Agenda

Advancing economics in business

How to pay for advice and distribution in financial services?

The question of commission payments to financial intermediaries has recently come to public attention, as EU policymakers discuss the issue in the context of the Insurance Mediation Directive (IMD2, a new set of rules for the European insurance sector) and the Markets in Financial Instruments Directive (MiFID, which aims to harmonise rules for investment services). What are the economics of commission payments, and what has been the experience of countries where specific regulations have been introduced?

Organisations distribute the products and services of producers to consumers in all sectors of the economy, and in all cases their distribution services need to be paid for. For example, a travel agent may receive commissions from a tour operator, or it may charge service fees directly to the consumer (which may be the case with booking flights). These distribution services are paid for in a wide range of ways.

The situation is no different in financial services. Financial intermediaries, such as agents and brokers, facilitate transactions between retail consumers and the providers of financial services. Their services range from simply providing access to products to providing advice to consumers about which product may be the best option for them (including advice not to buy any product at all). The nature of the service will depend on the product, the distribution channel and the consumer's circumstances.

In most European countries, financial intermediaries are remunerated to some extent through commission payments by the provider, with the commission generally being contingent on the completion of a transaction. These commission payments take different forms, depending on the relationship between provider and distributor (in many cases, the two may be vertically integrated as part of the same firm, such as a bank). There is an increasing regulatory focus on the issue of commission payments, however, and some countries have introduced regulation to restrict these payments.

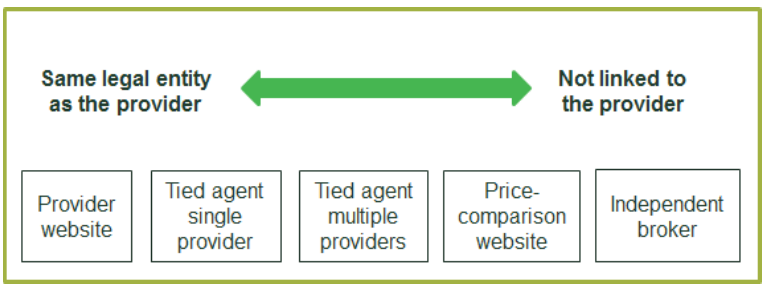
Traditionally, regulation of commission payments would often focus on the potential impact of payments on the behaviour of distributors, but it is also important to take account of the impact on the behaviour of providers and consumers. Regulators are increasingly taking into account the findings of behavioural studies with regard to how consumers respond to different situations, and Oxera's analysis in this area has been informed by behavioural economics.[1]

The key conclusion of this analysis is that no single method of payment for the distribution of financial services can be considered to be ideal in all circumstances—the pros and cons vary according to the situation. A range of regulatory options can be considered, depending on the circumstances, including 'smart' disclosure, financial education and company supervision, and restrictions on 'inducements' (e.g. volume-related bonuses) and commission payments. The optimal regulatory approach depends on the precise circumstances of the market in question.

The economics of payments for distribution services

In financial services, there are a wide range of distribution channels, depending on the nature of the relationship between the provider and the distributor. Figure 1 summarises the spectrum of options, from direct 'in-house' sales by the provider to brokers acting on behalf of their

Figure 1 Spectrum of types of financial distributor



Source: Oxera.

clients. Different types of distributor may also undertake different types of activities. For example, price-comparison websites tend to list only products and prices, while brokers may focus on the provision of advice about the suitability of products to the consumer's needs.

As distributors facilitate transactions between consumers and providers, they can receive payment from either party, although ultimately all payments come from the consumer. The form of payment can be expected to have an impact on both consumer demand for financial services products and the intermediary's incentive to offer different services and advice. The various impacts are summarised in Figure 2, and discussed in detail below.

