Regulating remuneration systems: effective distribution of financial products

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Contents

	Executive summary	**1**
1	**Introduction**	**3**
1.1	Objectives and scope	3
1.2	Approach and report structure	3
2	**Payment for the distribution of products and services**	**4**
2.1	Impact of commissions and alternative regulatory approaches	6
2.2	Impact on the behaviour of distributors	7
2.3	Impact on the behaviour of consumers	8
2.4	Impact on the behaviour of providers	12
2.5	The need for empirical research to inform regulation	14
3	**Experience of regulating commission payments**	**15**
3.1	United Kingdom	15
3.2	The Netherlands	24
3.3	Denmark	30
3.4	Sweden	32
3.5	Finland	33
3.6	Australia	34
3.7	Key findings	36

Figure 2.1	Spectrum of types of financial distributor	5
Figure 2.2	Potential impacts of diffent types of payments	6
Figure 2.3	Market and charging structures post RDR	10
Box 3.1	Short overview of developments in UK regulation of distribution of financial products	16
Box 3.2	Payment protection insurance	20
Box 3.3	Self-certified mortgages	21
Box 3.4	The *woekerpolisaffaire*	26
Box 3.5	Storm Financial	34
Table 3.1	Product/sales channel scope	36

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Executive summary

Organisations distribute the products of producers to consumers in all sectors of the economy, and in all cases their distribution services need to be paid for—ultimately by the consumer. Financial intermediaries, such as agents and brokers, receive remuneration for their services from the provider (e.g. commission payments) or from the consumer (e.g. an upfront fee for advice).

This study seeks to inform the debate on whether restrictions on commission payments to distributors are appropriate, by assessing the pros and cons based on evidence from countries that have introduced restrictions.

Experience of regulating commission payments

Oxera's analysis shows that regulation of commission payments has typically focused on the potential impact of payments on the behaviour of distributors. However, the nature of payments to distributors can also affect consumer demand for financial products (which may be below the optimal level due to difficulties in engaging with the products), so it is important to consider these impacts too.

The most relevant insights based on evidence from countries that have introduced restrictions include the following.

- **No blanket bans on commission payments**: restrictions on commissions have been introduced in a limited number of countries. No country has introduced a blanket ban on commission payments for all financial products. Moreover, no country has introduced a ban on commission payments for general insurance products for private individuals.
- **Regulation is often motivated by mis-selling cases**: regulators have taken a case-by-case approach to regulating commission payments. In most of the countries considered in this study, regulation to restrict or ban commission payments was introduced following a number of high-profile mis-selling cases.
- **Bans on commission payments are often not appropriate**: restrictions on commission payments were not deemed to be appropriate regulatory responses in a number of cases where:
  - there was no evidence of a commission-related problem (such as a case of mis-selling);
  - a ban was not seen to be an effective solution to the problem being addressed; and/or
  - there was a concern that a ban might have undesirable effects on consumer access to financial advice and products.
- **Increasing focus on consumer response**: regulators are increasingly taking into account the findings of behavioural economics studies with regard to how consumers respond to different situations.

Potential negative implications of restrictions on commission payments

There is an increased awareness of some of the negative consequences that banning commissions might have on the supply and demand of financial advice and, consequently, financial products for certain types of consumer:

- **higher prices for advice to less wealthy consumers**: less wealthy consumers pay less for financial advice if the advice is paid for with reference to the amount to be invested, as is generally the case with commission payments. A payment based on time invested by the adviser is likely to increase the prices for poorer consumers, which could further reduce access to financial advice;
- **reduced demand for financial advice**: the risk of upfront fees may deter consumers from seeking and obtaining financial advice and products, potentially leading to an under-provision of services;
- **increased demand for execution-only products**: there is the risk of an unwarranted increase in the attractiveness of the execution-only (non-advised) channel;
- **distorted competition between distributors**: it is difficult to achieve a level playing field between in-house distributors and independent brokers. Providers of financial products who also provide advice may have an incentive to treat some of their distribution costs as product costs. The resultant artificially low cost for advice could price brokers out of the market.

Conclusions

The main conclusion of this analysis is therefore that 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 included in this study 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.

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. There has been a significant reduction in the number of brokers in the UK, particularly with regard to the banking sector, although these changes are also due to other regulatory changes.

Restrictions on commission payments may lead to adverse implications, including higher prices for advice to less wealthy consumers, reduced demand for financial advice, and increased demand for execution-only products. A commission ban could also distort competition between distributors.

1 Introduction

1.1 Objectives and scope

The Gesamtverband der Deutschen Versicherungswirtschaft (GDV), the German insurance association, asked Oxera to conduct an independent study into how the distribution of financial services can be affected by the way in which distributors are paid for their services.

The objective of the study is to provide an understanding of the role of commission payments, the rationale for regulation, and the potential impacts that can arise from restricting payment through commissions. The study aims to provide guidance on the key issues that need to be taken into account by a regulator considering whether regulation is required and the type of impacts it might have.

Restrictions on commissions have been introduced in a limited number of countries, and in these countries only in relation to specific products and sales channels. This study provides an overview of the design of the regulatory regimes in the EU member states where a ban on commission has been introduced: the UK, the Netherlands, Denmark, Sweden and Finland (where restrictions have been introduced for particular financial products, and particular sales channels). It also provides a brief overview of the experience in a non-EU country, Australia. Australia is often selected to highlight the alternative approach to the regulation of financial services outside of Europe.

1.2 Approach and report structure

The Oxera study is based on desk research on the economics of payments to distributors of financial products, insights from the economics literature, and Oxera's own experience in the area of distribution of financial products.[1] Our understanding of the experiences in the various countries considered in this study was further informed by discussions with relevant parties such as industry associations, firms and regulators.

The remainder of this report is structured as follows:

- section 2 explores the forms of payment for the distribution of financial products, providing a conceptual framework for considering how payments may be regulated;
- section 3 sets out the experience of regulating commission payments in six countries: the UK, the Netherlands, Denmark, Sweden, Finland and Australia.

[1] The research was conducted up to the end of November 2014. With regard to Oxera's previous experience in this area, see, for example, Oxera (2009), 'Retail Distribution Review proposals: Impact on market structure and competition', prepared for the FSA; and Oxera (2012), 'Safe as houses? The implications of the Mortgage Market Review', *Agenda*, April.

2 Payment for the distribution of products and services

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. Supermarkets and many other types of retailer tend to recover their distribution costs by charging a retail price that covers the wholesale price plus a mark-up. Similarly, a producer selling products directly to consumers will also typically charge a mark-up on the wholesale price that they charge to other businesses. In other markets, retailers may receive payments from the provider. A travel agent may receive commissions from a tour operator (e.g. a cruise liner), or it may charge service fees directly to the consumer (which is often the case with booking flights). Similarly, a mobile phone shop that sets up contracts between consumers and mobile network operators could take a commission payment from the mobile network operator for arranging the transaction. Distribution services are paid for in a wide range of ways.

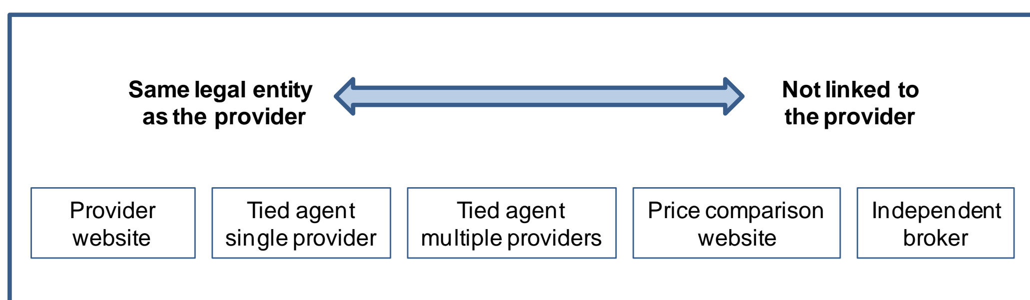
The situation is no different in financial services. Financial intermediaries, such as agents and brokers, facilitate transactions between retail consumers and the providers of financial products. Their services range from simply providing access to products to providing advice to consumers about which 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 circumstances of the consumer, the product and the distribution channel.

There is also a wide range of types of distribution channel, depending on the nature of the relationship between the provider and the distributor. Figure 2.1 summarises the spectrum of options, from ‘in-house’ sales by the provider to brokers acting on behalf of their clients.

Different types of distributors may also undertake different types of activities. For example, price comparison websites tend to only list products and prices without providing advice. Brokers and other types of distributors may provide advice but also conduct administration and claims handling. The activities may also vary by the size of distributor—for example, larger brokers may conduct claims-handling activities, while small brokers may leave this to the provider.

There are various definitions of whether a broker is ‘independent’ of providers. One legal definition is that a broker is independent of the provider as it represents the interests of the client, acting on behalf of the client in the relationship with the provider (whereas an agent is typically employed by the provider and therefore acts on behalf of the provider). An independent broker may offer consumers whatever services they wish, often providing the consumer with access to the whole of the market (i.e. a variety of products). Some regulators (see section 3) have argued that a broker is independent only if that broker receives no commission payments from providers. These interpretations are shown in Figure 2.1.

Figure 2.1 Spectrum of types of financial distributor



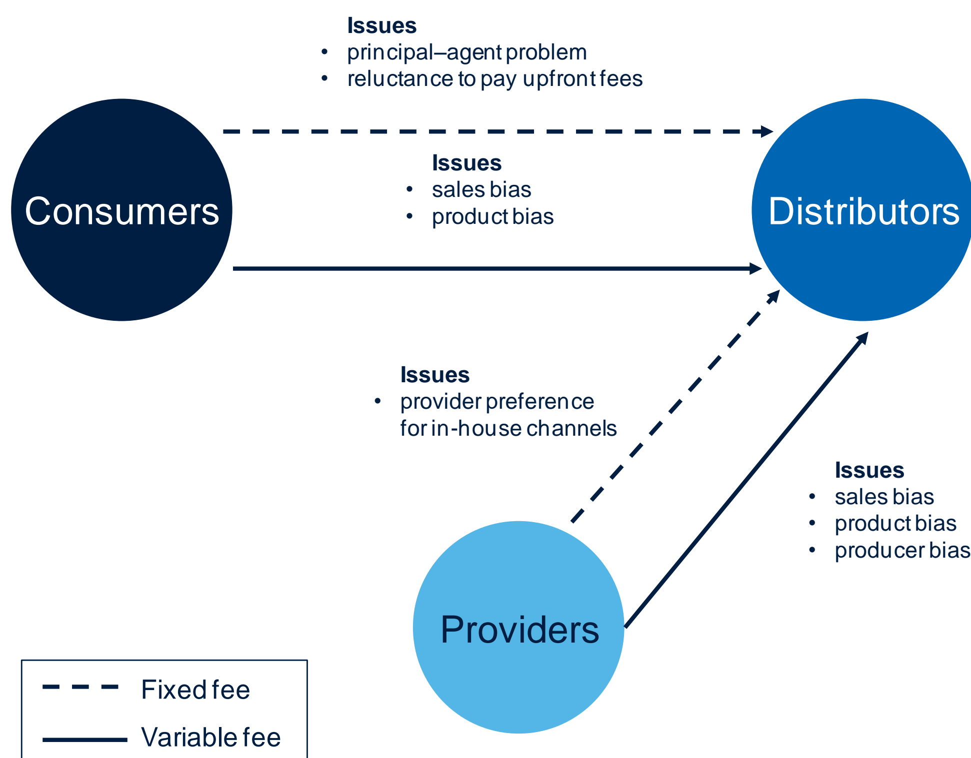
Source: Oxera.

As distributors facilitate transactions between consumers and providers, they can receive payment from either party, although ultimately all payments come from the consumer. The payment can come in several forms:

- as a fixed fee that is unrelated to the value or frequency of transactions (e.g. a fixed fee to hire the services of an insurance broker);
- as a fixed fee that depends on the completion of the transaction (e.g. a fixed commission paid to an insurance broker or the price comparison website by the insurance company for each sale);
- as a one-off fee that is linked to the value of the transaction (e.g. a commission paid by a provider of non-life insurance that is a percentage of the value of the premiums);
- as an ongoing fee that continues for as long as the consumer maintains the contract with the provider of the product (e.g. ongoing commissions paid by an insurer to the broker for as long as the customer continues to pay for the policy).

