A commission ban for financial advice: Lessons learned from The Netherlands

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Abstract

In 2013 a commission ban was introduced in The Netherlands for the mediation of complex financial products like life- and investment insurances and mortgages. In this paper an evaluation is made of this regulation so far. The commission ban is meeting most of its objectives, but has also some downsides, especially the accessibility of financial advice, which is addressed here. A commission ban is not the answer for all kinds of market failure in financial advice markets. To mitigate the unwanted side effects of the commission ban, this paper contains several policy options for the Dutch government.

Introduction

Financial intermediation and financial advice is key in European markets and societies. Because most financial products and financial services are complex, people rely on intermediaries' advice.

The primary function and added value of financial intermediation is reducing information asymmetries and transaction costs. As described in the theory of financial intermediation (Santomero, 1984, Bhattacharya & Thakor, 1993), markets do not function perfectly because sellers have more information than buyers. Also the closing of transactions is a time-consuming process, costing a lot of money. An intermediary is able to close the information gap between buyers and sellers, closing transactions more cost-effectively.

The financial intermediation market is confronted with principal-agency structures. A financial intermediary is the agent who has to deal with two principals, the supplier (bank or insurer) and the customer (consumer or business client). The agent has to serve two principals, which can lead to conflicts of interest. Also agency costs occur, which are described as the sum of all costs principals pay in order to monitor the agent and to make sure the agent proceeds in the principal's interest (Jensen & Meckling, 1976). The most

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common way of making sure the agent does as such is through the remuneration of the agent.

Traditionally, the financial intermediary only has a legal contract with one of the principals, the supplier. Therefore this principal was for a long time the only party paying the agent for his services. Nowadays more and more situations occur where the agent is paid directly by the customer, however value-based commissions paid by the insurer is still by far the main remuneration system for financial intermediaries throughout Europe.

With the supplier paying for the services of the intermediary, the debate today is whether the agent serves the interest of the supplier over the interest of the client. A problem when it comes to financial advice and financial intermediation is that financial products are so-called credence goods (Darby & Karni, 1973). Customers find it difficult to value the quality of advice and the financial products. This is especially the case with life insurance and investment products, where the value only becomes clear after several years, sometimes even twenty or thirty years after the product was purchased. So when financial products are more complex, it is harder for customers to value the quality of the service provided by the intermediary. Also the risk of conflicting interests between agent and customer is higher. European legislation is particularly focused on mitigating the risk of conflicts of interest occurring and the main feature in this discussion is the remuneration system.

The Netherlands has the strictest rules of all European countries concerning commissions for financial intermediation. In 2013 a ban on paying and receiving commissions was introduced for the mediation of complex financial products (life insurance, investment based insurance, mortgage, funeral, inability, death risk). In 2014 also a ban on commissions for the sale of investment products was introduced. The Dutch commission ban covers more financial products than in other European countries, and the conditions under which fees have to be collected are more restricted. This paper deals with the questions why The Netherlands chose for this strict regime and what the experiences with this ban are at this moment.

The market of financial intermediation

Insurance intermediation is a high-impact market in The Netherlands as well as in Europe. From a financial as well as a social point of view. Insurance products are recommended and sold by many thousands of intermediary businesses. The market consists of several types of businesses in diverse segments: tied agents, multi-tied or semi-tied agents, brokers and bank assurance. The way insurance intermediaries are being paid for their services depends on the country and type of business involved. In The Netherlands, insurances and mortgages are mainly sold through and advised by the independent intermediary channel (brokers). The Dutch Association of Insurers (Verbond van Verzekeraars, 2016) reports that of all life, non-life and income insurances, 73% is closed through brokers (banks included). The Dutch Authority Agency (GfK, 2017) reports that 64% of all mortgages are being closed through the broker channel.

