and behaviours as a gateway for incentive eligibility.
- ✓ **Increased discretionary ratings for non-financial performance**, through new performance measures that require manager ratings, and removing formula-based calculations.
- ✓ **Changes in incentive mechanics**, such as changes to the ratio of fixed to discretionary pay, changes to the range of incentive amounts typically paid, introduction of caps, and so on.

Positive effects of change can take time

- ▼ Analysis of relationship between time since change and survey results on staff engagement and perceived customer outcomes²⁴



- ◆ Incentive system changes, particularly in relation to non-financial performance, can have long-term benefits to staff and customers. The analysis above suggests that banks that introduced incentive system changes earlier (within the past five years) tended to show better **perceived customer outcomes** and higher **staff engagement**, compared to banks that introduced the changes more recently.



SECTION III: PRACTICAL CONSIDERATIONS

INTRODUCTION

INCENTIVE DESIGN PRINCIPLES AND SOUND PRACTICES

The previous section shared a range of common incentive practices observed across the Hong Kong banking industry, leading to four key challenges:

- A. Incentive systems may not fully reflect ‘good customer outcomes’
- B. Some common incentive practices may unintentionally push staff to prioritise business objectives over customer outcomes
- C. Incentive systems generally emphasise financial incentives when other types of rewards can be used more effectively to motivate good customer outcomes
- D. Some factors may impact the effectiveness of incentives that are designed to reinforce good customer outcomes

Although these challenges and the practices contributing to them were relatively common across the industry, the review also observed a range of sound incentive practices being discussed and implemented by various banks. These practices may provide important information about common characteristics of sound incentive design.

The review has identified six guiding principles for incentive design to reinforce good customer and conduct outcomes for banks to consider. These principles may provide a starting point for banks to consider ways of addressing common challenges shared by the industry. We also encourage banks to make reference to the sound incentive practices which illustrate these principles. The individual practices shared in this section may not always be suitable or effective for every bank. However, banks may consider whether each of the practices is suitable and effective when designing their own incentive systems, taking into account their positioning in the industry as well as their desired culture, values, and behavioural standards.

INCENTIVE DESIGN PRINCIPLES

INCENTIVE DESIGN PRINCIPLES TO REINFORCE GOOD CUSTOMER AND CONDUCT OUTCOMES

The following six key principles for the design of incentive systems are based on observations of common and sound incentive practices across the industry, and their impact on perceived customer and conduct outcomes. A range of sound practices are described on the following pages as references to illustrate how banks could apply these principles when designing their incentive systems. When designing their incentives, banks should ensure incentive systems align to the bank's overall context, including organisational culture, structure and location (e.g., local versus international headquarters), scale and resources, strategic focus and talent management objectives.



1

Clear prioritisation of customer outcomes. Banks need to satisfy multiple objectives, which are usually reflected in staff incentives. Incentive practices should explicitly reinforce prioritisation of customer outcomes, to avoid staff struggling with competing goals.



2

Development of an aligned system. The review observed that more effective incentive practices tended to be an embedded component of an overall culture with many other mutually reinforcing components.



3

Focusing on intrinsic motivators. The review noted that in contrast to a traditional focus on financial incentives, some banks reinforced better outcomes by relying more on robust non-financial incentives, with less risk and cost to banks.



4

Wise use of technology. The review observed that some banks embrace Fintech and adopt more advanced technologies such as Artificial Intelligence and Machine Learning. This can help banks detect undesirable behaviours and monitor misconduct more efficiently and effectively, and use technology resources to support good customer outcomes.



5

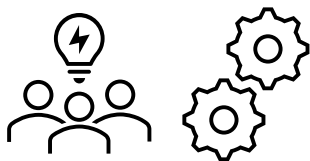
Close connection between leaders and staff. Leaders and staff often perceive bank conduct and customer outcomes differently. Stronger alignment often improves the impact of incentives by increasing opportunities for robust oversight, feedback, and assessment, especially on non-financial performance.



6

Minimising potential misconduct and mis-selling behaviours. Banks need to carefully design their incentive systems to induce sound behaviour of staff and minimise any potential misconduct and mis-selling activities, such as investment fund churning and life insurance policy replacements.²⁵

OVERVIEW OF SOUND PRACTICES



INCENTIVE DESIGN PRINCIPLES

SOUND PRACTICES	1	2	3	4	5	6	THEMES
1. Rewarding investment in long-term relationships	•	•	•				
2. Aligning internal policy with values	•	•	•				
3. Reinforcing customer outcomes over solely fulfilling customer requests	•	•	•			•	
4. Increased focus on customer-oriented behaviour, not sales	•	•	•			•	
5. Supporting staff to understand customer needs	•	•		•		•	
6. Customer outcomes over process compliance	•		•	•		•	
7. Integrating compliance requirements into system design	•	•		•		•	
8. Fair and objective monitoring of conduct				•		•	
9. Responding to staff feedback		•		•	•		