The form of payment can be expected to have an impact on both consumer demand for financial products and the intermediary's incentive to offer different services and advice. The payment structure could also affect the behaviour of providers. The various impacts are summarised in Figure 2.2, and discussed in detail below.

Figure 2.2 Potential impacts of diffent types of payments



Source: Oxera.

2.1 Impact of commissions and alternative regulatory approaches

Commission payments can be characterised as payments from the provider of the financial products to the distributor of those products, with the commission generally depending on the completion of a transaction.

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 the analysis in this report has been informed by behavioural economics.[2]

To assess the need for regulation of different forms of payment to distributors, it is vital to have a suitable economic framework for understanding the impacts on the behaviour of the different parties involved. On this basis, this section considers the economics of payment methods with regard to:

- the impact on the behaviour of distributors (section 2.2);
- the impact on the behaviour of consumers (section 2.3);
- the impact on the behaviour of providers (section 2.4).

Section 2.5 then brings together the findings to highlight the need for empirical analysis in informing optimal regulation.

[2] See, for example, 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); and FCA (2013), 'Applying behavioural economics at the Financial Conduct Authority', Occasional Paper No.1, April.

The main conclusion of this analysis is that no single method of payment for the distribution of financial products can be considered to be ideal (or not 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, as well as restrictions on ‘inducements’ (e.g. volume-related bonuses) and commission payments. The choice of the optimal regulatory approach depends on the particular circumstances of the market in question.

2.2 Impact on the behaviour of distributors

The type of payment may affect the behaviour of the distributor of financial products. Any salesperson in any sector may be influenced by the way in which they are paid, which is why it is important to understand the range of impacts that can arise from different forms of payment. In particular:

- payments that do not depend 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, the consumer wants to buy insurance). This issue is often referred to as the ‘principal–agent problem’;
- any payment that depends 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’);
- the different balance of payments from consumers and providers will affect the incentives of the intermediary—for example, higher commission payments from a particular provider can be expected to incentivise the intermediary to favour achieving transactions involving that provider (‘provider bias’);
- any difference in payments, from either the consumer or the provider, with regard to different products can be expected to incentivise the intermediary to favour achieving transactions involving that particular product (‘product bias’); 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).

It is important to consider these different forms of payments 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 mainly be around obtaining a competitive price. In this case, the impacts of payment methods described above are not likely to be very important. 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 impacts arise. Furthermore, the impact may depend on how aware consumers are about potential conflicts of interest in financial advice. While a ban on commissions may benefit some consumers who are particularly reliant on the investment advice provided, it may hurt more sophisticated consumers who are more wary of potential conflicts of interest. The presence and effects of these impacts are a matter of degree. This is ultimately an empirical question, as it depends on the

circumstances of the situation, as discussed further at the end of this section. Payments do not necessarily affect consumer outcomes.[3]

2.3 Impact on the behaviour of consumers

The different forms of payment can also have an impact on the behaviour of consumers, which in turn may affect the way competition works in the relevant markets. There are reasons why consumers may make sub-optimal decisions with regard to financial products ('consumer biases'), which can make the distribution of financial products challenging, which in turn has implications for regulation. These are considered in turn below.

2.3.1 Consumer biases

Behavioural economics is increasingly being used to inform regulation, as the success of regulation of providers and distributors of financial products and services 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:

- **lack of consumer engagement**, leading to insufficient demand for services by consumers;
- **the existence of multiple prices**, which may make it harder for consumers to compare across products.

Lack of consumer engagement

There has been an increasing interest in recent years, from regulators and academics, about the implications of behavioural economics for the provision of financial products. It has been noted that financial products can often involve relatively low levels of consumer engagement, relative to the importance (or expense) of the services.[4]

Economic research has noted that consumers can have difficulty in engaging with, understanding and selecting financial products. This is certainly one of the primary concerns of the UK Financial Conduct Authority (FCA), which has concluded that 'Consumers face well documented difficulties in engaging with financial services'.[5] Financial products have several attributes which make them especially difficult to engage with. They tend to be more abstract and less tangible than many more visible goods and services. A pension plan, as set out in a detailed information pack of documents which outline the product features, is

[3] The debate about regulating commissions appears in the academic literature as well as in policy-making. Some of the more recent papers are Inderst, R. and Ottaviani, M. (2012), 'How (not) to pay for advice: A framework for consumer financial protection', *Journal of Financial Economics*, **105**:2, pp. 393–411; and Gorter, J. (2012), 'Commission Bans and the Source and Quality of Financial Advice', Dutch Central Bank Working Paper No. 350, September. The analysis in Indest and Ottaviani (2012) suggests that the policy decision about whether to impose a ban would partly depend on the proportions of more or less sophisticated customers. When more customers are more aware of incentives, the negative side effects of intervention are likely to be greater and could outweigh any benefits. Gorter (2012) concludes that, in practice, the welfare benefits of a ban on commissions may be limited. Gorter extends Inderst and Ottaviani's framework by allowing for both direct and intermediary advice (rather than just intermediary advice). Gorter's model suggests that, in equilibrium, customers who are less aware about conflicts of interests tend to prefer direct advice (i.e. advice offered by a direct sales force of a provider) over intermediary advice, in spite of the fact that the latter may be of better quality. Sophisticated customers rationally prefer intermediary advice.

[4] See, for example, FCA (2013), 'Applying Behavioural Economics at the Financial Conduct Authority', April, for a comprehensive discussion of the FCA's concerns.

[5] See FCA (2013), 'Applying Behavioural Economics at the Financial Conduct Authority', April, for a comprehensive discussion of the FCA's concerns.

much more abstract than a piece of furniture or a bus journey.[6] People tend to be less responsive to information that is abstract and statistical (as financial services disclaimers typically are) than information that is salient and vivid.[7]

Furthermore, consumers may fail to engage with some financial products because these products are linked to negative outcomes that the consumer would like to avoid thinking about. For example, people may be unwilling to purchase life insurance because they do not want to contemplate that they may die sooner than they expect.

Consequently, there is a risk of under-supply: there are reasons to expect that consumer demand for financial services could be below an optimal level due to difficulties in engaging with the products.

Existence of multiple prices

Financial products can be relatively complex and, partly due to their complexity, they may involve multiple charges at the time of purchase and throughout the product lifecycle.

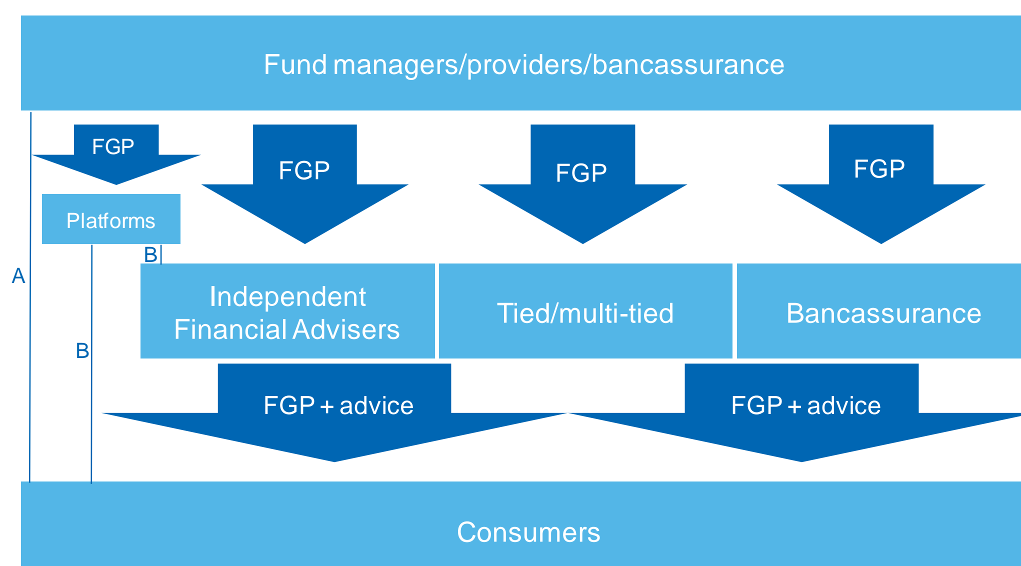
Financial products often involve multiple prices and charges that are incurred at the time of purchase. This could be the result of the market structure:

- there may be multiple agents involved in the provision of a product—for example, when investing in a fund, consumers have to pay separate charges such as a fund management fee, adviser fee and platform fee;
- consumers may be purchasing auxiliary products (for example, insurance add-ons) that add to the main price;
- the cost structure of the industry may require a two-part tariff pricing—for example, a mortgage provider may charge a fixed administrative fee that is uniform across customers, and an interest rate that depends on the client's riskiness.

In previous analysis of the Retail Distribution Review (RDR) in the UK,[8] Oxera presented the relationship between factory gate prices (FGPs), advice and platform fees for retail investment products diagrammatically, as reproduced in Figure 2.3 below.[9] This shows how measures included in the RDR that aimed to improve transparency of the payments to distributors resulted in a complex set of payments, splitting FGPs from payments for advice and the distribution services of platforms. While the RDR may have provided some customers with greater clarity on pricing, arguably it also increased the complexity of pricing.

[6] Gilbert (2006) points out that objects we can see come to mind more readily, since they activate the visual cortex (the part of the brain responsible for processing visual information). See Gilbert, D. (2006), *Stumbling on Happiness*, Knopf.
[7] Sunstein, C.R. (2013), *Simpler: the future of government*, Simon and Schuster.
[8] See Oxera (2009), 'Retail Distribution Review proposals: Impact on market structure and competition', p. 43, Figure 4.1, available at: http://www.oxera.com/Oxera/media/Oxera/RDR-proposals-June-2009.pdf?ext=.pdf.
[9] A platform is an online service that allows financial advisers to manage their clients' investment portfolios. Some platforms can be used by customers directly. In its most basic form, a platform aggregates data from several sources to provide a consolidated view of the client's total investments. Many platforms, however, also provide facilities for investments to be selected, bought and sold. Some platform operators use their platform to sell their own products as well as those of other providers.

Figure 2.3 Market and charging structures post RDR



Note: A = FGP + provider processing charges. B = FGP + platform administration charges. Although not shown in the figure, distributors can also offer products on an execution-only basis. Providers include both pure savings/investment products and combined savings/investment with insurance products.

Source: Oxera.

The existence of multiple charges may complicate comparison across competing products. If a consumer is focused on finding the most competitive price for a particular product, one would expect their focus to be on the final price of the product, and not the split of payments between provider and distributors. Providing this split may therefore not improve shopping around, and could, in fact, be detrimental if it caused confusion. Furthermore, the disclosure of multiple prices may cause the consumer to focus only on a subset of the price. 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.[10] 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.

On the other hand, if the consumer is focused on finding a financial adviser to advise on a broad range of possible investment options, for example, including the option not to invest at all, then it might be beneficial for the consumer to be better informed about the payment that goes to the distributor for providing this advice. In this case, the consumer is not focused on judging the quality and price of the final product, but rather on judging the quality and price of the distributor.

The FCA considered these issues when developing the RDR package of reforms, as discussed further in section 3.1.

2.3.2 Implications of consumer biases for regulation

As described above, financial services can involve relatively low levels of consumer engagement, and consumer biases can also reduce the consumer's

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

ability to compare prices and identify the best deal. These biases therefore have implications for the regulation of payments to distributors. Three possible implications are explored in further detail below:

- the impact of the cost of distribution on consumer demand;
- the benefits of charging in relation to the value of the transaction;
- the impact of upfront fees on competition.

Impact of the cost of distribution on consumer demand

As noted above, low consumer engagement with financial products can result in consumer demand being below the optimal level. There is a risk that this issue could be further exacerbated by payments for the distribution of services.