The position and role of insurance intermediaries in Europe is widely discussed, on a national and a European level. Supervisors' biggest concerns regarding intermediation is that the variety of products offered by intermediaries is low, which is more the case with insurance agents than with brokers. There is concern about the suitability of the advice given and the incentive of high (first-year) commissions, which leads to conflicts of interest between serving the insurer or the customer. Supervisors' main concern is about the markets of more complex financial products, such as life insurance, investment insurance and the bundling of life insurance with investment products or credit.

Why a commission ban?

Legislation concerning commissions for intermediaries was introduced because there was some kind of market failure, which affected the position of the consumer in a negative way. Market failure (in the mortgage market) has been demonstrated, among other things, in Ecorys research (Bas et al, 2004). The main conclusion of this research was that the remuneration structures of intermediaries contained financial incentives, such as bonuses and commissions, which promote the advise of complex mortgage products and encourage mortgage lending by a limited number of mortgage providers. This means that consumers, when engaging with an independent mortgage advisor, bought more than average complex mortgages and also less favourable interest rates and quality. In addition, the research made clear that there was no complete picture among consumers for which mortgage providers intermediaries mediate. The results of the Ecorys survey showed that mortgage advice was negatively influenced by the existence of commission control of intermediaries. There was both a provider and a product stimulus in the mortgage advisory market. *"The reward structure in place holds perverse incentives for consumers not always advising the most suitable mortgage form and the best mortgage provider. The transparency and ambiguity of the intermediary's offerings strengthens the ability to tailor opinions to the financial benefits of intermediaries rather than the consumer's situation and wishes. Similar conclusions were drawn based on earlier empirical research in the United Kingdom. "* In addition to the bias that Bas et al signalled, there was another stimulus perceived as a result of commission, a mortgage amount bias. The commission for mortgages was largely aligned with the amount of the loan taken. The higher the mortgage, the higher the commission. Bas et al concluded that consumers who closed mortgages through intermediaries were not better off than consumers who bought a mortgage directly at a bank. Research of the Dutch Central Planning Bureau (CPB, 2006) on the advice of a purchase price policy, contained a similar conclusion, with the advice of intermediaries being less favourable for the customer than the advice of insurers.

In the Netherlands the debate about commissions became more intense in 2010. In 2010 SEO concluded from their research on the existing commission rules (transparency, inducements and a subscribed balance between first year and on-going commissions) at that point, the following:

1. Customers are insufficiently informed and therefore not effective counterbalance against advisors / brokers, making a good price / quality ratio for the customer is not guaranteed.
2. The main perverse incentives and hit-and-run practices have, also thanks to legislation, disappeared from the market.
3. The parties to the market largely adhere to the rules for costs and costs service transparency. However, this does not yet mean that the intended culture cover with advisors and brokers has been achieved in thinking and behaviour. The regulatory standards are still insufficiently internalized and there are indications for evasion behaviour, although their size is difficult to detect.

In 2010 the Minister of Finance concluded, based on this evaluation by SEO, that the legislation on commissions was not effective enough to enhance the change in culture in the financial sector. In his letter he wrote: "*The desired cultural change is a move from product-driven sales to customer-oriented advice. This move requires the unbundling of tasks and responsibilities of providers, advisors and brokers to remove control capabilities. This can only be achieved by regulation, without which the practice of commission payments is most likely to continue*."[2]

The conclusions of SEO and the Minister of Finance were supported by the findings of De Jong (2010). In his dissertation research he showed that the main reason for the market failure within the Dutch intermediary market, is the tight connection between banks / insurers and brokers through the commission system. Research also indicates that the quality of (independent) advice increases as commissions are lowered or banned (Gorter, 2013).

The commission ban in The Netherlands

As of 2013 all commissions are banned for so-called complex financial products (life insurance, investment, mortgage, funeral, disability, death risk). Also the

[2] Staatsblad 2012 695, Besluit van 21 december 2012 tot wijziging van het Besluit Gedragstoezicht financiële ondernemingen Wft, het Besluit marktmisbruik Wft, het Besluit prudentiële regels Wft, alsmede enige andere besluiten op het terrein van de financiële markten (Wijzigingsbesluit financiële markten 2013)

expertise requirements were increased to secure a proper minimum competence level of financial advisors.