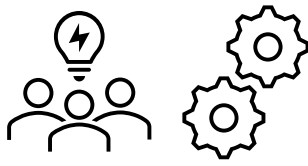
Incentive Design Principles

- 1** Clear prioritisation of customer outcomes
- 2** Development of an aligned system
- 3** Focusing on intrinsic motivators
- 4** Wise use of technology
- 5** Close connection between leaders and staff
- 6** Minimising potential misconduct and mis-selling behaviours

Themes

- Understanding customer outcomes
- Aligning staff behaviour
- Motivating frontline staff
- Effectiveness of incentive systems

OVERVIEW OF SOUND PRACTICES



INCENTIVE DESIGN PRINCIPLES

SOUND PRACTICES

1

2

3

4

5

6

THEMES

SOUND PRACTICES	1	2	3	4	5	6	THEMES
10. Aligning metrics with behaviour	•				•		
11. Rewarding non-financial performance	•	•	•				
12. Reducing incentive system complexity		•	•				
13. Setting dynamic targets		•				•	
14. Managing behavioural risk from tactical incentive programs		•				•	
15. Clear and appropriate consequences for undesired behaviour		•				•	
16. Considering diverse perspectives		•	•		•		
17. Amplifying good conduct with social rewards			•		•		

Incentive Design Principles

1

Clear prioritisation of customer outcomes

2

Development of an aligned system

3

Focusing on intrinsic motivators

4

Wise use of technology

5

Close connection between leaders and staff

6

Minimising potential misconduct and mis-selling behaviours

Themes



Understanding customer outcomes



Aligning staff behaviour



Motivating frontline staff



Effectiveness of incentive systems

SOUND PRACTICES

PRACTICE 1

Rewarding investment in long-term relationships

Practice

Bank A's incentive system puts a strong emphasis on long-term relationships, in line with the bank's strategic focus on customer loyalty. Customer relationships are a core component of relationship manager performance appraisals, and staff must demonstrate holistic performance over three years to earn good rewards. This approach rewards relationship managers for building long-term relationships, and ensures their performance is not overly impacted by short-term factors, such as market conditions and one or two large transactions.

Challenge this practice addresses

Through the review, banks indicated that cultivating customer loyalty and trust is seen as important for success and can take many years to achieve. Incentive practices, on the other hand, are often short-term in nature (for example, quarterly assessment and incentive payments), which can make it difficult to sustain focus and motivation towards long-term customer objectives and relationships.

KEY TAKEAWAY

To focus staff on delivering good long-term outcomes for customers, which in turn builds trust and loyalty, it is helpful if incentives explicitly reward staff for long-term performance and avoid rewarding solely for short-term achievement.

Principles this practice reflects



Clear prioritisation of customer outcomes



Development of an aligned system



Focusing on intrinsic motivators

Themes this practice may help



Understanding customer outcomes



Aligning staff behaviour



Effectiveness of incentive systems

SOUND PRACTICES

PRACTICE 2

Aligning internal policy with values

Practice

Bank B has strong internal values that place long-term relationships and loyalty to customers at the forefront. In line with these values, the performance of frontline staff is evaluated against internal policies that set a higher expectation than regulatory requirements on certain dimensions, including treatment of vulnerable customers (e.g., including additional flags that expand the possible reasons why customers could actually be vulnerable, and require further controls in these cases). This practice makes it clear to frontline staff that meeting minimum regulatory requirements is not necessarily sufficient to meet internal expectations of customer protection.

Challenge this practice addresses

The review observed that most banks in our sample demonstrated a keen awareness of regulatory requirements in relation to customer outcomes. Incentive systems that reward for compliance are often well-intentioned but can lead staff to view basic compliance as the 'end-goal', rather than good outcomes themselves. Further, banks that focus on compliance overlook the opportunity to reinforce their own bank's values, which generally go beyond the regulations.

KEY TAKEAWAY

Incentives that reinforce an authentic set of values that may not necessarily copy the regulatory guidelines, are more compelling and intrinsically motivating to staff than mandated requirements.

Principles this practice reflects



Clear prioritisation of customer outcomes



Development of an aligned system



Focusing on intrinsic motivators

Themes this practice may help



Understanding customer outcomes



Aligning staff behaviour



Motivating frontline staff

SOUND PRACTICES

PRACTICE 3

Reinforcing customer outcomes over solely fulfilling customer requests

Practice

Bank C has created a deliberate focus on the different ways frontline staff can support the delivery of good customer outcomes, which goes beyond service-oriented factors. Bank C fosters this holistic view via scenario-based training, feedback and promotion of real-life examples where staff have demonstrated deep understanding of how to navigate challenging situations to deliver good outcomes (such as refusing an elderly customer's request to withdraw a fixed deposit prematurely, after noticing red flags that indicated the customer was very likely falling victim to a scam).

Challenge this practice addresses

In customer service industries, there is a common adage: *the customer is always right*. This saying reflects the intent of providing excellent customer service. However, the review observed that frontline staff may perceive multiple priorities with regards to serving customers. There are times when these priorities conflict: what staff understand as having the higher priority will ultimately determine the customer outcomes achieved.