Research in behavioural economics suggests that, when consumers are unsure about the value or quality of a particular product, an upfront fee for advice or other intermediation services could have a larger negative impact on consumer demand than a payment spread over time, particularly if the continued payment depends on the continued provision of services.[11] Consumers may be reluctant to engage with financial services in the first place (due to inertia and optimism bias), and even more unwilling to pay upfront for services (due to present bias).

Behavioural economics therefore suggests that the regulation of payments to distributors could have unintended consequences for consumer demand, even if the size of payments remains exactly the same. These potential impacts need to be considered alongside the impacts on the behaviour of distributors.

These impacts can also be exacerbated by regulation that results in a loss of some form of 'cross-subsidy' from high-wealth consumers to poorer consumers. Upfront fees for advice can force distributors to charge customers the same price for the same service, irrespective of their relative wealth, if the distributor can no longer charge the two customers differently on the basis of the size of the transaction. On the other hand, charges based on the value of the transaction, or commission payments, allow distributors to charge wealthier consumers more. This is discussed in more detail in the next section.

Benefits from charging in relation to the value of the transaction

At first sight, one might expect that distributors charge a fixed fee for their service, as the cost of distributing a €100 service might be expected to be similar to the cost of distributing a similar service that costs €200, for example.

In reality, however, there are many situations where distributors charge for their services relative to the value of the transaction. For example, real estate agents typically charge a proportion of the value of the property. More generally, retailers typically have mark-ups on the products that they sell which are percentages of the value, rather than a fixed amount per item.

Partly, this is because distributors may face costs that are related to the value of the transaction. Real estate agents are likely to put more effort into selling a €1m property than a €100,000 property. Also, real estate agents, as with most other distributors, have significant costs that are not directly related to the transactions for which they are paid (the 'fixed costs'). For example, they have office overheads, they need to search for new work, and they have costs from failed

[11] See Chater, N., Huck, S. and Inderst, R. (2010), 'Consumer decision-making in retail investment services: a behavioural economics perspective', Report for the European Commission.

attempts to sell properties (for which they receive no payment). These costs need to be covered by the transactions that do succeed, and there is no reason why these costs should be split equally between successful and unsuccessful transactions.

Agents are able to charge more for financial advice if the value of the transaction is higher due to a behavioural bias known as 'reference dependence', whereby consumers may not assess outcomes in their own right, but rather as gains and losses relative to a reference point. From an economic perspective, consumers with greater resources (e.g. those with more assets to invest) are more likely to have a higher willingness to pay for distribution services, so that paying for a proportionally larger share of fixed costs is less likely to reduce their demand for distribution services (such as advice) than it might be for poorer consumers. Consequently, it can be optimal to allocate a greater proportion of fixed costs to wealthier consumers, as this will result in more consumers benefitting from the services. This is an example of where price discrimination can be beneficial, as it results in an increased number of transactions. Without price discrimination, lower-wealth consumers may be excluded. This is an example of a concept known as 'Ramsey pricing'.[12]

Similarly, from a societal point of view, there may be a preference to somehow subsidise advice and other distributional services to consumers with fewer resources, by charging more to those consumers with greater resources.

This suggests that a payment system based on the value of the transaction may be preferable to a flat-fee payment system, in that it can achieve more optimal results. This can be the case even if there is intense price competition, as long as the prices charged to the poorest customers at least cover the costs that are directly attributable to those customers (e.g. the cost of the advisers' time in advising the customers).

2.3.3 Impact of upfront fees on competition

Upfront fees paid by consumers which are not dependent on completion of the transaction can encourage the consumer to use only one distributor to achieve the desired transaction, in order to avoid duplicating costs. For example, a consumer who is purchasing a mortgage in the Netherlands (where, as explained in section 3, a commission ban has been imposed in relation to mortgages), and who is using the services of a financial adviser, may be reluctant to switch advisers because they would have to pay another (potentially significant) upfront fee.

More generally, the impact of upfront fees on consumers depends on what they are familiar with in the market. If an upfront payment for advice has been a fairly typical pricing feature in a market, one can expect that the impact of requiring upfront fees will be much more limited than in a market where upfront fees were not typical. In other words, the willingness of consumers to pay upfront fees, or pay for advice more generally, may vary by country.

2.4 Impact on the behaviour of providers

As well as affecting the behaviour of distributors and consumers, payment methods can be expected to affect the behaviour of providers. This impact is

[12] See Viscusi, W.K., Harrington, J.E. and Vernon, J.M. (2005), *Economics of regulation and antitrust*, MIT press, pp. 350–3.

likely to affect the nature of competition in the market, which will have consequences for consumers. Potential impacts include:

- **changes in relative bargaining power**, as distributors may have more bargaining power than customers in relation to providers;
- **the choice of distribution channel**, depending on how much influence the provider wishes to have over how products are sold.

2.4.1 Changes in relative bargaining power

Another impact that could, in principle, arise from how distributors interact with providers concerns bargaining power. Distributors that receive commissions from providers will be incentivised to maximise those commissions, while minimising the final price to the end-consumer in order to attract more consumers, especially if those consumers are price-sensitive. This means that they are incentivised to minimise the net price charged by the provider (the FGP, which is the price charged to the consumer minus commission payments to the broker).

This is also the situation if the broker is paid only by the consumer, as the consumer will be incentivised to drive down the FGP. However, it may be the case that the broker has greater bargaining power with the provider than the individual consumer has. In this case, the broker may be able to negotiate a lower FGP than the individual consumer can.

Ultimately, this could mean that commission payments to brokers increase the competitive pressure on providers. Oxera conducted a series of interviews with industry participants as part of a previous study[13] on the potential impact of the RDR in the UK, which banned commissions (see section 3.1 for a description of the RDR). A number of firms indicated that higher provider profitability was expected, as advisers will no longer be chasing the highest commissions. A study by Deloitte[14] also found that around half of the larger providers that it interviewed (with turnover of £500m or more) expected their profitability to increase as a result of the RDR.

2.4.2 Choice of distribution channel

Providers will have an interest in how their products are sold, which in turn will have implications for consumers. Providers often have a choice over distribution channels, and can choose to sell products through their own in-house distribution channels (e.g. their own website) as well as through tied agents (distributors that sell the products of only one or a few providers) or independent brokers (who may provide products from across the market to consumers, without any restrictions from providers). If providers are unable to influence independent brokers through commission payments, for example, they may choose to favour distribution through in-house channels and tied agents.

There does not appear to be evidence that the actions of providers alter the prevalence of distribution channels in the countries analysed in this report, as discussed further in section 3. However, it may be too early to assess the impact of the ban on commissions.

[13] Oxera (2009), 'Retail Distribution Review proposals: Impact on market structure and competition', prepared for the FSA.
[14] Deloitte (2009), 'Firm behaviour and incremental compliance costs', research for the FSA.

2.5 The need for empirical research to inform regulation

It is clear from the discussion above that there are a wide range of factors that need to be considered in assessing the relative merits of different payment methods. These factors will depend on the characteristics of consumers, distributors and providers, as well as products, which means that the pros and cons of different payment methods will vary by market and product.

Ultimately, the way in which payments to distributors affect markets and consumers is an empirical question. Regulators need to consider the specific circumstances in relevant markets to understand whether payments to distributors are having a negative impact on outcomes for consumers, and whether regulation of the form of the payments could help to address these concerns. There are various ways in which regulators could conduct such analysis, as follows.

- Regulators can look for evidence of mis-selling that has been caused by the nature of payments to distributors. As discussed further below, cases of mis-selling of financial products have arisen for a number of reasons, which are not necessarily all linked to the nature of payments to distributors. Regulators would need to consider what type of regulation or supervision could have helped to prevent the mis-selling.

- Regulators can assess the positive and negative effects of a ban on commissions by conducting a cost–benefit analysis for the different potential impacts on consumer outcomes. This approach is likely to require survey evidence to determine how consumers are likely to respond to different forms of pricing.

- Regulators can also consider alternative forms of regulation that may address the issue of concern more directly. For example, with PPI in the UK (see Box 3.2 in the next section), the UK Competition Commission chose to address the underlying issue that was inhibiting consumers from applying competitive pressure, rather than addressing the issue through payments between providers and distributors.

- Regulators may also take into account wider societal objectives. Access to advice on financial products may be desirable for all consumers, irrespective of wealth, which in turn may require payment systems that allow for cross-subsidisation from wealthier consumers to poorer ones. Regulators may choose to adopt a longer-term perspective on the desired consumer outcomes in determining appropriate regulation of payments to distributors.

To illustrate how regulators have approached these issues in practice, the following section examines the experience of a number of countries that have introduced different forms of restrictions on commission payments. It explores how the restrictions were introduced, the rationale for doing so, and whether market impacts have been observed. It will be some time before the full effect of the relatively recent restrictions on the operation of markets (and therefore their outcomes for consumers) becomes apparent, although a review of the experience so far is helpful in putting the conceptual analysis of this section into context.

3 Experience of regulating commission payments

Restrictions on the payment of commissions from providers to distributors of financial services products have been introduced to varying degrees in several countries in Europe and elsewhere, for various reasons. Such restrictions have been introduced to address specific concerns in these countries, but it is informative to understand the rationale and specific details of the regulation, and its impact, which in many cases is still unfolding.

Oxera's study examined the developments in six countries where restrictions on the payment of commissions have been introduced by the regulator in recent years—the UK, the Netherlands, Denmark, Sweden, Finland and Australia. These countries were selected because the regulation introduced in each has been significant, and the actual or potential implications of that regulation have been documented to some extent. The Oxera study included the most relevant EU member states (in terms of experience of regulation), and a single non-EU country, Australia, which provides an alternative case study.

Developments in each of the countries are described in the sub-sections below, followed by a summary of the key findings.

3.1 United Kingdom

Regulation of commission payments in the UK was primarily driven by a concern that the complex nature of retail investment products was increasing consumers' reliance on financial advice, while there was concern that commission payments could influence the advice provided by brokers. The regulation focused on financial advice relating to retail investment products because the same issues were not seen to arise in other areas, such as insurance products or mortgages. The regulation was applied to all distributors of retail investment products, with the objective of maintaining a level playing field.

The regulation has only recently come into force and the full impact on the distribution of retail investment products has yet to become apparent. The debate on the regulation is ongoing, and is likely to be further informed by the post-implementation review that the FCA is planning to conduct in late 2014/early 2015.[15]

3.1.1 Background and rationale for regulation of commission payments

In June 2006, the UK Financial Services Authority (FSA, which became the FCA in 2013) initiated the RDR.[16] This was an in-depth review of the way in which

[15] The FCA published its post-implementation review in December 2014, after this report was finalised—see FCA (2014), 'Post-implementation review of the Retail Distribution Review - Phase 1', December. The review shows that professional standards have increased and that product prices have fallen by at least the amounts paid in commission pre-RDR. While there was some exit from the advisory market, particularly in the period leading up to the RDR, by the banks and by some financial advisers, numbers of advisers and advisory firms now appear stable and there remains a large number of advisory firms and advisers to serve consumers. However, in other areas, the impact is less clear and potentially negative. For example, there is evidence that the cost of advice has increased. It has therefore not yet been possible for the FCA to draw firm conclusions on the total cost of investment—the total costs may have increased. Furthermore, 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 conclude 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 (e.g. some consumers think they get advice for free or it is paid for by commissions). 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. Second, the unwinding of existing cross-subsidies may continue and may also result in more people being unwilling to pay for advice. The FCA will continue to monitor the provision of advice going forward and examine the impact in more detail in Phase 2.

[16] The initial development of the RDR is explained in the FSA Consultation Paper: FSA (2009), 'Distribution of retail investments: Delivering the RDR', CP09/18, June.

financial products were distributed to retail customers in the UK, focusing on the distribution of retail investment products. The FSA aimed to examine whether the widespread cases of mis-selling in the UK were due to the bias resulting from commission payments that advisers received from product providers on successful conclusion of a sale.