The commission ban affects brokers and agents as well as bank assurance and providers. Brokers, agents and bank assurance are not allowed to receive commissions for the advice and selling of regulated complex products. When these complex products are sold directly to the customer by a salesperson of a bank or insurer, the insurer or bank has to be transparent about the amount of advice and distribution costs. It is not allowed to set the costs of advice and distribution at zero euros, because that would falsely suggest that the bank or insurer’s advice is free. This is to make sure there is a level playing field between brokers/agents and direct suppliers.

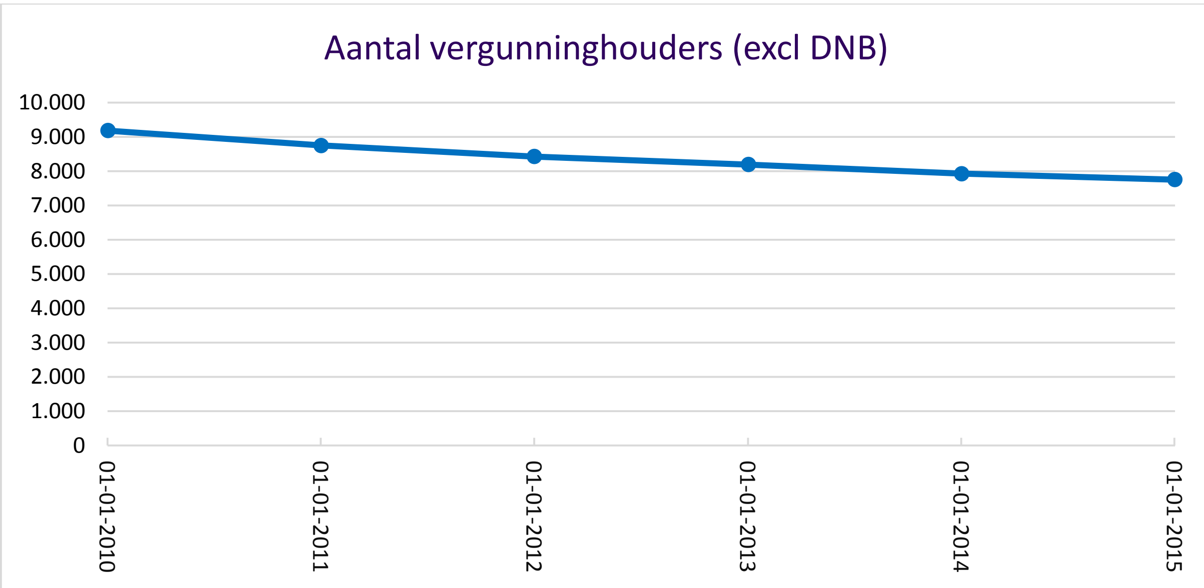
Evaluation of the commission ban

In 2017 the Dutch Ministry of Finance is evaluating the commission ban rule (Ministerie van Financiën, 2016). The evaluation focuses on four main outcomes:

1. Has the quality of advice improved since the commission ban became effective?
2. Has there been a shift from a sales-driven culture towards a more customer-centric culture?
3. What impact did the commission ban have on the accessibility and price of financial advice?
4. Is the scope of products still appropriate?

Number of financial intermediaries

The number of financial intermediaries has decreased since the introduction of the commission ban, but this trend already presented itself before 2013 as the following graph shows.



(AFM, 2015)

The blue line reflects the licenses for financial intermediaries since 2010. It is clear that the decline of intermediaries is not influenced significantly by the commission ban. Other developments like the banking crisis, stricter professional skills, digitalization etc. also had a significant impact on the need for financial intermediation. A survey with new entrants in the Dutch financial intermediary market shows that the commission ban did not influence these starting companies. About 80% of the new entrants would even have started as an intermediary, if a total commission ban had been effective (Adviesbureau Fred de Jong, 2017).

