



FSUG Position Paper

“Study on the remuneration structures of financial services intermediaries and conflicts of interest”

1. Introduction

Remuneration structures of financial service intermediaries and conflicts of interest in providing advice to investors is of concern to consumers and other stakeholders. The FSUG commissioned The Institute for Financial Services (*iff* – Hamburg) to carry out a study to investigate the concerns of consumers and other stakeholders of intermediaries providing advice where there are potential conflicts of interest. (MARKT/2012/026/H).

This study analysed various sales commissions (premiums) and other inducements granted to **insurance intermediaries** selling life insurance products to consumers (e.g. brokers and agents). The first objective of the study was to evaluate the current status of existing remuneration models in 10 selected Member States (Spain, Germany, UK, France, Italy, Poland, Denmark, Finland, Ireland and Slovenia)¹. These countries were chosen as there was evidence of existing remuneration models. The second objective was to describe existing regulations while focusing on certain types of remuneration schemes of insurance intermediaries and conflicts of interest. The third objective was to map possible steps that could be taken to improve remuneration schemes to reduce potential conflicts of interest .

The study spans a number of areas, including **three dimensions of conflicts of interest**:

- short-term profit maximisation vs. long-term customer satisfaction;
- The role of a intermediary for the consumer versus the role of a seller for the insurance company;

¹ In addition to the ten Member States, the contractor also gathered some data from Netherlands and Austria.

- incompatible roles as advisor versus broker

Iff states that intermediaries can be classified as insurance employees, tied or exclusive agents, brokers, bancassurance, retailers and fee-based advisors. Life insurance plays not only a large role for consumers, but also for intermediaries who earn their income mainly from commissions. However, the **role of the different intermediaries of life insurance contracts varies significantly between countries**. Distance-selling of life-insurance plays only a minor role in all countries.

2. Results of empirical study

The research is based on evidence derived from the *iff*-authors' own empirical research in all 10 countries. This is compared and analysed against the researchers' background knowledge from past and legal literature.. The survey questions were sent to all stakeholder groups throughout the geographical area covered by the research.

While a number of trade association representatives responded for the industry (representing insurance undertakings and intermediaries), the individual intermediaries (firms and individuals) that were contacted did not choose to respond. . The survey response rate was disappointing and did not improve with reminder emails and requests for input. In the end, **a total of 59 respondents** (legal experts, regulators, consumer advocates, and trade unions) **answered the questionnaire. The following are the main conclusions drawn from this study but should be interpreted with care due to the limitation of the study:**

- There was some evidence indicating forms of mis-selling with detriment to consumers. These include churning, twisting, overcharging, inflated products, forced bundling, the sale of unsuitable products or the confusion with products, and a lack of transparency. About half of the respondents considered mis-selling practices a problem at national level..
- The short-term perspective generated by first-year commissions and the conflicts faced by an intermediary who has to *serve two masters* and reconcile brokerage and advice services were both seen by a majority of the respondents as being **main sources for conflicts of interest**. Problems appeared to be concentrated in life insurance, especially when bundled with investment

(capital life) or with credit (payment protection insurance, endowment credit). Bancassurance was named as a major source of mis-selling.

- Respondents were overwhelmingly in favour of seeing regulations introduced to mitigate the potential conflicts of interest and encourage impartial advice. They supported having legislators, either European (40%) or national (40%), introduce legislation rather than rely on stakeholders taking personal responsibility (6%) or other means (8%). However, 6% of the respondents preferred that no regulations be introduced.
- Respondents commented on whether or not they favoured **disclosure of status, role and dependencies** of an intermediary. The **responses**, although not representative as such, build a strong case for indicating that transparency is a route that should be favoured. When asked if they are in favour of a duty to disclose status, role and dependencies of the intermediary, **86%** were in favour of disclosure and consider that **it should be compulsory** (including respondents from AT, DE, DK, FR, FI, IE, IT, SL, PL).
- Disclosure of **the amount of remuneration** that the intermediary receives should be explored as a transparency tool. When asked if they favoured a duty to disclose the amount of remuneration the intermediary receives, 45% of our respondents agreed that this duty should be compulsory (PL,NL,DE,DK,FR and SI). An additional piece of information that may be of use to consumers concerns the origin of the remuneration. When asked if they favoured a duty to disclose the origin of remuneration, over half of our respondents (**64%**) said **this duty should be compulsory**.
- *iff* asked respondents to rate and explain the significance of current regulation of remuneration on a sliding scale. 64% of respondents felt that regulation on remuneration was very effective or effective (. DK, FR, FI, IE, IT, NL, PL) whereas 36% found it was only marginally effective or altogether ineffective (. DE, FR, PL). For instance, legislation is considered effective in Denmark by all respondents which reflects rules of good conduct, a ban on commission and a stronger brokers' independence.
- Respondents were asked to indicate the extent to which they agree that remuneration regulation has **improved quality of advice**. Only 18% agreed that quality of service has improved thanks to regulation (. DK, FI, IT, IE). Another