The FSA identified three types of bias that might stem from commission payments:

- **product bias**—recommendations may be biased towards a type of product that pays higher commission than other types. For example, where higher-risk products are connected with a higher commission compared with lower-risk products, an adviser might recommend an excessively risky product;
- **provider bias**—advisers may recommend a particular provider based on expected commission payments. In this case, an adviser may recommend a suitable product, but from a provider that offers a higher commission, rather than a lower price to the consumer;
- **sales bias**—an adviser might recommend the sale of a product (or switching provider in relation to an existing product) based on receiving a payment for each new transaction, even though the transaction yields insufficient benefit to the consumer.

Each bias increases the likelihood of financial advice not being provided in the best interests of the consumer, but instead with a view to the adviser maximising commission payments. This potentially leads to consumers being mis-sold financial products.

The FSA found that mis-selling was further facilitated by consumers' limited understanding of the financial products they purchased. The regulator attributed this to advisers' inability to explain these services sufficiently clearly, possibly because of a lack of professional training or qualifications.[17]

The proposals put forward in the context of the RDR were intended to reduce the potential for mis-selling by lowering the risks of significant bias from remuneration structures. In parallel, the FSA proposed to increase the professional qualifications required from financial advisers.[18]

Notably, after discussions with the industry, the FSA did allow for 'provider facilitation' of payments. This is where the customer agrees payments with the intermediary, but it is the provider that delivers the payment to the intermediary, for example from premiums paid (see section 3.2.4 for further details). Box 3.1 provides an overview of developments in UK regulation.

Box 3.1 Short overview of developments in UK regulation of distribution of financial products

Regulation of retail distribution of financial products

The regulation of the distribution of financial products in the UK has developed over time. The Financial Services and Markets Act 2000 resulted in the FSA prioritising making retail markets for financial products and services work more effectively, thus helping retail consumers to 'get a fair deal'. Over several years, the FSA worked to raise levels of confidence and capability among consumers. From 2004, this work was described as a national strategy on building financial capability in the UK.

[17] FSA (2007), 'A Review of Retail Distribution', para. 3.
[18] FSA (2007), 'A Review of Retail Distribution', para. 2.36.

In 2005, the FSA introduced a third type of distributor—so-called 'multi-tied agents'. These agents covered financial products that were offered by a (limited) number of providers and complemented the existing Independent Financial Advisors (IFAs, which are brokers that advise on retail investment products) and single-tied agents. Under this regime—often referred to as 'depolarisation', since the previous regime (IFAs and single-tied agents) was polarised—distributors were obliged to supply a description of the firm's services (initial disclosure document, IDD) which describes its distribution model and its remuneration scheme (the 'menu'). The rationale behind the IDD was to reduce commission bias and confusion about the type of service. These rules came into full effect in June 2005.

In June 2006, the FSA initiated the RDR programme, which aimed to enhance consumer confidence in the retail investment market (see section 3.2.2).

A number of factors, including regulatory changes, have resulted in a significant reduction in the number of advisers. There was an initial drop in the number of firms authorised to provide financial advice following the announcement of the RDR programme, from 5,584 in September 2008 to 5,482 at the end of 2011.[19] The FSA also recorded how the introduction of the RDR affected the number of retail investment advisers (which counts individuals, not firms, and is broader than just IFAs as it includes tied agents and in-house (mainly banks) advisers), which underwent a further reduction from over 40,000 in 2011 to just over 30,000 by the end of 2012.

Savings and protection gap

There is an ongoing debate in the UK about the savings and protection gap. Various studies (see references below) have provided analysis suggesting that a significant proportion of people do not save enough for retirement and are not sufficiently protected against certain negative events such as death, illness or unemployment.

The protection and savings gap, together with the RDR, has contributed to the demand for making access to financial products easier, in the following ways.

- **Simple products**—there have been a number of attempts to create a range of simple products that consumers can purchase without taking financial advice. One of the first attempts was the Sandler Review of Long-term Savings in 2002,[20] which proposed creating a suite of simple savings products in order to reduce the need for regulation of the sale process. 'Stakeholder' was the name given to the range of simple pension and savings products introduced. More recently, an independent steering group was set up to devise a new suite of Simple Financial Products to help consumers navigate the financial marketplace (the Sergeant Review).[21] The industry and government are currently working on the implementation of the Sergeant Review recommendations.[22]

- **Simplified advice**—there is an ongoing debate about the need for a simplified advice regime. The FCA has made it a priority to help advisers change their business models to reach the middle market, and intends to publish a paper.[23] This paper would provide clearer guidance on how the FCA will approach simplified advice, including liability issues:

[19] Based on industry figures sourced from the FSA, as recorded by the *Financial Times*. See Girard, S. (2012), 'FSA data shows drop-off in IFA numbers', *FT Adviser*, 19 January, available at: http://www.ftadviser.com/2012/01/19/regulation/rdr/fsa-data-shows-drop-off-in-ifa-numbers-IPmp2GAkIKsu5tl6Wh9gaI/article.html.

[20] HM Treasury (2002), 'Medium and Long Term Retail Savings in the UK: A Review' (The Sandler Review), HM Treasury, London.

[21] See HM Treasury (2013), 'Sergeant Review of Simple Financial Products, Final report', March.

[22] Updates on this initiative can be found at: https://www.gov.uk/government/publications/simple-financial-products.

[23] FCA (2014), 'Making innovation work for firms and consumers', speech by Martin Wheatley, Chief Executive, 29 May, available at: http://www.fca.org.uk/news/making-innovation-work.

The cost of advice was made explicit by the abolition of commission by the Retail Distribution Review (RDR), which led to some consumers shying away from paying for it, Martin Wheatley admitted.[24]

Source: Oxera.

3.1.2 Details of the regulation

As of 1 January 2013, intermediaries can no longer receive commission on retail investment products offered by product providers (even if they intend to rebate these payments to the client). Instead, advisers can be paid for their services only by—or on behalf of—the client.[25]

The commission ban relates to retail clients only.[26] In terms of products, the commission ban relates to retail investment products including pension policies, investment trusts and savings schemes, but also securities, equities and structured capital-at-risk products.

The commission ban is applied to all distributors of retail investment products, including:

- **single-tied agents**—such as an insurance company's own sales staff;
- **multi-tied agents**—financial advisers who cover financial products offered by a (limited) number of providers;
- **'independent financial advisors' (IFAs)**—retail investment product brokers who are not tied to any provider but consider all providers.

The ban on commission payments means that financial advisers have to provide their customers with two sets of fees (or prices): one for the financial product at hand (the factory gate price), and one for the advisory services they provide. The total adviser charge payable must be agreed with, and disclosed to, the client. The cost must be shown in cash terms (or converted into illustrative cash equivalents).

The RDR requires firms with direct sales forces—i.e. firms that provide products as well as advice on products—to set advice charges so that they are 'reasonably representative' of the costs incurred in relation to the services offered. In principle, this prohibits distributors cross-subsidising advice charges with profits made from other parts of the business. An adviser charge is likely to be reasonably representative of the services associated with making the personal recommendation if:[27]

- the expected long-term costs associated with making a personal recommendation and distributing the retail investment product do not include the costs associated with manufacturing and administering the retail investment product; and

[24] As reported by the website *Professional Adviser*. Reichman, C. (2014), 'Wheatley: FCA to "fast-track" advice model innovation', *Professional Adviser*, 29 May, available at: http://www.professionaladviser.com/professional-adviser/news/2347194/wheatley-fca-to-fast-track-advice-model-innovation.
[25] Conduct of Business Sourcebook (COBS) 6.1A.
[26] Conduct of Business Sourcebook (COBS) 6.1A.
[27] Conduct of Business Sourcebook (COBS) 6.1A.10G.

- the allocation of costs and profit to adviser charges and product charges is such that any cross-subsidisation from product charges to advice charges[28] is not significant in the long term.

It should be recognised that an assessment of whether charges are 'reasonably representative' will always be open to a degree of interpretation, particularly due to the need to allocate fixed costs.

3.1.3 Regulation of other financial products

Pure protection products

As part of the RDR, the FSA also considered whether to include pure protection products.[29] These include critical illness cover, income protection and non-investment life insurance, which are commonly sold by retail investment advisers.

The FSA recommended that commission payments should not be banned in the case of pure protection insurance. This decision was based, for example, on the overall picture in the pure protection market of a falling number of complaints to the Financial Ombudsman Service and an absence of the kind of large-scale mis-selling episodes that the regulator identified in the context of the investment advice (in addition, the PPI mis-selling case was not directly linked to commission payments by the UK's Competition Commission and the FSA, as explained in Box 3.2 below).

The regulator's assessment was that the types of adviser behaviour that had driven the detriment in the investment advice market—the sale of expensive or inferior policies and switching—were less prevalent with regard to pure protection products. This was because of the inherent differences between pure protection and investment products. In particular:

- the cost to the customer is relatively transparent (in contrast to investments, where the cost is typically a function of the fund value and therefore subject to change[30]). This will be enhanced as the remaining distributors implement the standard for protection sales requiring disclosure of the total amount of premiums over the term of the contract as well as the monthly premium;
- customers are 'budget-sensitive' and are interested in reducing the premium;
- pure protection is a 'distress purchase' bought to cover something that the customer hopes will not happen, in contrast to an investment where the consumer's aspiration is for a financial return. This may suggest that the consumer is more focused on cost minimisation with pure protection insurance than they are with an investment (on the assumption that, with the latter, the focus is more on perceived potential investment returns).

[28] This does not refer to cross-subsidisation between different types of customer, but rather from product charges to advice charges.
[29] See FSA (2009), 'Distribution of retail investments: Delivering the RDR', Consultation Paper CP09/18, June.
[30] The charges applied to investment funds are usually applied as a percentage of the fund value, such as the Annual Management Charge (AMC). If the fund value increases, the charges (in absolute terms) will therefore also automatically increase by the same proportion.

Box 3.2 Payment protection insurance

In 2009, the UK regulatory authorities found that PPI had been widely mis-sold, leading to a large volume of claims for compensation. PPI was mis-sold for a variety of reasons, but most notably due to customers being pressured into buying the product (when in reality it was optional), or being sold the product when they would not be eligible to claim (for example, if they were self-employed or unemployed, and only those made redundant from employment could claim).

The Competition Commission (now the Competition and Markets Authority) conducted a market investigation into PPI.[31] It found that:

> each distributor and intermediary faces little competition for the sale of Payment Protection Insurance (PPI) when it is sold in combination with the credit it insures.[32]

Consequently, it found that the profit margins for distributors selling PPI were very high.

The Competition Commission proposed that this problem should be addressed by imposing a ban on distributors selling PPI within seven days of a credit sale—i.e. a 'point of sale prohibition'. This addressed the underlying problem, which was that consumers were not applying sufficient competitive pressure on distributors at that time, as they were focused on the associated credit product (the loan) that they wished to obtain.[33] Consumers, at the point of sale of the credit product, were often unaware of either the true value of the insurance (e.g. the likelihood of them claiming) or of the price for the insurance if they shopped around.

The case study is interesting as the Competition Commission did not seek to alter the payments from providers to distributors. The underlying problem was that distributors were able to make such high profits from selling PPI (as a result of companies having effective market power at the point of sale of the related credit product—e.g. a loan—as the consumer was primarily focused on obtaining the loan), and the Competition Commission concluded that measures to improve the disclosure of information on these profits (such as disclosure of information on commission payments) would not be sufficient to address the underlying problem. Consumers were found to be poorly placed to judge the cost of PPI.

The Competition Commission findings therefore suggest that the problem was likely to persist whatever distribution model was employed, including the types of payments to distributors, and therefore the underlying cause of the issue needing to be tackled. This led to the point of sale prohibition.

Source: Oxera.

Mortgages

In October 2009, the FSA published a Discussion Paper setting out the case for regulatory reform of the mortgage market.[34] In that paper, the regulator recommended that commission payments should not be banned for this kind of product.