KEY TAKEAWAY

To reinforce a comprehensive focus on all the factors that drive good customer outcomes, including how to manage situations where short-term customer satisfaction may be in conflict with achieving a good outcome, frontline staff need deliberate support to build knowledge, confidence and judgment.

Principles this practice reflects



Clear prioritisation of customer outcomes



Development of an aligned system



Focusing on intrinsic motivators



Minimising potential misconduct and mis-selling

Themes this practice may help



Understanding customer outcomes



Aligning staff behaviour



Effectiveness of incentive systems

SOUND PRACTICES

PRACTICE 4

Increased focus on customer-oriented behaviour, not sales

Practice

Bank D makes deliberate attempts to not only better recognise staff for non-financial performance, but to decrease the significance of traditionally celebrated financial results. Bank D has monthly case sharing with frontline staff, recognising those staff who demonstrated exceptional customer service or who went 'above and beyond' to support a customer. The case sharing does not draw attention to sales or any large revenue generating events or individuals. The intent is to increase the salience of customer-focused behaviours, and ensure staff feel there is reward associated with these behaviours. It also begins to socialise desired behaviours, as staff learn from the good examples set by others.

Challenge this practice addresses

Sales performance remains highly salient to frontline staff as it is a core function of their role. Changing the way these staff are rewarded, via more balanced incentives, is only one lever to influence behaviour change and is unlikely to shift the priority of staff if not reinforced by other factors.

KEY TAKEAWAY

To make it clear to staff that the bank prioritises customer outcomes over financial results, it is important to recognise and celebrate customer-oriented behaviour. Supplementing financial incentives with opportunities for recognition increases the attractiveness of customer-focused behaviours.

Principles this practice reflects



Clear prioritisation of customer outcomes



Development of an aligned system



Focusing on intrinsic motivators



Minimising potential misconduct and mis-selling

Themes this practice may help



Understanding customer outcomes



Aligning staff behaviour



Effectiveness of incentive systems

SOUND PRACTICES

PRACTICE 5

Supporting staff to understand customer needs

Practice

Bank E has implemented technology that supports their relationship managers to have a better understanding of their customer needs. By investing and building this core technology that integrates data into a single platform, Bank E's relationship managers have been equipped with live-data on their customers including risk appetite, vulnerability, investment objectives, and details related to their financial situation, which enables them to 'know their clients' and make use of live data to assess their customer needs before soliciting any products to their customers. The digital approach enables staff to make use of their time and energy in more valuable ways that supports good customer outcomes.

Challenge this practice addresses

In the review, knowing your customer was described as a critical part of a relationship manager's role. Whether in branch, or over the telephone, relationship managers are expected to have regular contact with their customers to stay up to date to their changing needs. By use of relevant technology, this practice intends to equip staff to use their time more effectively to better understand their customers, and reduce reliance on memory and paper. Importantly, this allows staff to be aware of their customers' current situation, and their needs, before they sell them products.

KEY TAKEAWAY

To help relationship managers serve their customers, efficient use of technology can equip staff with information that enables them to have a better understanding of their customers needs.

Principles this practice reflects



Clear prioritisation of customer outcomes



Development of an aligned system



Wise use of technology



Minimising potential misconduct and mis-selling

Themes this practice may help



Understanding customer outcomes



Aligning staff behaviour



Effectiveness of incentive systems

SOUND PRACTICES

PRACTICE 6

Customer outcomes over process compliance

Practice

Bank F mitigates the risk that incentive systems may reward staff only for process compliance rather than good outcomes, by clearly articulating and systemically reinforcing the difference between ‘process-following’ and the ultimate objective of protecting customer interests. The distinction is reflected throughout procedure guidance, and assurance activities. As an example, where the process requires staff to obtain confirmation that customers ‘understand the product’, the bank is exploring the use of Regtech solutions to review the sales calls automatically to detect instances of non-compliance. This would enable more resources to focus on quality assurance to review more complex and high-risk cases to genuinely understand customers beyond a compliance check-box exercise.

Challenge this practice addresses

The review observed that most banks reward staff for compliance (or penalise for non-compliance) with stringent sales processes intended to protect good customer outcomes. However, the review also observed that a focus on compliance with sales procedures does not always guarantee good outcomes for customers, for a range of reasons. Excessive emphasis on process compliance may overshadow the original intent – leading staff to rely too heavily on established processes, and overlook the actual result for the customer. By using technology to automatically detect instances of non-compliance for sales procedures, more resources can be allocated to evaluating more nuanced drivers of customer and conduct outcomes.

KEY TAKEAWAY

When implementing incentive systems, deliberate strategies, such as the use of technology, are helpful to avoid staff solely pursuing operational measures (such as compliance with process) rather than ultimate goals (good customer outcomes).

Principles this practice reflects



Clear prioritisation of customer outcomes



Focusing on intrinsic motivators



Wise use of technology



Minimising potential misconduct and mis-selling

Themes this practice may help



Understanding customer outcomes



Aligning staff behaviour



Effectiveness of incentive systems

SOUND PRACTICES

PRACTICE 7

Integrating compliance requirements into system design

Practice

Bank G has integrated compliance requirements into frontline systems, including a mechanism to flag potential frequent trading of investment funds and reduce the likelihood of staff processing such transactions. This helps to protect staff from breaching compliance requirements by mistake. It also decreases the attractiveness of deliberately breaching compliance obligations in the hope of maximising financial results, as it is highly likely to be identified and quickly addressed.