Preview of the evaluation

Because the final conclusions of the evaluation of the commission ban in The Netherlands were not public when writing this paper, some observations are discussed here.

The Dutch Financial Markets Authority (AFM, 2015) reported a slight increase in the quality of advice on ability insurance and mortgage advice. They also reported that there was still room for further improvements. But the AFM only investigates whether a financial advisor is compliant with the rules and legislation. Of course this legislation is set to improve the quality of advice, but it is not conclusive that being compliant is a guarantee for good quality of advice.

The debate amongst financial intermediaries involves the accessibility of financial advice. Are customers in some cases not able or not willing to pay for financial advice directly to the intermediary? Research from Nibud (2017) indicates that consumers with low incomes are more likely not to ask financial advice because of the price of financial advice.

Also in some markets the distribution of products has shifted from the intermediary channel to the direct channels of insurers. This is for instance the case with funeral insurance (GfK, 2016). In this market, although this also applies to disability insurance, the government wanted a commission ban not because these are complex products, but because extremely high commissions were being paid. So here, the commission ban was a measure for a different kind of market failure than the commission ban for mortgages, life insurance and investment products.

Whether or not a culture shift has taken place in the Dutch financial advice market is difficult to conclude. At least financial advisors themselves are of the opinion that the culture has changed to a more customer central approach. The commission ban has led to a culture shift according to 85% of Dutch financial advisors who are a member of the Stichting Erkend Hypotheekadviseur (SEH, 2017), an organisation of mainly mortgage advisors. The shift from a product-driven to a customer centric approach could be made more difficult because of tax policies. In The Netherlands financial advice is free of Value Added Tax (21%) when the advisor has the intention to mediate in financial products. This means that when a financial advisor chooses not to mediate in products, his price will increase with 21% VAT. So having the intention to sell financial products lowers the price of financial advice. I would argue that this is a perverse incentive from the government to sell products over advice only, which won't help in shifting to a more customer centric approach.

Still 44% of customers say that the price of financial advice is too high (Nibud, 2017), which prevents them to ask for advice. The AFM Consumermonitor (GfK, 2017) concludes that the price of mortgage advice dropped by 15% just after the introduction of the commission ban, but that the prices are now almost at the same level as before 2013. Still there is a shared opinion that the commission ban has led to lower prices for financial advice (Financieel Dagblad, 2017).

When consumers, but this also is the case for entrepreneurs, choose not to get financial advice because they feel the price is too high, this can cause problems of underinsurance or no insurance at all. This is a real threat especially when self-employed entrepreneurs without personnel are not insured for disability risks. The insurance rate with these entrepreneurs is only 19,7% in 2015 (CBS, 2017). In 2013 this was 21,9%. The question is if this decrease is caused by the commission ban or that also other factors like the economic crisis and the increase of self-employed entrepreneurs play their part.
Customers who are confronted with a commission ban, and who have to pay the insurance intermediary by fee, need to adjust to the new system. Some consumers are not able to value the intermediaries' services; others thought that according to the commission system, intermediaries' advice and services were free. These latter customers find it difficult to pay the fee. In the Netherlands the question arose as to whether consumers are unable or not willing to pay the advisory fee. The evaluation of the commission ban in 2017 has to make clear whether due to the commission ban customers will take out less advice than before. There are some concerns in the countries with a commission ban,

believing customers will choose not to take advice because of the additional or higher costs paid directly to the intermediary.

International comparison

Experiences with a commission ban and transparency throughout Europe, give a diverse outlook. In Denmark, Finland, the Netherlands and the UK there has been a decline in the number of intermediaries, but it is doubtful that this is all due to the commission ban. Also the economic crisis had an impact, as well as the increased rules on professional skills and the digitalization that leads to more direct sales of insurances.