The FSA supported this decision by citing the absence of evidence suggesting that the commission-based remuneration model for mortgages had caused the same degree of consumer harm or needed the same regulatory response as investment products. While the wrong mortgage may be bought, the regulator

[31] See Competition Commission (2009), 'Market investigation into payment protection insurance', January.
[32] Competition Commission (2009), 'Market investigation into payment protection insurance', January, para.1.
[33] Oxera has conducted a study on the market for PPI. See Oxera (2009), 'Competition in secondary products: the case of payment protection insurance', *Agenda*, June. See also Oxera's review of the recent FCA proposals on insurance add-ons: Oxera (2014), 'Adding up the add-ons: the FCA's first market investigation', *Agenda*, May; as well as a review of behavioural biases involved in the market for extended warranties: Oxera (2012), 'Behavioural problem, behavioural solution: the case of extended warranties', *Agenda*, October.
[34] FSA (2009), 'DP09/03: Mortgage Market Review'.

found the mortgage market to be characterised by a relatively high level of switching.[35]

The FSA also noted that its comparative analysis (at that time) did not identify any other countries that prohibit commission payments in mortgage markets.[36]

Box 3.3 Self-certified mortgages

Another example of mis-selling in the UK (and notably also in the USA) concerns self-certified mortgages. In this case, mortgage distributors were accused of recommending that applicants take out so-called self-certification mortgages and advising applicants to overstate their true income in order to obtain a larger mortgage, which they might have had trouble in servicing later.

These intermediaries were incentivised to assist applicants in obtaining larger mortgages for two main reasons: first, because they were paid on the basis of a transaction being successfully concluded (creating 'sales bias');[37] and second, because they did not face the consequences of the customer defaulting at a later date (which is a type of principal–agent problem, as the mortgage provider has not incentivised the intermediary to avoid high-risk situations).

The FCA has addressed these concerns by tightening the regulation on self-certified mortgages, as part of the Mortgage Market Review (MMR).[38] The MMR led to mortgage lenders being required to collect much more information (and evidence) about borrowers (e.g. income, regular expenditure) in order to assess 'affordability'. However, this review has not attempted to address the problem by restricting commission payments. In fact, as described above, the regulator recommended that commission payments should not be banned for this kind of product. The problems arising with self-certification mortgages were not driven by commission payments, but were instead due to the separation of brokers and providers. Brokers did not have sufficient regard for the risk created by arranging a mortgage for a customer that they might not be able to afford.

In banking more generally, these kinds of 'principal–agent' problems have sometimes been addressed by commission payments being deferred, so that intermediaries or employees are forced to have regard for longer-term outcomes—for example, deferred bonus payments to bankers.

Source: Oxera.

Group pensions

As part of the RDR, the FSA also considered a commission ban for group personal pensions, group stakeholder pensions and group self-invested personal pensions. At the time, the regulator decided not to introduce a commission ban on these products but to continue to discuss this issue with the Department for Work and Pensions (DWP).[39]

Platforms

Investment fund platforms, which provide a range of tools that allow consumers (and advisers) to compare funds and analyse their portfolios, as well as providing custody for a client's assets, but which do not provide investment funds, are

[35] FSA (2009), 'DP09/03: Mortgage Market Review', para. 5.42.
[36] FSA (2009), 'DP09/03: Mortgage Market Review', para. 5.41. This analysis was conducted before the Netherlands introduced a ban on commission payments for mortgage brokers.
[37] In this case, the intermediary was paid in the form of commissions. However, intermediaries would also have been subject to a sales bias if they had not been paid in the form of commissions but in the form of a fee by the consumers. There is a sales bias irrespective of the form of payment.
[38] For details, see 'Mortgage Market Review' on the FCA website: http://www.fca.org.uk/firms/firm-types/mortgage-brokers-and-home-finance-lenders/mortgage-market-review.
[39] FSA (2010), 'Distribution of retail investments: Delivering the RDR - feedback to CP09/18 and final rules', para. 1.11.

covered by the RDR. Platforms must now separate their charges from the charges of the fund managers and are not allowed to recover their costs from the providers—they can recover their costs only from consumers.[40] Provider facilitation of payments is common, with platforms mostly charging on the basis of a percentage of assets per year.

3.1.4 Impact of the regulation

Before the RDR came into force, various commentators expected that a ban on commission payments would result in the demand for financial advice decreasing dramatically, as consumers were believed to be unwilling to pay for it. Equally, many commentators expected financial advisers to cease providing such advice, as the loss of commission payments would render it commercially unviable.

Customers with a lower income and/or lower investment requirements were expected to face particularly strong restrictions to accessing financial advice. The rationale was that the adviser’s fee would become disproportionate to the level of investment/insurance coverage. When giving evidence to the Parliamentary Commission on Banking Standards, Martin Wheatley (CEO of the FCA) acknowledged that policy change or intervention—such as the RDR—might have adverse effects on the financial inclusion of customers affected by social or economic deprivation.[41]

Interviews with industry participants (insurance providers, financial advisers and associations) suggest that adverse effects, in terms of access to financial advice, are not clear at this stage. There is no clear evidence at this time that the changes have significantly altered consumer behaviour, although changes may occur in the future. Where effects have materialised—e.g. with regard to the number of financial advisers decreasing (see the figure in Box 3.1 above)—it is unclear whether this is due to the ban of commission or to other factors, such as the increase in the mandatory level of professional standards.

It should be noted that provider facilitation of payments to distributors (see below for details) may have helped to reduce the impact on consumers, as the payment of a fixed upfront fee for advice can be avoided. At this stage, however, the impact on consumer behaviour remains uncertain.

The FCA is conducting a three-stage thematic review to assess firms’ overall approaches to RDR. The first stage[42] of the review interviewed 50 firms across the industry (including providers and intermediaries), in order to assess how the RDR is being implemented. Overall, the results of the review showed that firms have acted to implement the new requirements.

At the same time, there were certain areas where the FCA considered that more effort was needed and these were addressed in the second stage. In particular, the second stage[43] focused on:

- whether distributors that describe themselves as being independent of providers are acting independently in practice;
- whether distributors are complying with the disclosure requirements.

[40] FSA (2010), ‘Platforms: delivering the RDR and other issues for discussion’, FSA Discussion Paper 10/2.
[41] House of Commons (2013), ‘Uncorrected transcript of oral evidence: HC 642i’, Transcript of the Parliamentary Commission on Banking Standards, 10 September.
[42] FCA (2013), ‘Supervising retail investment advice: how firms are implementing the RDR’, Thematic Review 13/5, July.
[43] FCA (2014), ‘Supervising retail investment advice: Delivering independent advice’, Thematic Review 15/5, March.

The results show that distributors do understand the new requirements of the RDR, and that firms are indeed acting independently. The FCA is providing continued support to firms that need clarification and assistance in the implementation of the rules.

Provider facilitation of payment advice

Consumers can choose to pay an adviser's fee separately from the payments for the product, or have the adviser's fee deducted from their investment/insurance contribution. If payment is to be taken from the investment, the product provider must obtain clear instructions from the client about the amount to be deducted.

Product providers may also offer credit facilities to help clients pay the adviser fee. This is a form of provider facilitation of payment, where the distributor receives payment upfront, with payment from the customer being collected by the provider over time thereafter. Product providers entering into agreements with adviser firms to offer credit must abide by guidance and evidential provisions intended to prevent such arrangements from channelling business from the firm or influencing the advice it gives to clients.

The requirement for fees for financial advice to be made more explicit will have created a greater awareness among consumers that such advice is not free. At the same time, provider facilitation may have helped to soften the impact of such fees on consumers. Information gathered by Oxera in interviews suggests that provider facilitation is widely used by financial advisers/product advisers.

Unwinding of the cross-subsidy

An FSA survey found that, like commission payments, advisers' fees still tend to be charged on a percentage basis of the investment value.[44] The general expectation—including by the FSA/FCA—was that fees would move to a fixed or hourly fee basis.

Percentage-based fees imply that the products with twice the investment value may result in twice the commission payment—regardless of whether the costs of providing the advice are twice as high (which is unlikely to be the case). Fee structures that are based, for example, on an hourly fee are likely to better reflect the costs of providing advice.

Economic principles suggest that, in a competitive market, the price of a product or service is closely related to the cost of providing it. The persistence of percentage-based fee structures in the context of financial advice is therefore somewhat counterintuitive. However, as described in section 2, there are reasons why distributors of services often charge using a percentage-based fee structure, due to the need to recover fixed costs that are not directly linked to any particular client. A degree of cross-subsidisation from higher-wealth consumers to lower-wealth consumers may also be desirable from a policy perspective.

Number of financial advisers

Many commentators predicted that the RDR would result in a significant drop in the number of financial advisers (and therefore reduced access to financial advice). Indeed, the FSA published figures suggesting that the number of

[44] FCA (2013), 'Supervising retail investment advice: how firms are implementing the RDR', Thematic Review 13/5, July.

financial advisers amounted to 32,690 in 2013, compared with 35,899 a year earlier—a 9% decrease (see the figure in Box 3.1).[45]

There are, however, a number of possible reasons why there may be a reduction in the number of financial advisers, including the increase in the professional requirements for financial advisers.

As set out above, the FSA identified that low levels of professional qualifications required from financial advisers had contributed to financial products being mis-sold to consumers. As a result, financial advisers are now required to be in possession of an FCA-approved qualification and a Statement of Professional Standing, issued by an FCA Accredited Body.

These requirements might also have led some advisers to leave the industry. This is particularly likely for advisers that were close to retirement, as the additional costs (both monetary and non-monetary) might have been seen as an inducement to retire early.

Several large banks that provide products as well as advice on products have exited the financial advice business, but not necessarily due to changes in commission payments.[46] Barclays closed its advice arm in 2011. Lloyds closed its mass market advice service in November 2012, and Santander stopped offering advice to new customers as of early 2013. HSBC is also understood to have taken the decision to stop offering advice to customers that fall below a certain net worth—in its case, £50,000.[47]

3.2 The Netherlands

The Netherlands has introduced perhaps the widest-ranging regulation of commission payments to advisers among the six countries considered. The ban on commissions, implemented in 2013, is the centrepiece of this regulation, although there remain exemptions to the ban and, more generally, the regulation may be amended in response to evidence of detrimental impacts. The independent distribution channel is strong in the Netherlands, particularly for mortgages, which may explain its wide scope. The application of the regulation across all sales channels has created difficulties, however, as regulating distribution costs for in-house sales channels is not straightforward (as explained below).

The gradual introduction of regulation in the Netherlands, and its impact on distribution, may become an informative source for understanding the impact of a ban on commissions on the distribution of financial products, including aspects such as the price, scope and quality of advice. While rules have now been implemented in full, it is still too early to identify and estimate the full impact, as consumers and distributors are still adjusting to the changing regulation and market environment. Post-implementation review of the ban is scheduled for early 2017.

[45] FSA (2013), 'Retail Distribution Review Newsletter', **9**, February.
[46] It is likely that changes were influenced by the tightening of professional standards requirements, cases of mis-selling (such as PPI), and the ongoing impact of the financial crisis, which led to significant reductions in banking activities and workforce.
[47] Whiteman, H. (2014), 'The death of bank advice: more than just the RDR to blame?', *money marketing*, 23 May, available at: http://www.moneymarketing.co.uk/the-death-of-bank-advice-more-than-just-the-rdr-to-blame/1070770.article.

3.2.1 Background and rationale for regulation of commission payments

Following a number of high-profile mis-selling cases,[48] the Dutch government, the regulator (AFM), and representatives of the financial services industry (both providers and distributors) recognised the need for a gradual process in amending the model of distribution and remuneration for advice and intermediation. From discussions with AFM, Oxera understands that this recognition resulted in a combination of rules on information disclosure, a ban on commissions, and a prohibition of inducements, being implemented in the period 2008–14. The aim of this combination of measures was to prevent the excesses of over-charging and mis-selling and to introduce greater transparency into the pricing of advice, intermediation and financial products, and to encourage the move towards a level playing field with sound incentives for advisers and providers of financial services alike.