Challenge this practice addresses

Our review indicated that frontline staff are highly conscious of compliance expectations, and of the impact of compliance and conduct on their incentives. Staff are motivated to avoid any deductions and can come to rely heavily on the systems they use in customer interactions to avoid unintentional breaches of compliance. This also helps banks to guard against any potential investment fund churning activities.

KEY TAKEAWAY

When designing the systems staff use in their interactions with customers, building in compliance requirements can greatly assist staff to do the right thing and can help protect customers. In addition, it makes it harder and less attractive for staff to do the wrong thing deliberately, and also helps banks to detect and mitigate misconduct and mis-selling risks in the selling of investment funds (or other products).

Principles this practice reflects



Clear prioritisation of customer outcomes



Development of an aligned system



Wise use of technology



Minimising potential misconduct and mis-selling

Themes this practice may help



Aligning staff behaviour



Effectiveness of incentive systems

SOUND PRACTICES

PRACTICE 8

Fair and objective monitoring of conduct

Practice

Bank H uses data and technology to identify potential misconduct in a timely and effective manner. Using data that covers all wealth management activities and transactions – both traditional key risk indicators and how the activity or transaction was conducted – a combined approach using both data analytics and machine learning models to identify transactions that reflect a high-risk scenario or ‘typology’. This alerts risk or conduct management staff to pay more attention to whether the selling process of the product is in order. They can apply judgment reasonably to see if ‘flags’ can be explained or suggest a more systemic issue. Broader trends reflective of increased risk of poor customer outcomes can also be identified through the analytics.

Challenge this practice addresses

Our review indicated that there may be a perception among frontline staff and supervisors that incentive deductions are overly punitive for minor compliance errors or mistakes. Additionally, most monitoring of sales quality and compliance relies on information generated post transactions which, whilst important, does little to pre-empt or correct failures before they occur. The use of technology-driven data analytics would help banks adopt a more systematic and ‘real time’ approach to monitoring conduct.

KEY TAKEAWAY

By combining technology and behavioural science, banks can move towards more insightful and effective methods of compliance monitoring. Supplementing such approaches with investigation by a specialist team, is likely to ensure the outcome is considered in context and increase perceptions among staff of a fair system for monitoring conduct.

Principles this practice reflects



Wise use of technology



Minimising potential misconduct and mis-selling

Themes this practice may help



Aligning staff behaviour



Motivating frontline staff

SOUND PRACTICES

PRACTICE 9

Responding to staff feedback

Practice

Bank I had recently changed their incentive framework, following feedback from staff that the current system was non-transparent to them. At Bank I, staff had a variety of channels to provide their opinion to the bank, including an app for staff to freely provide comments and special hotlines. Through the feedback received from these channels, leaders understood that the most common questions and feedback from staff was on the transparency of the incentive system. Subsequently, the bank chose to implement changes that simplified performance ratings, as well as making visible the method of calculation, and payment range of payment that staff could expect for a given score. Implementation of these changes were supported with extensive communication and guidance for staff. Bank I is now rolling out additional anonymous surveys this year to gain further feedback on the new incentive program.

Challenge this practice addresses

The review highlighted how different banks navigate the challenges associated with continuously changing and improving their current incentive systems. For some banks, changes were applied with a top-down approach to meet other requirements (e.g., regulatory). Engaging staff in the process of implementation and reflecting their needs in the changes applied can pose significant challenge.

KEY TAKEAWAY

To improve staff perception of control over their incentives, banks would benefit from actively seeking out staff feedback, and implement changes that improve transparency.

Principles this practice reflects



Development of an aligned system



Wise use of technology



Close connection between leaders and staff

Themes this practice may help



Understanding customer outcomes



Aligning staff behaviour



Effectiveness of incentive systems

SOUND PRACTICES

PRACTICE 10

Aligning metrics with behaviour

Practice

Bank J has developed a robust and holistic approach to assessing staff performance on customer and conduct outcomes. Guidance materials outline clear expectations for what staff should demonstrate to achieve a high rating on their customer-related KPIs. Managers are expected to take into consideration a range of information sources. Some of these sources include easily determined, quantitative metrics (e.g., net promoter score, customer satisfaction surveys), but others require more discretionary judgments of staff behaviour. For example, managers are told to look for stories or cases where staff have demonstrated customer advocacy and proactive support of vulnerable customers.

Challenge this practice addresses

Performance metrics are a powerful way to focus staff attention on what their priorities should be – after all, ‘what gets measured, gets done’. Through our review, customer metrics were found to focus on customer satisfaction (e.g., net promoter score, customer complaints), while other metrics provide a lagging indicator of conduct outcomes (e.g., quality assurance scores, mystery shopper program results). Putting focus on more proactive, long-term customer and conduct outcomes remains an ongoing challenge faced by many banks.