41% did agree only partly that the regulation had improved quality of advice (. AT, DE, FR, IE, IT, PL, SI). The rest (41%) disagreed or were not aware or did not know whether regulation has improved the quality of the financial advice (. DE, DK, FR, IE, PL, NL).

- **A large number of restrictions are already in place on** a variety of intermediaries and products. The main types of restrictions include employee remuneration, caps on remuneration, forfeiture of remuneration and duration of contracts. A number of bans are in place mostly targeting brokers. While those bans can have some positive impact, the evidence indicates limited effects and at worst, negative impact on competition and on consumers. In particular, the tougher regulations has resulted in the exclusion of many consumers, being pushed into an advice gap, is worrisome. Bans have tended to be justified on grounds that they help to avoid conflicts of interest and are the most efficient vehicle. Bans seemed to be reserved for niche products or certain types of intermediaries (although the ban in the UK is broader).
- **Transparency is necessary** and useful only if implemented in a way that enables consumers to understand the key elements presented to them. For this to happen, three elements are crucial: timing, form and content.
- *iff* asked representatives of the participating Member States to provide the total number of **consumer complaints** recorded, the source of these figures and, if possible, give any additional details. The responses showed that data specific to the activities of intermediaries generally do not exist. Eurobarometer opinion polls show how the proportion of consumers who do not complain when they experience detrimental practices varies from 12% in Ireland to over 50% in Poland. It is also noteworthy from this source that on average, only **15% of the complaints are addressed to intermediaries**. This finding suggests that they may not be able to resolve problems or provide redress or may be perceived as not being able to do so.²

2.1. Elements of commission-based models

There is a large range of supplier-led incentives for promoting the sale of financial

² European Commission, Special Eurobarometer 373, Retail Financial Services, 2012, p.102.

services. Direct incentives include commissions linked to specific products and/or the amount of sales (either by unit or, most frequently, by value). Indirect incentives comprise score systems, rankings and job promotion in multi-level marketing systems.

In the insurance industry, they are based in principle on two performance measures: volume and/or profit. Profit-based contingent commissions vary with changes in the insurer's profitability. Volume-based commissions change with the amount of business that a particular employee/agent generates for the insurance company.

Volume-based sales commissions remain the most widespread form of remuneration for advice in insurance, credit and investment markets, except in countries that introduced a ban on commissions (such as Finland, Denmark, the UK and the Netherlands). Many different schemes are used within the commission-based remuneration system. Those schemes are not published by providers.

Similarly, in most countries, intermediaries do not disclose the form and level of remuneration they receive. This is a key problem for consumers, as also suggested by the findings of a concurrently conducted internet-based test that requested offers from various intermediaries be submitted. Receiving clear information on costs is unfortunately the exception. The survey (internet-based research, 11 Member States) headed up by the Austrian Chamber of Labour (2013) found some intriguing and confusing examples. To cite only one, an Italian broker explained: '...after everything is calculated, 24% of premiums go to acquisition and administration costs for insurance sums below EUR 150,000, representing EUR 33 per year'. Even more curiously, the broker only offered one product from one provider and after a second inquiry could or did not want to offer any savings product.