A more direct aim of the measures was to prevent 'hit-and-run' advice, whereby intermediaries would advise customers on investment-linked policies and receive large commission payments at the outset of the transaction. The measures did this by limiting the proportion of the commission that the intermediary could receive upfront to 50%, with the remaining 50% being paid out over the lifetime of the financial service purchased. In 2009, the regulator then placed a cap on commissions.[49] Finally, a ban was introduced on commissions (the 'provisieverbod') in January 2013 for a range of products (e.g. mortgages, insurance, the more complex savings products, participation in investment funds). The ban was extended to other investment products (not just participation in investment funds) in January 2014.[50]

Prior to implementation of the ban on commissions, payments to advisers were typically part of total payments for financial products. This made it difficult for customers to learn how much they were paying for advice, and how much they were paying for the product. It was also believed that this lack of transparency made it more difficult for consumers to compare across products, providers and advisers.[51] The ban was argued to result in greater transparency about prices paid for advice, intermediation and products, and to benefit the range of services that could be provided by advisers.[52] For example, it was claimed that consumers would be in a better position to compare advisers, and to decide on which elements they wanted to receive advice about.

The ban reflects the regulator's preference to move from product-driven sales of financial products towards client-centred advice.[53] The regulator therefore aimed to ensure the clear separation of the payment streams between customer to adviser and customer to provider. This led to advisers being prohibited from accepting inducements (such as turnover-related bonuses) from 2009 onwards, and being increasingly restricted in their right and ability to take payments for financial products (e.g. premiums) from their customers and transfer them to providers (from 2013 onwards).

The Dutch Minister of Finance recognised that the creation of a level playing field was an important consideration and objective for the ban on commissions. In

[48] See, for example, the case of the *woekerpolisaffaire* in Box 3.4.
[49] For example, the cap for mortgage advisers was approximately €5,000. See van der Linden, R. (2014), 'Banning protection commissions – the Netherlands Experience', *Cover*, 18 March, available at: http://www.covermagazine.co.uk/cover/feature/2333037/banning-protection-commissions-the-netherlands-experience.
[50] See http://www.afm.nl/nl/professionals/diensten/veelgestelde-vragen/provisieverbod-beleggingsondernemingen.aspx.
[51] Minister of Finance (2011), 'Uitwerking regelgeving provisieverbod', Letter to Dutch Parliament, 13 April.
[52] Minister of Finance (2011), 'Uitwerking regelgeving provisieverbod', Letter to Dutch Parliament, 13 April.
[53] Minister of Finance (2011), 'Uitwerking regelgeving provisieverbod', Letter to Dutch Parliament, 13 April.

particular, this involved competition between non-tied advisers and advisers working for banks (or other providers of products).

Box 3.4 The *woekerpolisaffaire*

In the Netherlands, the *woekerpolisaffaire*, or 'profiteering policy affair', which was uncovered in 2006, was seen to be one of the motivations for the regulation of the distribution of financial products and, more specifically, the ban on commissions. The affair related to the sale of mortgage and investment insurance products, whose value was linked to investments. For example, the payments of mortgage-holders would be invested rather than used to pay the interest and principal on the mortgage directly. These policies were similar to endowment mortgages in the UK.

The rise of these policies coincided with the equity boom of the late 1990s, which made them look attractive. These mortgages also had the advantage of smoothing out real mortgage payments in the higher inflation environment of the 1980s and early 1990s.[54] However, following an investigation by the Dutch financial regulator, AFM, these policies turned out to be complex, unclear and relatively expensive. There was a concern that distributors, typically in-house agents of insurance companies, were incentivised to advise consumers to take these products due to the commissions they were receiving.

A similar issue with endowment mortgages arose in the UK, but the UK regulator did not conclude that the solution would be to restrict commission payments to mortgage intermediaries. In the UK, the policies were also mostly sold by the providers' own in-house distribution arms, and so the regulator instead chose to regulate the products of the mortgage provider rather than the activities of the distributor. The nature of the chosen regulation was different, as the market operated in a different way in the UK.

Source: Oxera.

3.2.2 Details of the regulation

The ban prohibits advisers from receiving payments from product providers when advising their customers to purchase financial products.

The ban was imposed on a selection of products that the Minister of Finance had identified as both complex and having a potential material impact on consumers.[55] Furthermore, the Minister took into account the intensity of competition in the market for products. The idea was that, if competition for a product is intense, there is likely to be greater transparency and greater potential for the market to provide value for consumers. In practice, the Minister of Finance and the AFM have considered past incidents to be important. Cases of mis-selling have been regarded as good indicators of there being a need for products to be covered by the ban on commissions. Typically, one would expect incidents to be related to product complexity as, in markets with simple products, consumers can be expected to have a greater ability to discipline advisers and providers of services.

Products covered in the 2013 ban included funeral and term life income protection insurance, fiscally facilitated savings products (such as annuities), participation in investment funds, and mortgages. The ban was expanded to cover all investment products (not just participation in investment funds) in January 2014. Funeral insurance products are an example of a product that is not necessarily complex (pay-out is easy to comprehend), but where it was decided

[54] With a standard repayment mortgage, the monthly repayments are fixed in nominal terms, so in a high inflation environment, the repayments are high in real terms at the beginning of the mortgage, and low in real terms at the end. With an endowment mortgage, it was possible to smooth out payments in real terms to a greater extent, although this might be feasible in practice only if the value of the house was also rising.
[55] Minister of Finance (2011), 'Uitwerking regelgeving provisieverbod', Letter to Dutch Parliament, 13 April.

on the basis of past incidents that the product should be covered by the ban. The AFM's review of the distribution of funeral insurance products in 2011 had resulted in the conclusion that the interests of customers were not central to the sale of these products.[56]

The ban does not cover typical property and casualty insurance (such as motor, contents, liability and legal aid insurance). Excluding property and casualty insurance from the scope of the regulation was based on the existence of strong competition among providers, and consumers' good understanding of these products and awareness of there being multiple providers.[57] The AFM will continue to monitor competition in property and casualty insurance markets and, if it observes a decrease in competition, it can recommend for that product to be covered by the ban.[58] At the same time, the AFM might remove the ban on products for which it observes an increase in competition and an improvement of transparency.

A specific exemption was introduced for mortgage-takers who are in financial distress (having either current or expected problems in paying mortgage payments), and would thus have difficulties paying an upfront fee for advice. In this event, advisers can add their fees as part of the amended mortgage. The fees are effectively spread over the lifetime of the mortgage, with provider facilitation of the collection of those fees, although the fees are still agreed between the distributor and the consumer. Part of the reason for this exemption related to the uncertainty about whether advice was new or continuous. New advice would be covered by the ban, and continuous advice would not. The AFM was concerned that uncertainty might discourage advisers from recommending a switch to new (better-suited) mortgages, even in circumstances in which a switch would clearly be in the interests of consumers.

Consumptive credit is also excluded from the scope of the ban on commissions. Here, the AFM was more concerned about consumers: the overrepresentation of vulnerable consumers in the taking of consumptive credit pointed to a greater risk of abuse and consumer harm. Recognising this risk of abuse, the AFM considered it to be more appropriate to directly regulate the prices of advice relating to consumptive credit, applying the principle that the price has to be proportional to the advice given (the 'kennelijke onredelijkheidsnorm').[59]

The ban covers all sales channels. The aim of this channel-neutral approach was to maintain a level playing field between independent advisers and advisers tied to product providers.

Providers of financial products who are also advisers (direct sales) are also required to ensure that fees for advice/intermediation are cost-reflective, and that they do not fall below the direct cost of providing the advice/arranging the implementation.

This requires ongoing monitoring, and may require investigations by the regulator. For example, the AFM challenged Rabobank for setting (excessively) low prices for advice. Rabobank had advertised on the basis that it would charge for mortgage advice only where the consumer decided to take a mortgage from

[56] AFM (2011), 'Onderzoek naar de distributie van uitvaartverzekeringen', marktstudie, December.
[57] For an explanation of the reasons for exemptions for different products, see the letter of the Minister of Finance to Parliament, dated 11 April 2013, available at: http://www.rijksoverheid.nl/bestanden/documenten-en-publicaties/kamerstukken/2011/12/13/kamerbrief-nadere-uitwerking-beleid-provisieverbod-complexe-producten/kamerbrief-nadere-uitwerking-beleid-provisieverbod-complexe-producten.pdf.
[58] Minister of Finance (2011), 'Uitwerking regelgeving provisieverbod', Letter to Dutch Parliament, 13 April.
[59] Minister of Finance (2011), 'Uitwerking regelgeving provisieverbod', Letter to Dutch Parliament, 13 April.

Rabobank.[60] Following a discussion between the AFM and Rabobank, the latter withdrew its offer to provide advice for free if consumers opted not to take a mortgage. The AFM's concern was that advisers who were not tied to financial service providers could not match this offer (Rabobank was considered to be selling advice below cost), and that consumers who had engaged with Rabobank for free advice would opt to take a mortgage with Rabobank.

More generally, there is no easy solution for separating the cost of product provision from the cost of advice in a vertically integrated company that both provides and distributes a product. There are shared fixed costs, and the allocation of fixed costs will necessarily involve some degree of judgement.

It is understood that the AFM applies this sort of rule when reviewing prices/arrangements offered by distributors. This example highlights the challenges in applying the regulation across all sales channels. The AFM has developed a 'cost price' approach, whereby fees charged for advice have to cover costs incurred in the process of giving the advice. The AFM has given some guidance about the treatment of differing types of costs, and expects advisers to provide financial statements audited by accountants.

Fee structure and disclosure

Advisers have to set distinct prices for advice and intermediation. Fees are agreed between the advisers and consumers. To help consumers spread the cost of distribution over time, advisers and consumers can agree on the fee payment being spread over a set period (maximum of 24 months).

The ban on commissions was accompanied by information disclosure measures. Advisers are obliged to draft a summary disclosure document called *dienstverleningsdocument* (DVD), which presents information on the fees they charge (these are given for an average customer, as the precise fee for a given customer will depend on the services they choose), the type and scope of their advice, and the costs they incur. The aim of DVDs is to inform consumers about the fees and scope of work offered by advisers. Moreover, because all advisers are required to produce this document, consumers are able to more easily compare across different advisers.

The AFM has indicated that, while it allows consumers to purchase financial products without purchasing financial advice (execution-only), it believes that such advice should be recommended to most consumers, particularly if the financial products are complex.[61]

In response to concerns that requiring consumers to pay for advice could result in more consumers choosing execution-only services, a knowledge and experience test has been introduced.[62] This test has to be passed by consumers who have declared their intention to purchase financial services execution-only. The test is intended to allow consumers to determine whether they have sufficient knowledge and experience to purchase financial services execution-only. It is not entirely clear how this would be enforced—Oxera understands that the AFM is not currently able to verify whether consumers opting for execution-only have passed the test.

[60] See AFM (2013), 'Provisieverbod is strikte scheiding tussen product an advies', 3 January, available at: http://www.afm.nl/nl/nieuws/2013/jan/provisieverbod.aspx.
[61] AFM (2009), 'Leidraad passende provisie financiële dienstverleners', *Guidance*.
[62] See 'Wat weet jij van financiële producten?', available at: http://www.afm.nl/nl/consumenten/aanpak/test-jezelf/producten.aspx.

From 2015 onwards, advisers will no longer have the unconditional right to transfer payments made by customers to providers of financial products (e.g. the payment of premiums to insurers).[63] This change in regulation applies to financial products covered by the ban on commissions, and not to financial products exempted from the ban. Such a function will be allowed only if customers, advisers and providers of financial products reach explicit agreement on a role for advisers in transferring payments from customers to providers of financial products.

The Dutch Minister of Finance recognised that compensation is primarily a matter between advisers and customers, and is wary about getting involved in the setting of prices and the agreement of the scope of advice. Only in cases where 'unreasonable' compensation has been asked for will there be intervention by the regulator (AFM). In addition, the regulation requires advisers to be transparent and inform customers about their fee and scope of work model.

3.2.3 Impact of the regulation

As the ban on commissions has been in place only since January 2013, it is difficult to evaluate its impact. Moreover, in the same period (2009–13), various related pieces of regulation were implemented, so there is also the challenge of disentangling the effects of the ban and other pieces of regulation.

The market for financial advice appears to have consolidated over recent years. This development cannot necessarily be attributed to the ban on commissions, as the trend towards consolidation had already begun before implementation of the ban.