KEY TAKEAWAY

By setting clear behavioural expectations that align individual performance goals with desired bank outcomes, banks can encourage staff to prioritise decisions and actions aligned to customers’ best interest.

Principles this practice reflects



Clear prioritisation of customer outcomes



Close connection between leaders and staff

Themes this practice may help



Understanding customer outcomes



Aligning staff behaviour



Effectiveness of incentive systems

SOUND PRACTICES

PRACTICE 11

Rewarding non-financial performance

Practice

Bank K has implemented a performance and incentive system that rewards their staff for good non-financial performance. Staff can gain a positive adjustment to their non-financial KPIs (e.g., customer-related behaviour, leadership behaviour). For example, gaining customer compliments may give staff a certain percentage increase on their performance score, which then impacts the amount of incentive they are able to earn at the end of the quarter. Furthermore, staff are given the opportunity to overachieve on some of their non-financial KPIs, unlike most other banks where overachievement is only permitted on financial KPIs. Annual performance scores may receive a positive multiplier (i.e., a 'boost') if staff demonstrate excellent behaviour aligned with the bank's values.

Challenge this practice addresses

Across the banks in the review, poor non-financial performance was typically met with some sort of penalty or deduction to performance rating and/or incentive. Few banks had practices for the reverse – allowing staff to increase their incentive for good non-financial performance. The imbalance in opportunity to earn may subsequently lead to an imbalance in the motivation staff feel to achieve their different performance objectives.

KEY TAKEAWAY

To effectively motivate staff, banks may consider the balance in how different performance goals are rewarded, and should support messaging on the importance of non-financial performance with the commensurate reward.

Principles this practice reflects



Clear prioritisation of customer outcomes



Development of an aligned system



Focusing on intrinsic motivators

Themes this practice may help



Understanding customer outcomes



Aligning staff behaviour



Motivating frontline staff

SOUND PRACTICES

PRACTICE 12

Reducing incentive system complexity

Practice

Bank L has kept their incentive design deliberately simple. Staff can expect a relatively stable annual bonus each year, provided they have not breached conduct or compliance expectations. Low pay differentiation between average and top performers, aligns to the banks' culture of collaboration, where all staff (i.e., front and back office) are seen as equally responsible for ensuring good customer outcomes. Reducing complexity in incentive calculation can alleviate some of the pressures on staff to interpret their scorecard or track their KPIs. While earning potential may not be as high as at other banks, this system does create security and stability for staff and aligns to the banks' corporate values.

Challenge this practice addresses

Banks use the design and implementation of incentives as a way of reinforcing organisational priorities to frontline staff. In this review, increasing complexity in incentive calculation is often a direct result of banks trying to reinforce many different performance and business objectives. Complex scorecards can be difficult for staff to interpret and may create discomfort when staff who rely on these incentives find it hard to estimate financial outcomes.

KEY TAKEAWAY

While incentive systems are becoming increasingly complex across the industry, there may be some cases where a simplified system is preferred by frontline staff. This may be a strategic decision informed by the culture of the bank, that also attracts and retains the staff most aligned to this culture.

Principles this practice reflects



Development of an aligned system



Focusing on intrinsic motivators

Themes this practice may help



Understanding customer outcomes



Aligning staff behaviour



Effectiveness of incentive systems

SOUND PRACTICES

PRACTICE 13

Setting dynamic targets

Practice

Bank M has utilised a set of guidelines to determine staff scorecard and targets, designed to guard against staff experiencing excessive pressure when striving to achieve sales goals. The guidelines consider, for example, factors in the external environment that may influence how difficult it is for staff to appropriately meet targets, and place restrictions on increasing targets if a certain percentage of staff are unable to reach their targets consecutively. Targets may be adjusted, though this is discouraged to prevent a negative impact to the frontline. If there is significant shortfall, targets may be adjusted downward or reallocated. Data is used to simulate current market and performance and determine whether changes are required. During the COVID pandemic, Bank M was able to take a more dynamic approach in setting targets, allowing mid-quarter changes and reducing revenue targets to relieve pressure.

Challenge this practice addresses

Sales and/or revenue targets present a common source of pressure for staff across all banks in the industry. While targets provide staff with a clear goal to motivate them towards, targets that are unrealistic due to factors outside of the control of staff may cause undue pressure that drives undesirable behaviour – such as mis-selling to reach revenue targets.

KEY TAKEAWAY

By using clear guidelines for setting targets, as well as taking a dynamic approach that makes adjustments in light of what staff are able to actually achieve, banks can be better equipped to ensure the targets they set are fair and achievable for their staff.

Principles this practice reflects



Development of an aligned system



Minimising potential misconduct and mis-selling

Themes this practice may help



Aligning staff behaviour



Motivating frontline staff

SOUND PRACTICES

PRACTICE 14

Managing behavioural risk from tactical incentive programs

Practice

Bank N has developed a set of guidelines for the design of tactical incentive programs within the bank, which are intended to help ensure that these programs do not drive undesirable behaviour. These guidelines include principles such as not promoting specific product or product types, as well as applying the same magnitude of incentive deductions on the quarterly incentives to any tactical program awards. The amount of reward was also taken into careful consideration, with the total amount an individual receives from tactical programs limited to a limited amount of their total compensation. Furthermore, Bank N emphasised that tactical programs, which are intended only to be short-term boosters, should not become part of business-as-usual, and to this effect, the same tactical programs are not allowed to be run continuously.