Impact on the behaviour of distributors

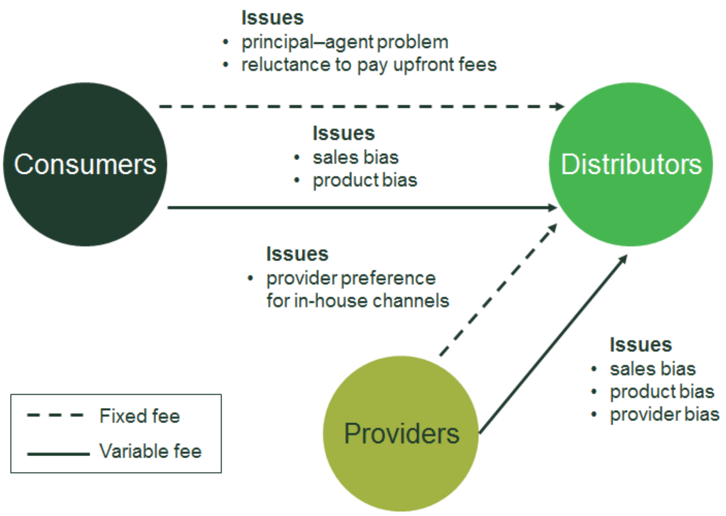
The type of payment will affect the behaviour of the distributor. Any salesperson in any sector is influenced by the way in which they are paid, which is why it is important to understand the range of 'biases' that can be created by different forms of payment. These can include the following.

- **Sales bias**: any payment that is contingent on the transaction being completed, from either the consumer or the provider, will incentivise the intermediary to achieve a successful transaction. Although this is their primary economic function, there may be concern in some situations that intermediaries are incentivised to complete more transactions than may be in the interests of either the consumer or the provider ('sales bias')—for example, a turnover-related bonus may create a strong incentive to sell a product in order to reach the bonus threshold.

- **Product bias/provider bias**: any difference in payments, from either the consumer or the provider, with regard to different products or providers can be expected to incentivise the intermediary to favour achieving transactions involving that particular product or provider; this applies equally to differential margins on products (i.e. payments from the consumer to the distributor) and differential commission payments (i.e. payments from the provider to the distributor).

- **The principal–agent problem**: payments that are not contingent on completion of the transaction may fail to incentivise the intermediary (the 'agent') to achieve the aim of the consumer or the provider (the 'principal')—which is to complete the transaction (for example, a consumer buying insurance).

Figure 2 Potential biases across different types of payments



Source: Oxera.

It is important to consider these different forms of payment from the point of view of the consumer, as the impact on the final outcomes depends on the consumer's situation. For example, if a consumer has to buy motor insurance, and the choice of product features is fairly straightforward, then the extent to which the distributor can affect the outcome is relatively limited and the service it provides to the consumer will be mainly around obtaining a competitive price. On the other hand, a consumer looking for investment advice may be more reliant on the distributor, and there may be a risk of consumer detriment if these biases arise.

Impact on the behaviour of consumers

The different forms of payment can also have an impact on the behaviour of consumers, which can make the distribution of financial services challenging. Behavioural economics is increasingly being used to inform regulation, as the success of regulation of firms depends not only on how it affects the behaviour of those firms, but also on how consumers will respond. In this case, consumer decisions can be particularly affected by the following.

- **Lack of consumer engagement**: financial services can often involve relatively low levels of consumer engagement, relative to the importance (or expense) of the services,[2] which can lead to insufficient demand for services by consumers. Financial services products have several attributes which make them especially difficult to engage with. They tend to be more abstract and less tangible than many other, more visible goods and services. Furthermore, consumers may fail to engage with some financial services products (e.g. life insurance) because these products are linked with negative outcomes that the consumer would rather avoid thinking about. Consequently, there is a risk that making consumers pay directly for distribution services could result in consumer demand being below an optimal level, for example due to a lack of demand for financial advice.

- **Complex pricing**: financial services products can be relatively complex and, partly due to this, they may involve multiple charges at the time of purchase and throughout the product lifecycle. For example, a mortgage involves both upfront charges and variable interest payments.

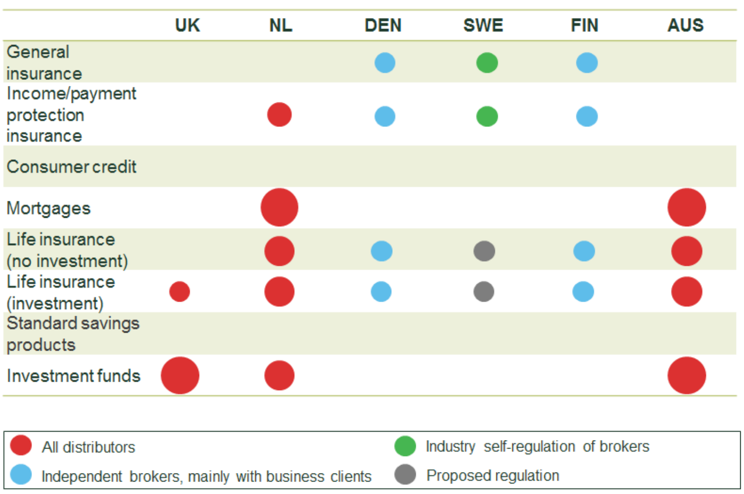
Lack of consumer engagement and complexity can result in negative outcomes. For example, the US Federal Trade Commission conducted an experiment which explored the impact of mortgage brokers disclosing to prospective consumers the commissions that the brokers received for arranging a loan with a particular provider.[3] It found that consumers treated the commission information as particularly salient. They placed too much emphasis on the commission, and too little on whether the loan was keenly priced. Consumers paid more for their loans than they would have done without the commission information.