The test also provided research featuring empirical examples of the level of commissions charged by intermediaries. The resulting spreads in commissions for insurance intermediation in the 11 Member States expressed as a percentage of premium volume were as follows: For mystery shopper 1 (N=15), the spreads for commissions for life insurance contracts (with investment) was 3.7% to 4.2%, and for pure risk life insurance 2.75% to 3.85%. For mystery shopper 2 (N=12), the spreads ranged from 3.17% to 3.98% and from 3.7% to 6.23% respectively.

A further survey on the German life insurance market showed that initial sales commissions amounted to 2.5% to 4% of the insurance sum. Additionally, intermediaries are paid a commission over the lifetime of the contract (portfolio management commission, *Bestandspflegeprovision*), which ranges between 1% and 2% p.a. of the annual premium.³

The model for and amount of commission payments vary according to insurance intermediary and product type. Brokers tend to receive higher commissions than tied and linked agents. Sales commissions in life insurance are based either on the insurance sum or on the annual premium, or in non-life insurance simply on the annual premium. In addition, intermediaries usually receive portfolio commissions based on the annual premium of both life and non-life insurance.

The *iff*-survey results show that remuneration in the insurance industry takes many forms. It is not possible to point to a single model of remuneration. Rather, the industry uses a variety of models.

2.2 Fee-based models and experiences with them in Nordic countries

Fees paid directly by the customer usually represent the time the independent advisor invests in consulting the customer about his or her circumstances and providing pertinent advice. However, consumers are not accepting fee-based systems as a remuneration model (**Germany**). This lack of acceptance is a major problem and one reason these systems are not prevalent. In 2011, the market share of fee-based remuneration systems in Germany was 1%.⁴

Iff concludes that hourly fees may often be more expensive than the commissions included in the insurance premium (e.g. EUR 400-500 for 1.5 to 2 hours of financial advice without additional fees for advice services by e-mail, or by regular mail in Germany). This hypothesis should be verified by potential future research.

³ <http://www.geld-banken-versicherungen.de/versicherungen/abschlussprovisionen-versicherungen.htm> (viewed 18/05.13); Beenken, M. (2011), Provisionen und Courtagen -was die Versicherer ihren Vermittlern zahlen, Ahrensburg: VersicherungsJournal-Verl. (Versicherungs-Journal Marktübersicht).

⁴ Ludwig Finanzberatung auf Gegenseitigkeit (2011): Neues Bezahlungssystem in der Honorarberatung - ein Hoffnungsschimmer für die verschmäht Branche?, www.presse-portal.de.

The experience of countries that introduced a ban on commissions indicates the following problems. Consumers are unwilling to pay the high fees of intermediaries (**Finland**). Experience in the **UK** also shows that customers have to pay more for financial advice than they did before the ban. The ban on commissions for financial advisors did not lead to big changes in how customers and advisors interact. Most advisors avoid issuing separate invoices for the advice and the product and still opt to recover their fees through the premium payments collected by the provider. British banks are also giving up independent advice business completely in order to concentrate solely on assisting wealthier customers through external independent intermediaries. In investment markets, volume-based fees are used frequently and provide incentives to focus on customers with a comparatively high level of wealth to the detriment of less wealthy and more vulnerable consumers.

Following the ban, the number of brokers or advisors declined (**Finland, Denmark, UK**). This fact might increase their market strength for setting higher fees. In **Denmark**, brokers have found ways to bypass the ban on commissions in the life insurance market with the result that consumers have no influence on the pricing of their life-insurance contracts.

3. Regulation

Remuneration regulation takes various forms. There is no one model that prevails across the Member States studied. *Iff* notes that the **four pillars of regulation** are dependency, transparency, prohibition of certain remuneration forms and professional qualifications.

The definitions in the law vary across the EU. Some Member States define and regulate activities, while others focus on individuals. There is no harmonised understanding of what conflicts of interest are or what behaviours are to be expected from which intermediaries. These shortcomings explain, in part, the divergence in requirements on authorisation and licensing, with some intermediaries subject to professional qualifications while others are not.

The main types of restrictions include employee remuneration, caps on remuneration, forfeiture of remuneration and duration of contracts. A number of bans are in place,

most of which target brokers.