A consumer monitor by the AFM in the area of mortgages[64] shows some evidence to suggest that the ban may have caused a reduction in fees. This study, a consumer monitor in the area of mortgages, presents results based on an extensive survey of consumers who took out a mortgage in the autumn of 2013. Since the AFM had undertaken a similar survey, also presented in a consumer monitor, in the spring of 2013,[65] it was able to compare responses given before and after the imposition of the ban. For clarity, the consumer monitor published in the spring of 2013 presented the results of a survey undertaken towards the end of 2012 when the ban had not yet been implemented.

The AFM found that, between the spring and autumn of 2013:

- the proportion of mortgage customers using the services of a mortgage broker remained broadly stable, at around 60%;
- mortgage customers spent more time researching mortgages themselves, and less time with advisers;
- the average amount paid for advice decreased from €2,166 in the spring of 2013 to €1,749 in the autumn of 2013.[66]

[63] Minister of Finance (2011), 'Verdere uitwerking beleid provisieverbod complexe producten', letter from Minister to Dutch Parliament, 13 December.
[64] AFM (2013), 'AFM Consumentenmonitor najaar 2013 Hypotheken', December.
[65] AFM (2013), 'AFM Consumentenmonitor najaar 2013 Hypotheken', June.
[66] These results must be treated with caution as there could have been other factors that affected the outcomes, such as the types of mortgages agreed. There is also the risk that the drop in the cost of mortgage advice could have been influenced by the separation of distribution and provider costs of banks that have in-house distribution channels.

From discussions with AFM, Oxera understands that a full assessment of the impact of the ban is expected to be undertaken in the first half of 2017. The Dutch Minister of Finance has publicly stated that it is currently too early for an assessment, and that an assessment can be informative only once consumers, advisers and providers of financial products had time to adapt to the new situation, which entails setting up new arrangements for providing advice and intermediation.[67]

Any impact observed in the Netherlands cannot be directly compared to and/or extrapolated to other countries. The situation in the Netherlands was specific in the sense that the network of independent advisers was already extensive prior to the imposition of the ban (in particular in relation to mortgages). Moreover, consumers were aware of the distinction between independent and tied-in advisers, and of the notion of paying for advice directly.

In relation to fiscally facilitated savings products (particularly annuities), initial anecdotal evidence (from discussions with market participants) points to consumers being somewhat reluctant to pay for advice, and purchasing less advice. Evidence in both mortgages and annuities suggests that consumers are opting for execution-only more frequently. The AFM has expressed a wish that, over time, the market (consumers and advisers) will explore and agree on new forms of advice, resulting in a more varied supply.[68] For example, this could involve consumers doing more themselves in terms of administrative work, and seeking advice where it is most important and adds the greatest value.

3.3 Denmark

In Denmark, regulation of commission payments for independent insurance brokers has been in place since 2006 (although it has been fully implemented only since 2011[69]), so any impact is likely to be more visible here than in countries where regulation is more recent. Regulation in Denmark is focused on a particular sub-section of insurance distribution—independent brokers—where there was a particular concern about the distribution of occupational pension schemes, given their mandatory nature. These brokers focus on providing life insurance products (including occupational pension schemes) to businesses, and the regulation appears to have had a limited impact on the scale of the sector. The number of independent brokers that are directly affected by the regulation is relatively small.

3.3.1 Background and rationale for regulation of commission payments

The Danish Act on Insurance Mediation was introduced in 2006, and required that independent insurance brokers no longer receive commissions or other types of remuneration from insurance companies. The Act does not cover ‘insurance agents’ (including tied agents and in-house advisers), who may continue to receive commission payments from insurance companies.

In Denmark, the sale of non-life and life insurance policies to consumers takes place mainly through tied agents and direct in-house sales channels. The main role for independent insurance brokers is in arranging occupational pension schemes (which, in Denmark, are supplied mainly by life insurance companies)

[67] Written response by minister of Finance Dijsselbloem to questions asked by MP Merkies, available at: http://www.rijksoverheid.nl/documenten-en-publicaties/kamerstukken/2014/04/22/beantwoording-kamervragen-over-schending-provisieverbod.html.
[68] AFM (2009), ‘Leidraad passende provisie financiële dienstverleners’, *Guidance*.
[69] The policy was introduced progressively across the range of customers, beginning with larger companies.

for company employees.[70] Occupational pension provision is mandatory for the vast majority of Danish workers, and insurance brokers play a significant role in this area.

The regulation was introduced due to a concern that insurance brokers may be incentivised to advise companies in a manner aimed at maximising commission payments from the insurance providers, rather than in the best interests of the customer.[71] In particular, there was a concern that brokers might be incentivised to encourage an excessive degree of switching between pension products, in order to achieve the commission payments that they received with each transaction.

Brokers are expected to deliver objective advice and remain independent from insurance companies. Consequently, the Danish Financial Supervisory Authority (FSA) sees the commission ban as a logical step. Tied agents are unaffected by the ban as they enter into explicit agreements with insurance companies. According to the Danish FSA, 'the customer does not expect objective advice from an insurance agent'.[72] Soft disclosure is required from agents—that is, at the customer's request, they are obliged to disclose the commission that they receive.[73]

The Danish FSA has stated that 'the experiences in connection to the prohibition are very positive', as the 'insurance brokers and insurance undertakings both highlight that they are very satisfied with the existing system'.[74]

It is understood by Oxera that the insurance brokers' share of the market has not declined since the ban, although note that insurance brokers continue to focus on occupational pension and business non-life insurance provision, and do not have a substantial market share in the direct provision of insurance products to consumers.

3.3.2 Details of the regulation

The Danish regulation covers non-life and life insurance products, which includes most occupational pensions, but not retail investment products (which is not a significant area of business for the affected firms). The prohibition on receiving commissions or other remuneration from insurance companies applies only to insurance brokers.[75] Insurance agents are not covered.[76]

The regulation was introduced gradually between 2006 and 2011, beginning with brokers who provide pension schemes to larger companies, and it now applies to all insurance intermediation by brokers.

Brokers retain a wide range of options for receiving payment from customers, including provider-facilitated payments. This is particularly common with regard to

[70] See Rasmussen, P.B. (2013), 'Insurance mediation: Benefitting from the potential of Danish experiences', presentation, available at: http://www.sven-giegold.de/wp-content/uploads/2013/03/Danish-Insurers-MEP-Seminar-20th-of-march.pdf.
[71] See Rasmussen, P.B. (2013), 'Insurance mediation: Benefitting from the potential of Danish experiences', presentation
[72] Danish FSA (2011), 'Response from the Danish FSA regarding the consultation on the Review of the Insurance Mediation Directive (IMD)', 2 March.
[73] This is consistent with the requirements of the Insurance Mediation Directive (IMD).
[74] Danish FSA (2011), 'Response from the Danish FSA regarding the consultation on the Review of the Insurance Mediation Directive (IMD)', 2 March.
[75] In the Danish Act on Insurance Mediation, brokers are defined as intermediaries who provide the customer with advice on the basis of an analysis of as many of the insurance solutions available on the market as possible, and who present to the customer insurance solutions from one or several insurance companies without an explicit agreement to this effect having been entered into with the insurance companies in question.
[76] In the Danish Act on Insurance Mediation, insurance agent activities are defined as selling the insurance products of an insurance company according to an agreement with one or more insurance companies.

life insurance (including pensions), where brokers often receive payment directly from the insurance provider (paid from the premiums received by the provider), once this payment has been agreed with the customer. Upfront fees are more typical with regard to non-life insurance.

3.3.3 Impact of the regulation

The market impact of the regulation is reported (see data below) to be relatively limited, as the scale of the sector has not changed markedly. There has been consolidation in the broker sector, although it is understood that this trend began before the act was implemented, so it may be occurring for other reasons. The total number of registered insurance brokers in Denmark was only some 500 individuals in 2011, which highlights the limited size of this sector.

3.4 Sweden

Sweden does not currently have regulation restricting commission payments, but the insurance industry introduced some self-regulation of commissions in 2003, and the regulator, the Finansinspektionen (FI, or SFSA—i.e. the Swedish Financial Supervisory Authority) has recently proposed a ban on upfront commissions.

As with the other Scandinavian countries, most retail distribution of insurance products is done by tied agents or in-house distribution, with independent brokers working mainly with business clients.

3.4.1 Background and rationale for regulation of commission payments

Self-regulation of commission payments was introduced by the Swedish insurance association, Insurance Sweden, in 2003.[77] This called for restrictions on non-life insurance commission payments to independent brokers. This self-regulation has remained in place, with a competition authority review of the regulation in 2004 leading to the continuation of the policy.

Swedish legislation allows for commission payments to all insurance intermediaries, which are defined under law as being either:[78]

- tied insurance intermediaries, which carry out the activity of insurance mediation for and on behalf of one or more insurance undertakings, but do not collect premiums; or
- independent insurance intermediaries (typically referred to as 'brokers'), which are not tied to insurance undertakings.

Intermediaries have to provide consumers with transparent and comprehensive information about the commissions they receive, but there are no restrictions on the commission payments. Swedish law is consistent with the EU Insurance Mediation Directive (IMD). There are, however, calls for regulation of commission payments. The Swedish Ministry of Finance commented on the European Commission's Consultation Document for IMD, calling for a level playing field for all participants involved in the selling of insurance products, and a strengthening of consumer protection.[79] The Swedish Ministry of Finance stated that the requirement under Swedish law to provide the consumer with transparent and comprehensive information about commission may not be sufficient to address

[77] As explained to Oxera by Insurance Sweden.
[78] There is also in-house distribution of insurance products by the insurance provider.
[79] See Finansinpektionen (2014), 'Konsumentskyddet på finansmarknaden', May.

the problem of conflicts of interest when the intermediary is remunerated by the insurance undertaking while serving the customer. Commissions paid over time were not, however, judged to be a significant problem by the Swedish FSA, which concluded that problems associated with banning commissions (not specified) would be avoided by allowing commission payments over time.[80]

3.4.2 Impact of regulation

The self-regulation of commission payments for direct non-life insurance distributed by independent brokers is not thought to have had a significant impact, as independent brokers did not (and still do not) play a significant role in the retail distribution of these products.[81]

3.5 Finland

The Finnish Insurance Mediation Act (570/2005) imposed a ban on commission payments to independent brokers of insurance products, in a similar way to the regulation in Denmark. The Act took effect on 1 September 2005 but was not fully effective until after a three-year transition period (2008), as the regulation was progressively rolled out over different customer types.

3.5.1 Background and rationale for regulation of commission payments

The precursor to this regulation was the 1994 legislation, which established a distinction between agents and brokers; the former acting on behalf of the insurer, the latter on behalf of the insured.[82] This distinction was seen to have been gradually undermined, resulting in the 2005 Act. The purpose of the 2005 Act was to increase transparency, drawing a clear distinction between agents and brokers, to ensure brokers' impartiality and avoid conflicts of interest.[83]

Brokers were already required to disclose their commission arrangements to their customers before the ban was introduced.

As in Denmark, in Finland the broker business focuses on non-life insurance for corporate clients. There is provider facilitation in the non-life insurance business, which in Finland is called the 'net-quoting system'. The broker charges the fee to the customer but the insurance company collects the money through the premiums paid.

3.5.2 Impact of the regulation

Due to the focus of brokers on serving corporate clients, as these brokers serve only a small proportion of the retail market, the regulation has had few implications for retail customers. An assessment by the Federation of Finnish Financial Services found some reduction in the non-life premiums of insurance brokers since the ban came into effect, although this was small and largely offset by an increase in premiums noted in the last year of the dataset (2011).[84] The number of registered insurance brokers has decreased somewhat, from a peak of

[80] See Finansinspektionen (2013), '2013 Supervision Report', 28 May, pp. 15–6.
[81] As explained to Oxera by Insurance Sweden.
[82] See Finansinpektionen (2014), 'Konsumentskyddet på finansmarknaden', May.
[83] The aims of the regulation were described in Federation of Finnish Financial Services (2013), 'Finnish Act on intermediation and the remuneration model for brokers', 20 March, available at: http://www.sven-giegold.de/wp-content/uploads/2013/03/EP-Breakfast-Finish-contribution.pdf.
[84] As described in Federation of Finnish Financial Services (2013), 'Finnish Act on intermediation and the remuneration model for brokers', 20 March, available at: http://www.sven-giegold.de/wp-content/uploads/2013/03/EP-Breakfast-Finish-contribution.pdf.

around 270 in 2004 to only 199 individuals in 2011.[85] The small number of registered insurance brokers highlights the limited size of this sector.