By analysing ten selected European countries (part of a research performed by Adviesbureau Fred de Jong for Eurapco in 2016) with regard to the remuneration system on financial intermediation, it becomes clear that only a few countries (UK, the Netherlands, Finland and Denmark) have introduced a commission ban. Also the commission bans only cover specific parts of the intermediary market in these countries and affects several specific insurance products.

Table 1: Remuneration of financial intermediaries in Europe

	Commission ban?	Products	Type intermediaries	Provider facilitation allowed
DEN	Yes	All insurance products	Independent brokers	Yes
FIN	Yes	All insurance products	Independent brokers	Yes
FRA	No			
GER	No			
ITA	No			
NL	Yes	Mortgage, Investment products, life insurance, private disability insurance, funeral insurance, mortality insurance	All	No
SPA	No			
SWE	No			
SWI	No			
UK	Yes	Retail investment insurance	All	Yes

(De Jong, 2016)

Though out of scope, Norway also has a commission ban for independent brokers regarding all insurance products (except large risks).

Whenever intermediaries work on a fee basis (this is only partly the case with independent financial advisors and brokers), their fee is by nature a transparent form of remuneration. Policyholders will want to agree upon the amount of the work and the fee being charged on a contractual basis. In the Insurance Distribution Directive (Directive EU 2016, to be implemented in 2018) article 19.2, a specific rule on the charging of fees is included:

Where the fee is payable directly by the customer, the insurance intermediary shall inform the customer of the amount of the fee or, where that is not possible, of the method for calculating the fee.

Transparency of commission is not common in most European countries. The current European law on insurance mediation (IMD) and the future law (IDD) do not include rules about the transparency of commissions. In the IDD insurance intermediaries have only to disclose minimal information about the remuneration. Articles 19.1.d and e read as follows:
Member States shall ensure that in good time before the conclusion of an insurance contract, an insurance intermediary provides the customer with at least the following information:
(d) the nature of the remuneration received in relation to the insurance contract;
(e) whether in relation to the insurance contract, it works:
(i) on the basis of a fee, that is the remuneration paid directly by the customer;
(ii) on the basis of a commission of any kind, that is the remuneration included in the insurance premium;
(iii) on the basis of any other type of remuneration, including an economic benefit of any kind offered or given in connection with the insurance contract; or (iv) on the basis of a combination of any type of remuneration set out at points (i), (ii) and (iii).

It seems that most European countries will follow the IDD and no specific 'gold plating' will take place regarding the remuneration of intermediaries. Only in the Netherlands, the United Kingdom, Norway, Denmark and Finland rules on the remuneration schemes are beyond the IDD.
In four of the five countries where a commission ban prevails (Denmark, Finland, Norway and the UK) the fee, which is negotiated with the client, may be recovered through the premium paid to the insurer. In daily practice, most insurance intermediaries choose this option because they do not want to send clients a separate invoice for the insurance advice. Only in the Netherlands it is forbidden to have fees paid from the premiums through the insurer. Experiences in the Scandinavian countries (Denmark, Sweden, Finland and also Norway) have learned that the number of intermediaries declined after the commission ban, however the number of complaints about intermediaries with the national

Ombudsman decreased. Customer satisfaction rose by 3.7% from 2004 till 2007 and customers are satisfied with the fee-based system (Steul-Fischer, 2013). In Norway, a commission ban was introduced in 2008.

The profitability of European insurers is of some concern. The economic crisis has led to low confidence in insurers as well as financial advisors. Consumers' general trust in insurance agents and brokers in Europe is significantly lower (-18) than the rest of the world. Europe has an average of 33% compared to 51% worldwide. The question in this survey was "Do I have complete / a high level of trust?" (GfK Verein, 2016).

New rules known as Solvency II require more from insurers about their solvability. New technologies like the internet of things, self-driving cars, big data, block chain etc.. put pressure on the sustainability of the insurance industry. Many insurers have to lay off employees, cut costs and proceed more efficiently. This will also interfere with the way and amount of remunerating distribution channels. For instance, in the Netherlands the first insurers have lowered the commission percentages on some products.