Experience of regulating commission payments

Restrictions on commissions have been introduced in a small number of countries, and in these countries only in relation to specific products and sales channels.[4] Figure 3 provides an overview of the scope of the regulatory regimes in selected countries where a ban on commissions has been introduced: the UK, Denmark, Sweden, Finland, the Netherlands and Australia. For example, in the UK commission payments have been restricted for investment funds by the Retail Distribution Review (RDR) regulation, which also affects life insurance with an investment element (e.g. unit-linked policies).[5] In general, regulators have taken a case-by-case approach to regulating commission payments, and introduced bans only in relation to a specific set of products and/or specific sales channels where there was evidence of consumer detriment and where, in most cases, other regulatory tools were not considered to have worked sufficiently.

In some situations, other forms of regulation were identified as being more appropriate for addressing the underlying causes of problems. In some cases, there was no justification for the ban, as there was no evidence of a commission-related problem (for example, the UK Financial Services Authority, FSA, did not include pure insurance distribution in the RDR regulation[6]). In other cases, there was no evidence that a ban would be an effective solution to the problem (such as with payment protection insurance in the UK[7]). Alternatively, there has been a concern in other situations that a ban might have undesirable effects (such as in the case of mortgage advice to those in financial difficulties in the Netherlands[8]).

Figure 3 Scope of regulation of commission payments



Note: The size of the bubbles indicates the relative scale of the distribution sector affected by regulation.

Source: Oxera.

Where restrictions on commission payments have been introduced, this has occurred only recently, and it appears to be too early to fully assess their impact. In the Netherlands, for example, the regulator plans to wait until 2017 to conduct its post-implementation review.[9] The FCA in the UK has recently published its 'Phase 1' post-implementation review for the RDR,[10] which does provide some insights into the developing impacts of regulation, as discussed below.[11] Phase 2 of the FCA review is not expected until early 2017, and Phase 3 has yet to be scheduled.

Impact of the RDR in the UK

With the RDR having been fully in place for a year, the FCA has conducted a review of its impact so far, concluding that 'overall, while in many respects the longer-term effects of the RDR are yet to become clear, the evidence from the first stage of the review shows a positive picture, with encouraging signs that the RDR is on track to deliver its objectives in many areas.'[12]

The FCA notes that product bias has been reduced, reflected in a decline in the sale of products which paid higher commissions pre-RDR. The FCA also found that the RDR has made it easier for consumers to compare investment platforms, and product prices have fallen by at least the amounts paid in commission pre-RDR. These are some of the main benefits that the FCA hoped to see from the RDR reforms.[13]

On the other hand, it may be too early to assess the possible negative impacts of the reforms. The FCA concludes that there is little evidence that the availability of advice has reduced significantly as a result of the RDR.[14] However, the FCA also notes that, by revealing the true cost of advice, the RDR has led some consumers to consider the extent to which the advice they receive represents value for money, and in some cases consumers conclude that it does not.

Looking further into the evidence, there are reasons to suspect that the negative impact on demand for advice could become more significant. First, consumer research suggests that consumers' understanding of both adviser charges and the nature of advice is currently limited (for example, some consumers still think that they do not need to pay for the advice, perhaps as it is paid for by commissions, even though the RDR reforms mean that the adviser can only receive payment from the consumer).[15] When awareness of adviser charges increases, the group of consumers that no longer take advice (due to lack of willingness to pay) may also increase. Also, the unwinding of existing cross-subsidies may continue and may also result in more people being unwilling or unable to pay for advice.

Restrictions on commission payments

The UK market has its own specific characteristics—in other markets, the impact may be different due to differences in consumer behaviour and market structure and dynamics.