Challenge this practice addresses

The review noted that the majority banks in the industry use tactical incentive programs, typically to drive sales activity over a short period of time. These tactical programs tend to be developed outside of the usual incentive schemes (e.g., quarterly incentive schemes), with separate targets and rewards. This practice helps ensure tactical programs are designed with factors that reduce the risk of driving undesirable behaviour, while also actively considering the cumulative impact that multiple incentives may have on staff perceptions of pressure.

KEY TAKEAWAY

To help mitigate the risk of driving undesirable behaviour, banks may seek to develop guidelines on the design and use of tactical incentive programs, which also consider the combined impact of all staff incentives to ensure the reward is reasonable.

Principles this practice reflects



Development of an aligned system



Minimising potential misconduct and mis-selling

Themes this practice may help



Aligning staff behaviour



Motivating frontline staff

SOUND PRACTICES

PRACTICE 15

Clear and appropriate consequence for any undesired behaviour

Practice

Bank O conducts regular meetings to specifically discuss and review life insurance policy replacement cases. Where adverse findings are confirmed, the bank will take action to implement an appropriate consequence for the sales staff involved, ranging from a score deduction from staff's performance scorecard, to disciplinary action.

Challenge this practice addresses

Given the long-term nature of life insurance policies, the customer may suffer losses as a result of the financial implications, insurability implications, claims eligibility implications, and so on, arising from the policy replacement. When banks apply clear and appropriate consequences for staff engaging in any insurance policy replacement activities, which could have implications on their performance rating and incentive pay-outs, this can send a strong message to their staff on the importance of not engaging in such activities vis-à-vis financial performance.

KEY TAKEAWAY

When designing incentive systems, banks need to have mechanisms in place which set out consequences for staff engaging in any undesired behaviours, and determine corresponding outcomes in line with the severity of undesired behaviour.

Principles this practice reflects



Development of an aligned system



Minimising potential misconduct and mis-selling

Themes this practice may help



Aligning staff behaviour



Effectiveness of incentive systems

SOUND PRACTICES

PRACTICE 16

Considering diverse perspectives

Practice

Bank P has implemented changes to their incentive system in a way that balances the bank's conduct direction with staff ability to follow and stay engaged. Recognising the importance of clarity of priorities across all organisational levels, Bank P sought to reinforce two-way feedback and communication. Senior management visibly instruct and explain the importance of serving the clients, while also holding direct discussions with branch staff to understand their perspective. Additionally, support functions gather ongoing comments and suggestions regarding the frontline experience, enabling them to adapt the pace of changes in line with the response of staff.

Challenge this practice addresses

Maintaining staff engagement and keeping motivation high can be a key challenge faced by banks when changing their incentive systems. Through the review, banks that had chosen to implement changes shared how they had initial concerns around staff attrition or decreases in productivity. Banks undertook a mix of practices to mitigate these risks to staff performance, some of which were more successful than others.

KEY TAKEAWAY

Ensuring strong two-way communication and feedback between leadership and frontline staff, and flexibility to adapt to changing needs, is vital to support staff engagement during incentive changes.

Principles this practice reflects



Development of an aligned system



Focusing on intrinsic motivators



Close connection between leaders and staff

Themes this practice may help



Understanding customer outcomes



Motivating frontline staff



Effectiveness of incentive systems

SOUND PRACTICES

PRACTICE 17

Amplifying good conduct with social rewards

Practice

Bank Q leverages a range of social rewards to celebrate and recognise staff who have achieved excellent non-financial performance. For example, Bank Q introduced peer-to-peer recognition program to reward staff who demonstrated exemplary behaviours. The bank also regularly produces a bank-wide magazine that highlights not only staff with top sales achievement, but also staff who display excellent anti-money laundering performance and achieve good customer feedback. Staff who receive these commendations are further recognised with direct acknowledgement and praise from senior management at certain events (e.g., branch visits, lunches), bolstering the initial reward with an opportunity to improve their reputation within the bank.

Challenge this practice addresses

The review observed that social rewards, such as giving awards or trophies to high performers, are a common practice across the banks. These rewards can be powerful motivators, appealing to intrinsic desires (e.g., wanting to be recognised). While a majority of banks typically award social rewards for sales performance, through ranking of top sales staff or trophies for the highest performing branch, not many use social rewards to commend staff for good conduct.

KEY TAKEAWAY

To amplify good conduct, banks can provide social rewards that elevate non-financial performance to a similar level of recognition as financial performance.