In Europe, several documents are being discussed about the financial sector, like the Green paper on retail financial services. In all European committees the subject of transparency, conflict of interest and consumer protection is being spotlighted. It means that the discussion about the remuneration of intermediaries will continue in the next few years.

Discussions in Europe about the intermediary market

The position and role of insurance intermediaries in Europe is widely discussed, on a national and a European level. Especially in the process of writing the Insurance Distribution Directive, the functioning of the intermediate market in financial services played a central role in the debates. Now these debates are held on a national level, because European member states have to implement the IDD before February 28th 2018. And because the IDD is minimum legislation, all European countries (EU members) have the possibility to propose stricter rules for their own markets. This also means that countries like the UK, the Netherlands, Denmark and Finland can maintain their regime under IDD legislation. There are no signs that these four countries are considering less strict rules for the intermediary sector.

In other countries more debates are held about the possible impact of the IDD. Germany, France and Italy, who represent large economies, have stated that they are against a commission ban (Matin, 2016), according to Michael Lodhi of the Spectrum IFA Group in Luxemburg. According to the same article by Matin, earlier on JPM Asset Management's head of UK funds, Jasper Berens, predicted, that *"regulation is moving at such a fast pace that within five years all financial services markets around the world will ban commission and implement an RDR-like regime instead."*
In Sweden the minster for Financial Markets and Consumer Affairs said that the Swedish government is not planning on banning commission-led sales of financial advice and products (Boyd, 2016).
European insurers (Insurance Europe, 2016) have pointed out that they have concerns about the technical advice of EIOPA regarding the delegated acts of the IDD. They have stated the following in a press release of October 4th 2016:
"Insurance Europe believes that the IDD rules on conflicts of interest must take into account the insurance-specific characteristics of insurance-based investment products (IBIPs), as the original legislation had intended, and that commission-based remuneration should not, in itself, be viewed as a conflict of interest. There is no overarching ban on commissions under the IDD. In contrast, the EU co-legislators decided to leave it explicitly as an option for member states. It is not up to EIOPA to introduce rules that will give rise to a de facto ban on commissions and interfere with this option. By specifying a broad list of inducements that are considered to pose a high risk of detriment to quality of the service, EIOPA is in effect doing just that."
Insurance Europe responds to a specific list drawn up by EIOPA (2016) about which types of inducements give high risks to conflicts of interest to insurance intermediaries. All kinds of commissions and other non-financial benefits are qualified as potential conflicts of interest, which should be regulated in the Member States. EIOPA suggests that insurance intermediaries at least describe the potential conflicts of interest arising from inducements and commissions and the actions taken to mitigate this risk. In their final technical advice, EIOPA (2017) states the following in response to the concerns of European Insurers:
"EIOPA would like to emphasise that the policy proposals on the identification of conflicts of interest are simply intended to make insurance undertakings and insurance intermediaries aware of situations where conflicts of interest would arise. The policy proposals do not require insurance undertakings and insurance intermediaries to avoid those situations, but to take appropriate

measures to manage and mitigate the identified conflicts of interest in a second step (as laid down in the proposal on a "conflicts of interest policy"). Furthermore, EIOPA would like to emphasise that EIOPA has an impartial view on the business models of insurance distributors and does not favour the establishment of fee based distribution models over commission based distribution models. At the same time, EIOPA acknowledges that similar conflicts of interest may arise in both instances which oblige the entities concerned to take appropriate measures to manage these conflicts of interest in order to avoid any damage to customers."

Further discussions in the European countries concerning remuneration of insurance intermediaries are mainly about the following issues:

- Is the insurance intermediary acting in the best interest of the customer and how can this be ensured?
- How does the remuneration of insurance intermediaries affect the risk of conflicts of interests arising?
- Should there be a difference in consumer protection between independent and (multi)-tied insurance intermediaries?
- Which regulation is adequate to solve market failure?