3.6 Australia

Australia was included in the study as an example from outside the EU. It provides a different example of how regulation of commission payments has developed, as here the focus has been more on the incentives of brokers to sell high-risk investment products to consumers. The reforms have only recently been introduced, and the effect on the market is therefore still evolving.

3.6.1 Background and rationale for regulation of commission payments

The Australian government announced its Future of Financial Advice (FOFA) reforms in April 2010,[86] with the primary objective of improving the quality of financial advice, and access to this advice for Australian consumers. The reforms aimed to restore the confidence and trust of retail investors in the wake of the collapse of financial services companies Storm Financial (see Box 3.5 below) and Opes Prime.

Box 3.5 Storm Financial

Storm Financial was a financial advice company in Australia. It is currently under investigation by the Australian Securities and Investments Commission (ASIC) following its collapse in 2008 and the subsequent losses suffered by its clients.

Before its collapse, the firm had 14,000 clients, of whom approximately 3,000 were leveraged investment clients. These investors, who included retirees and people about to retire, were encouraged to take out loans against the equity of their homes in order to generate a lump sum to invest in various funds proposed by the firm. As the financial markets collapsed in 2008, the value of Storm's investment portfolios severely decreased, causing severe losses to its clients, particularly those who were heavily leveraged. The firm itself collapsed when it could no longer service its own debt to its prime creditor, Commonwealth Bank.

Storm charged clients a 7% upfront fee on the total value of their investment. ASIC argued that this structure created incentives for the firm to raise the value of its clients' investments by encouraging them to take on more debt, even when they should not have taken on such a level of risk (in the case of retirees, for example).

The main cause of detriment for Storm's clients was the high-risk nature of the leveraged activities, not the existence of commissions in themselves. The commissions ban did not target such activities in particular; rather, it aimed to reduce any conflicts between the interests of consumers and financial advisers. The particular problem of excessive risk-taking was dealt with by introducing a rule that required that percentage charges applied only to unleveraged investments.

Source: Commonwealth of Australia (2009), 'Parliamentary Joint Committee on Corporations and Financial Services Inquiry into financial products and services in Australia', November.

The regulation came in response to an inquiry into the financial services sector by the parliamentary joint committee on corporations and financial services. In the inquiry, the committee commented that:

> A significant conflict of interest for financial advisers occurs when they are remunerated by product manufacturers for a client acting on a recommendation to invest in their financial product […] These payments place financial advisers in the

[85] Finnish FSA (2012), 'Insurance brokers 2011', 31 August 2012.
[86] As recorded in Australian Government (2010), 'Overhaul of financial advice', media release no. 039, 26 April, available at: http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/036.htm&pageID=&min=ceba&Year=&DocType=0.

role of both broker and expert adviser, with the potentially competing objectives of maximising remuneration via product sales and providing professional, strategic financial advice that serves clients' interests[87]

One of the key reforms that aimed to align the interests of consumers and advisers, and eliminate product and provider biases, was the ban on 'conflicted remuneration'. Conflicted remuneration refers to any benefit given to a financial adviser that could reasonably be expected to influence the recommendation of a financial product given to clients. This includes commission payments as well as volume-based benefits. In the words of ASIC Commissioner Peter Kell, 'the key principle underlying the conflicted remuneration ban is to ensure the interests of advisors and retail clients are more closely aligned, improving the quality of advice provided'.[88]

3.6.2 Details of the regulation

The law applies to all advice given to retail clients by Australian Financial Services Licensees on any retail financial product except non-life insurance products and basic banking products.

The regulation bans upfront commissions as well as trailing commission (charged as a percentage of the client's assets each year). This is aimed at removing the potential for providers to influence the adviser's recommendation (provider and product bias). Any form of payment from the provider to the adviser that is based on volume or sales targets is also prohibited. This is also intended to reduce sales bias.

In addition, percentage-based fees (known as 'assets under management fees') can be charged only on unleveraged products. When examining the Storm Financial collapse, the Parliamentary Joint Committee concluded that 'for at least a subset of Storm's investment clients – the advice to engage in aggressive leveraged investment strategy was clearly inappropriate'.[89] The measure is therefore aimed at reducing the cases where an adviser is likely to recommend leverage to increase the funds under management.

The reforms introduced a new adviser charging regime. Advisers are expected to agree their fees directly with their clients, and disclose those fees in a clear manner. If an adviser is providing an ongoing service, they are required to ask clients to opt in (or renew) their advice agreement every two years. This is to ensure that consumers are more engaged with their financial advice services.

In addition, the law introduced a statutory fiduciary duty, mandating that financial advisers act in the best interests of their clients, subject to a reasonable steps qualification, and place the best interests of their retail clients ahead of their own when providing personal advice.

The reforms commenced on 1 July 2012, and compliance was mandatory from 1 July 2013.

3.6.3 Impact of regulation

As the regulation has been fully in place only since July 2013, it is difficult to properly evaluate its impact. Much of the discussion so far has centred on the

[87] Commonwealth of Australia (2009), 'Parliamentary Joint Committee on Corporations and Financial Services Inquiry into financial products and services in Australia', November, para. 5.29.5.30.
[88] Commonwealth of Australia (2009), 'Parliamentary Joint Committee on Corporations and Financial Services Inquiry into financial products and services in Australia', November.
[89] Commonwealth of Australia (2009), 'Parliamentary Joint Committee on Corporations and Financial Services Inquiry into financial products and services in Australia', para. 337.

increase in administration costs. As a result of increased pressure from the industry, the government also proposed a series of reforms which are expected to reduce the regulatory burden of FOFA. One key amendment is the removal of the opt-in provision. However, there has not yet been an impact evaluation of the reforms.

3.7 Key findings

Overall observations from the six case studies include the following.

- Regulators have taken a case-by-case approach to regulating commission payments. In each of the countries considered, a ban has been introduced 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 other situations, other forms of regulation were identified as being more appropriate for addressing the underlying causes of problems (as explained above).
- The scope of regulation varies considerably across the six countries, as summarised in Table 3.1 below. The scope in terms of both types of product and types of sales channel is different in each case. For example, the product coverage is broad in Denmark, but applies only to independent brokers. In the UK, meanwhile, only retail investment products are included, but the regulation applies to all distributors. The result of these variations is that the number of brokers affected by regulation varies greatly between countries.

Table 3.1 Product/sales channel scope

	UK	NL	DEN	SWE	FIN	AUS
General insurance			independent brokers, mainly with business clients	industry self-regulation of brokers	independent brokers, mainly with business clients	
Income/payment protection insurance		all distributors	independent brokers, mainly with business clients	industry self-regulation of brokers	independent brokers, mainly with business clients	
Consumer credit						
Mortgages		all distributors				all distributors
Life insurance (no investment)		all distributors	independent brokers, mainly with business clients	proposed regulation	independent brokers, mainly with business clients	all distributors
Life insurance (investment)	all distributors	all distributors	independent brokers, mainly with business clients	proposed regulation	independent brokers, mainly with business clients	all distributors
Standard savings products						
Investment funds	all distributors	all distributors				all distributors

Legend: all distributors (red); independent brokers, mainly with business clients (blue); industry self-regulation of brokers (green); proposed regulation (grey)

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

Source: Oxera.

- The motivation for the regulation varies, resulting in different approaches. For example, in Denmark there was concern about incentives that encouraged excessive switching of pension provider, which led to measures to reduce the risk of 'sales bias'. Meanwhile, in the Netherlands, the focus was more on the profitability of certain products (e.g. endowment mortgages), which led to measures to reduce the risk of 'provider bias'. In Australia, in contrast, regulation followed concern about high-risk investment products.

- Different countries have chosen different approaches in relation to the sales channel. In Denmark, Sweden and Finland, regulation was applied only to independent brokers, as independent brokers had been treated separately from tied agents and in-house distribution, reflecting the nature of the market.[90] The issues affecting independent brokers were not seen to affect in-house distribution and tied agents. In contrast, the UK and the Netherlands applied regulation to all sales channels, including in-house and tied agents, as there was a focus on creating a 'level playing field'.

- The number of brokers affected by regulation is small in some cases, such as in Finland, where only some 200 independent insurance brokers are affected by the restrictions on commission. To put this number into context, the UK has around 33,000 affected retail investment advisers.

- While there was significant variation, there were also some common themes, such as concerns in the Netherlands and the UK about the complexity of products (which meant that consumers were more reliant on obtaining advice), and the effectiveness of price competition (due to difficulties that consumers were believed to have in comparing prices).

- Restrictions to commission payments were not deemed to be appropriate regulatory responses in some cases of product mis-selling, however, due to particular market characteristics. For example, UK regulators chose to address mis-selling of PPI by addressing the underlying problem, which was that companies selling PPI had market power at the point of sale of the related credit product (as described above). The decision was therefore to address the consumer bias rather than the system of commission payments.

- Reasons why regulators have not chosen to implement bans on commission include: (i) that there was no justification for the ban, due to lack of evidence of a commission-related problem (for example, the UK FSA did not include pure insurance distribution in the RDR); (ii) that there was no evidence that a ban would be an effective solution to a problem (e.g. with PPI in the UK); and (iii) that there was a concern that a ban might have undesirable effects (e.g. in the case of mortgage advice to those in financial difficulties in the Netherlands).

- Regulation of commission payments has produced some practical challenges. In the Netherlands and the UK, for example, achieving a level playing field between in-house distributors and independent brokers means that the regulator needs to ensure that in-house distributors charge a 'fair' price for distribution services. There is no clear way to determine a 'fair' price, as fixed costs (which can be significant) need to be allocated between services and customers, which complicates this task.

- Although research was conducted in some countries to understand the consumer detriment as a result of commission-based distribution of financial

[90] In the Scandinavian countries, independent brokers serve mainly business clients, with tied agents and in-house distribution being the main channel for retail customers. The concern of regulators was around how brokers provided advice to business clients, not to retail customers.

products, limited research has been undertaken on the impact of a commission ban on consumers. At the time the ban on commission was considered, there was more focus on the conduct of firms than on the behaviour of consumers. At that time, regulators had not yet taken the insights from behavioural economics into account.

- Although various commentators have made observations on the impact of the ban on commissions, most of these relate to other elements of the package of proposals that was introduced at the time (such as requirements for professional standards). It appears to be too early to assess the impact of the ban on commissions specifically. In the Netherlands, for example, the regulator plans to wait until 2017 to conduct the post-implementation review. This means that the impact of banning commission payments will not be known for a few years, and there may be additional lessons to be learned.

- There is an increased awareness of some of the potential negative consequences of banning commissions. This is the case in the UK, and also in the Netherlands, where an exemption was made for mortgages sold to consumers finding themselves in financial difficulty. There is a risk of reducing consumer access to financial advice and, consequently, financial products, and a risk of an unwarranted increase in the attractiveness of the execution-only channel. These risks have been acknowledged by regulators in the Netherlands and the UK, as discussed above.

- Regulation introduced in the six countries also varied in nature, as it was focused on addressing different issues, depending on the market failure being addressed. The details of the regulation of each country are explained in full in the sub-sections above.

- These differences do not so much reflect differences in the conceptual approach to regulation, as the reactions of regulators to specific market conditions. Regulation of commission payments has sought to address specific issues and market failures, and regulators have not typically considered blanket bans on particular types of payments to distributors.

The main conclusion of this analysis is therefore that regulation of commission payments needs to take account of specific market conditions, and be designed to address particular issues that have been identified, as different regulations are required for different issues. Regulators in the countries included in this study developed their approach to address the issues affecting their particular markets, and these issues were not common across all of the countries or, indeed, all of the product markets. Regulators therefore did not adopt a universal ban on commission payments.

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