Principles this practice reflects



Focusing on intrinsic motivators



Close connection between leaders and staff

Themes this practice may help



Understanding customer outcomes



Aligning staff behaviour



Motivating frontline staff

| CONCLUSION

CLOSING REMARKS

NEXT STEPS

Incentive practices often share a number of similar characteristics across banks for a range of reasons. Banks observe industry peers on how to approach common challenges in relation to incentive design, and competition for talent can be a driver of maintaining certain practices as industry norms. We heard in our discussions that when banks observe others using an approach to incentives, they may consider that it is likely to be reasonably effective.

However, this report has highlighted that banks should be cautious about accepting 'common practice' as 'sound practice'. In some cases, it is possible that the risks attached to some practices may have been overlooked by banks due to their widespread use. There may also be cases where some banks have managed the risks while others have failed to do so. Regardless of industry practices, banks should continue their efforts to ensure that their incentive systems are designed to motivate sound behaviour, and minimise potential misconduct and mis-selling behaviours. This caution is reinforced by the observation that in general, some of the practices we observed – such as ranking or accelerators – were less prevalent in banks with incentive systems designed to reinforce a focus on good customer outcomes.

The review has identified six principles that may assist banks in their efforts to design incentives to reinforce sound behaviour and mitigate the risk of misconduct and mis-selling practices. They include:

1. Clear prioritisation of customer outcomes
2. Development of an aligned system
3. Focusing on intrinsic motivators
4. Wise use of technology
5. Close connection between leaders and staff
6. Minimising potential misconduct and mis-selling behaviours

Culture is set and owned by banks, underpinned by appropriate incentive systems that induce desired behaviours at all levels. Banks are encouraged to make reference to the industry themes and observations identified in this review and consider the six principles which could form the basis of design of incentive systems that may address the common challenges shared by the industry. The individual practices shared in this final report may not always be suitable or effective for every bank. However, banks may consider whether each of the practices is suitable and effective when designing and adopting in their own incentive systems, taking into account their positioning in the industry as well as their desired culture, values, and behavioural standards. It is equally important for banks to continue their culture efforts in promoting a sound culture in order to safeguard good and sustainable customer and conduct outcomes.

IN CLOSING

As we close this final report, we again thank the selected banks for their active participation throughout the Focused Review. We thank the banks for their time and cooperation, and extend further gratitude to the leaders and staff who shared their perspectives in the survey, interviews, and focus groups.

NOTES

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¹ Cancialosi, C. (2014). The dark side of bonus and incentive programs. *Forbes*.
<https://www.forbes.com/sites/groupthink/2014/06/07/the-dark-side-of-bonus-and-incentive-programs/?sh=27280f65756d>

² A bank-level correlation analysis was conducted examining the relationship between two factors measured in the industry-wide survey, *business-focused incentives* and *perceived customer outcomes*, to see whether staff responses on one factor are associated with responses on the other.

- The factor *business-focused incentives* comprised of survey questions relating to staff perceptions of incentive practices used at their bank that are business focused, such as ranking staff based on their sales/revenue.
- The factor *perceived customer outcomes* comprised of survey questions relating to staff perceptions of customer and conduct outcomes, such as treating customers fairly.
- Results indicated that banks where staff perceived more business-focused incentives, were more likely to have less positive perceptions of customer outcomes, $r = -0.848$.

³ A bank-level correlation analysis was conducted examining the relationship between two factors measured in the industry-wide survey, namely customer-focused incentives (such as praising staff for treating customers fairly) and perceived customer outcomes (such as treating customers fairly).

⁴ See note 2.

⁵ A bank-level correlation analysis was conducted examining the relationship between two factors measured in the industry-wide survey, *bank culture* and *perceived customer outcomes*, to see whether staff responses on one factor are associated with responses on the other.

- The factor *bank culture* comprised of survey questions relating to staff perceptions of culture at their bank, such as prioritising customer outcomes over bank revenue.
- The factor *perceived customer outcomes* comprised of survey questions relating to staff perceptions of customer and conduct outcomes, such as treating customers fairly.
- Results indicated that banks where staff perceived more positive bank culture, were more likely to have more positive perceptions of customer outcomes, $r = 0.942$.

⁶ HKMA circular dated 28 October 2013 on *Treat Customers Fairly Charter*.
<https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2013/20131028e1.pdf>

⁷ Based on responses to two questions in the industry-wide survey assessing perceived customer and conduct outcomes, where respondents indicated their perceptions of full confidence in providing complete information and ensuring customers understand the products they buy in all circumstances.

NOTES

⁸ Thaler, R. H., & Sunstein, C. R. (2008). *Nudge: Improving Decisions about Health, Wealth, and Happiness*. Yale University Press. ISBN: 978-0-14-311526-7.

⁹ Yearly performance results:

- Performance appraisal results were obtained for financial and non-financial performance for one year, from the samples of appraisal reports or scorecards for top and average earning sales staff across all banks.
- Where an annual appraisal score was not available, performance for the year was calculated as the average of four quarterly performance scores.
- Where a ranking or rating system was used, it was first converted into a proportionate percentage score.
- Where a raw score provided in the appraisal report or scorecard do not take into account the weighting of financial versus non-financial factors, it was first converted into a weighted score.