Conflicts of interest

IFF (2013) concludes that there is widespread consensus *"that certain remuneration models in insurance intermediation are prone to creating a conflict of interest which can lead to forms of misselling and consumer detriment. These include churning, twisting, overcharging, inflated products, forced bundling, the sale of unsuitable products or the confusion of products and lack of transparency"*. The consensus is between national governments, EIOPA (European Insurance and Occupational Pensions Authority), FSUG (Financial Services User Group) and financial supervisors. Nearly all respondents of the IFF survey expressed their view that the logic of the commission-system leads to misselling.

Final remarks

By analysing the debate on remuneration of insurance intermediaries in Europe, it becomes clear how different the European countries act on this topic. The countries with the most regulated regimes have been confronted with financial scandals where the remuneration of intermediaries has played a substantial part.

Therefore a general policy on remuneration throughout Europe is not recommendable. The cure (for instance a commission ban) must fit the disease (financial scandals with remuneration system as a cause). However, the debate will continue the next few years. Therefore it is important to learn from the experiences in countries where remuneration of intermediaries is more regulated, in order to make better policy decisions in the future.
The commission ban is specifically introduced for those products that have proven to be sensitive for conflicts of interest and market failure. These are the complex financial products. But there is also debate about regulating the market for simple risk financial products like non-life insurance. The latest development in the Netherlands is that some insurers have lowered commissions on some products and there are signs that insurers are lobbying to get commissions for non-life insurance transparent. They might propose this option after the evaluation of the commission ban.

Policymakers and supervisors must ask themselves if further regulation is necessary. In The Netherlands there are no signs of market failure in the non-life insurance market, it is a very competitive market where the broker channel is loosing market share to direct writers. From that perspective further regulation should not be considered. Don't fix what isn't broken. But there are indications that some groups of consumers are struggling to pay directly for financial advice. If these groups don't get financial advice because they won't pay for advice directly to the advisor, this could cause severe financial problems. In The Netherlands estimates are that in 2015 about 15% of all households were facing problematic debts (SCP, 2016).

Policy options for The Netherlands

Because the commission ban is part of a package of measures to regulate the financial advice market and the lack of proper measurement at the start, it is not possible to give a conclusive answer to the question if the commission ban has met the goals set before the introduction in 2013. The official evaluation this fall will have to give extra insights. My estimation of this evaluation is that the researchers will conclude that the quality of advice is increasing slowly, that the culture shift is on-going, but not yet fulfilled and that there are some negative outcomes regarding the accessibility of advice for lower income customers. Also there will be question marks about whether insurers and banks have lowered their product prices in line with the amount of commissions that were paid before 2013.

My personal conclusion is that the commission ban should be given the benefit of the doubt. The commission ban in the Netherlands has not yet led to an extra decrease of independent financial advisors. The first experiences are that fees for financial advice have decreased, that new business models of financial advice are being invented (advice only, service subscription, digital intermediary, commission free (also in non-life)) and that conflicts of interest are more transparent. But there is also a downside: consumers are not always prepared to pay directly for independent financial advice because they do not experience the added value. Consumers tend to choose the cheapest form of advice instead of the best advice. The main lesson to be learned from the Dutch commission ban is that it is not the answer to all problems caused by market failure and that a commission ban also has downsides. Therefore this is a measure that has to be considered very carefully and has to be part of a total package of actions to stimulate a better functioning financial advice market.

To mitigate the effects of this regulation in the future, the Dutch policymakers should consider the following:

- Make financial advice without the intention to sell a product, VAT-free;
- Give financial advisors the option, like in the other European countries with a commission ban, to recover their fee through the premium paid to the insurer or mortgage rate to the bank. So introduce a Customer Agreed Remuneration (CAR) model for insurance and mortgages;
- Do not extend the commission ban to non-life insurances.

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