The regulation of commission payments needs to take account of specific market conditions, and be designed to address particular issues of concern and deliver good outcomes. Wide-ranging blanket controls are unlikely to be effective, as different regulations are required for different issues. Regulators in the countries considered in this analysis have developed their own approaches to addressing the issues affecting their particular markets, and these specific issues were not common across all of the countries or, indeed, all of the product markets considered.

Finally, as most regulatory restrictions on commission payments are recent, it appears to be too early to fully assess their impact. In the Netherlands, for example, the regulator plans to wait until 2017 to conduct its post-implementation review, and in the UK the second phase of the post-implementation review is also expected in 2017. Regulators should carefully monitor the impacts on the behaviour of both distributors and consumers.

This article is based on Oxera (2015), 'Regulating remuneration systems: effective distribution of financial products', January, commissioned by the German Insurance Association (GDV), available at: http://www.oxera.com/Latest-Thinking/Publications/Reports/2015/Regulating-remuneration-systems-effective-distribu.aspx.

[1] Oxera (2015), 'Regulating remuneration systems: effective distribution of financial products', January, available at: http://www.oxera.com/Latest-Thinking/Publications/Reports/2015/Regulating-remuneration-systems-effective-distribu.aspx.

[2] Oxera (2013), 'Behavioural economics and its impact on competition policy: a practical assessment with illustrative examples from financial services', prepared for the Netherlands Authority for Consumers and Markets (ACM), May, available at: http://www.oxera.com/Latest-Thinking/Publications/Reports/2013/Behavioural-economics-and-its-impact-on-competitio.aspx.

[3] Federal Trade Commission (2004), 'The effect of mortgage broker compensation disclosures on consumers and competition: A controlled experiment', Bureau of Economics staff report.

[4] See Oxera (2015), 'Regulating remuneration systems: effective distribution of financial products', January, available at: http://www.oxera.com/Latest-Thinking/Publications/Reports/2015/Regulating-remuneration-systems-effective-distribu.aspx.

[5] FCA (2014), 'Post-implementation review of the Retail Distribution Review - Phase 1', December, available at: http://www.fca.org.uk/your-fca/documents/post-implementation-review-of-the-retail-distribution-review-phase-1.

[6] For further details, see FCA (2010), 'Distribution of retail investments: Delivering the RDR', March, available at: http://www.fca.org.uk/your-fca/documents/policy-statements/fsa-ps10-06.

[7] For further details, see Competition Commission (2009), 'Market investigation into payment protection insurance', January.

[8] As explained in Minister of Finance (2011), 'Uitwerking regelgeving provisieverbod', Letter to Dutch Parliament, 13 April.

[9] As understood by Oxera, based on discussions with the AFM, the Dutch financial services regulator.

[10] FCA (2014), 'Post-implementation review of the Retail Distribution Review - Phase 1', December, available at: http://www.fca.org.uk/your-fca/documents/post-implementation-review-of-the-retail-distribution-review-phase-1.

[11] Oxera was involved in the assessment of the RDR proposals, and looked at the potential impact before implementation. See, for example, Oxera (2009), 'Retail Distribution Review proposals: impact on market structure and competition', prepared for the Financial Services Authority, June, available at: http://www.oxera.com/Latest-Thinking/Publications/Reports/2009/Retail-Distribution-Review-proposals-impact-on-ma.aspx.

[12] See paragraph 1.4 of FCA (2014), 'Post-implementation review of the Retail Distribution Review - Phase 1', December, available at: http://www.fca.org.uk/your-fca/documents/post-implementation-review-of-the-retail-distribution-review-phase-1.

[13] FCA (2014), 'Post-implementation review of the Retail Distribution Review - Phase 1', December, available at: http://www.fca.org.uk/your-fca/documents/post-implementation-review-of-the-retail-distribution-review-phase-1.

[14] FCA (2014), 'Post-implementation review of the Retail Distribution Review - Phase 1', December, available at: http://www.fca.org.uk/your-fca/documents/post-implementation-review-of-the-retail-distribution-review-phase-1.

[15] For further details, see Personal Finance Society (2014), 'The RDR and Consumers 2014: The public's views towards the advice market', September, available at: http://www.thepfs.org/knowledge/policy-and-public-affairs/articles/rdr-consumer-report-2014/28904.