¹⁰ Individual-level correlation analyses were conducted, examining the relationship between total earnings for one year for a sample of sales staff with their yearly financial performance score, and with their yearly non-financial performance score. See note 9 above for details on the yearly performance scores. Results indicated that staff who achieved a higher financial performance result for one year were more likely to earn higher pay for the year, $r = 0.439$; whereas staff who achieved a higher non-financial performance result for the year were much less likely to earn higher pay, $r = 0.055$.

¹¹ HKMA circular dated 23 November 2021 on *Interim Report on Focused Review on Incentive Systems of Front Offices in Retail Banks*. <https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2021/20211123e1a1.pdf>

¹² A bank-level correlation analysis was conducted for frontline staff, examining the relationship between perceived supervisor pressure and perceived prioritisation of good customer outcomes, as measured by the industry-wide survey. Results indicated that banks where staff (at both frontline and supervisor levels) perceived more supervisor pressure to meet business targets, had staff who were less likely to agree that people at their bank prioritise customer outcomes over bank revenue (frontline staff, $r = -0.351$; supervisors, $r = -0.354$).

¹³ Percentage of survey respondents who agreed or strongly agreed that this occurred in their bank.

¹⁴ Sharot, T. (2017). What motivates employees more: Rewards or punishments? *Harvard Business Review*. <https://hbr.org/2017/09/what-motivates-employees-more-rewards-or-punishments>

¹⁵ Rigby, C. S., & Ryan, R. M. (2018). Self-determination theory in human resource development: New directions and practical considerations. *Advances in Developing Human Resources*, 20(2). <https://journals.sagepub.com/doi/full/10.1177/1523422318756954>

¹⁶ Olafsen, A. H., Niemiec, C. P., Halvari, H., Deci, E. L., & Williams, G. C. (2015). On the dark side of work: a longitudinal analysis using self-determination theory. *European Journal of Work and Organizational Psychology*, 20(2), 275-285. https://selfdeterminationtheory.org/wp-content/uploads/2017/03/2017_OlafsenNiemiecEtAl_DarkSideOfWork.pdf

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¹⁷ Individual-level correlation analyses were conducted examining the relationship between perceived praise and penalties with the factor *intrinsic motivation* (e.g., finding it rewarding to achieve good outcomes for customers), as measured in the industry-wide survey. Results indicated that staff who agreed that they receive praise at their bank for good customer outcomes, also tended to agree to having higher intrinsic motivations, $r = 0.471$. Staff who agreed that they are penalised at their bank for causing poor customer outcomes were much less likely to show higher intrinsic motivations, $r = 0.158$.

¹⁸ To compare scores between top and average-earning sales staff, weighted scores (see note 9 above) were first converted to a standardised percentage score, to ensure that all scores were on a standardised scale. For example, financial performance weighted at 60%, and a weighted score of 45, equates to a financial performance score of 75% (45/60) in this analysis.

¹⁹ Data shows results from the poll in the focus groups. The top five response options selected by respondents are displayed.

²⁰ Seligman, M. E. P. (1975). Learned helplessness. *Annual Review of Medicine*, 23, 407-412.
<https://www.annualreviews.org/doi/10.1146/annurev.me.23.020172.002203>

²¹ Landry, N., Gifford, R., Milfont, T. L., Weeks, A., & Arnocky, S. (2018). Learned helplessness moderates the relationship between environmental concern and behavior. *Journal of Environmental Psychology*, 55, 18-22. <https://doi.org/10.1016/j.jenvp.2017.12.003>

²² Edmondson, A. C., & Lei, Z. (2014). Psychological safety: The history, renaissance, and future of an interpersonal construct. *Annu. Rev. Organ. Psychol. Organ. Behav.*, 1(1), 23-43.
<https://doi.org/10.1146/annurev-orgpsych-031413-091305>

²³ Based on responses to two questions in the industry-wide survey assessing potential conduct risk, where respondents indicated whether or not people they work with have exhibited such potential conduct risk when seeking to meet performance requirements or targets.

²⁴ Bank-level correlation analyses were conducted examining the relationship between time since incentive system change with *perceived customer outcomes*, and with *staff engagement*, measured in the industry-wide survey.

- The factor *perceived customer outcomes* comprised of survey questions relating to staff perceptions of customer and conduct outcomes, such as treating customers fairly.
- The factor *staff engagement* comprised of survey questions relating to staff self-perceptions of level of engagement in their job, such as finding their job to be meaningful.
- Results indicated that banks that implemented significant incentive system changes earlier were more likely have better perceived customer outcomes, $r = 0.220$, and higher staff engagement, $r = 0.296$.

Note: customer outcomes and staff engagement are separate factors assessed through different survey questions. Perception levels on these two factors are not comparable to each other, e.g., a 60% positive perception on customer outcomes is conceptually different to a 60% positive perception on staff engagement.

NOTES

²⁵ For details, please refer to the guidance set out in the Circulars issued by the HKMA:

- Dated 20 October 2020 on *Life Insurance Policy Replacement*.
<https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2020/20201020e2.pdf>
- Dated 22 November 2019 on *Feedback from Recent Reviews on Selling of Investment Funds*.
<https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2019/20191122e2.pdf>