There is a patchwork of regulation across all Member States. These approaches also vary in all countries according to category of insurance. Legislation and case law tend to be primary sources, but codes of practice in the form of principles for businesses are also in use.

In each country, conflicts of interests tend to be regulated vertically with specialised rules. Similarly, our study shows that key notions such as ‘remuneration’ and ‘intermediaries’ are not uniformly understood. Licensing regimes also vary. This part of the study also reviews restrictions imposed by regulation on remuneration (including employee remuneration, forfeiture, caps on commissions and duration). The regulation of remuneration and conflicts of interests has multiple sources, all depending on national preferences.

Denmark, Spain, France, Poland, Italy, Slovenia and **Finland** did not indicate that any ceilings had been imposed, including the imposition of ad valorem caps or maximum commissions. When caps do exist, they are very much localised and restricted. In the **Netherlands**, the restriction seems to apply to linked agents only. In **Ireland**, no caps exist, but the Insurance Act of 1989 allows for a reduction in commissions given to insurance intermediaries if the Central Bank considers the commission amount to be excessive. Section 38 allows the Central Bank to prohibit the paying of commissions in the form of any benefit in kind, or as a loan of money made to an intermediary. In **Germany**, legislators recently limited the initial commission or other remunerations for substitute (private) health insurance (health insurance that is appropriate as a substitute for compulsory health insurance) to 3.3% of the gross premium (calculated on a basis of 25 years) to be paid by the consumer. These new rules were introduced on 1 April 2012 and were preceded by a warning of the German Financial Supervisory Authority (BaFin) following a discussion about increasingly high commissions in the private health insurance sector. There is no jurisprudence focusing on this duty yet.⁵

Iff found no evidence of blanket bans on remuneration methods. **Remuneration**

⁵ By contrast, the prohibition of special commission rebating (still in Germany) is the object of jurisprudential debate. Special commissions are the ability for an intermediary to pass on or share its remuneration. We explore those questions.

methods are often restricted but these restrictions are limited to one or a few categories of intermediaries or to certain complex products.

4. FSUG Conclusions

Fin-Use (This was the name of the previous EU expert group which later became later the FSUG) already stated in its Annual Report (2007): *“Conflicts of interest and aggressive remuneration practices/inducements such as commission-driven sales encourage reckless selling of products that meet the firm’s commercial needs rather than consumers’ needs and must be dealt with.”* This most recent financial crisis has showed that badly designed remuneration strategies encourage excessive risk-taking and cause financial problems for consumers and financial institutions.⁶

In its position paper on IMD⁷ in 2011, FSUG said commissions should be defined clearly (they often entail money payments as well as non-cash benefits). The level of commissions and benefits could be capped:

- Cap on the commissions in life and private health insurance,
- No commissions at all when cover is transferred, underwriters should be changed,
- In life insurance **no more up-front loading**; instead all commissions have to be distributed **over the whole lifetime** of the contract.”

However, the ongoing negotiations on the insurance mediation directive⁸ at European Parliament level shows that some MEPs are not aware of the negative impact of the lack of transparency in the remuneration of those who distribute insurance products; the Rapporteur of IMD 2 has almost deleted the provisions relating to conflict of interest and transparency.

FSUG is aware that some findings in the study need to be evaluated in greater detail in future (in particular the effects of a ban on commissions). There is evidence that commission-based remuneration schemes still strongly predominate in the Member States. As initial first-year commissions (up-front loading) are often regarded as a problem, FSUG believes that remuneration schemes serve primarily the interests of product providers (insurance companies, banks) and financial services intermediaries

⁶ http://ec.europa.eu/internal_market/fin-use_forum/docs/annualrep_2009_en.pdf

⁷ http://ec.europa.eu/internal_market/fin-services_retail/docs/fsug/opinions/ins_mediation-2011_03_07_en.pdf

⁸ Negotiations have not yet started at Council level **at the beginning of December 2013**.

rather than consumers' interests. There are considerable spreads in sales commissions in all segments of financial service intermediation. Conflicts of interest from high sales commissions, incentives and sales targets still exist.

The lack of transparency of remuneration structures (sales commissions, inducements, fees) is evident. Neither individual intermediaries nor product providers (banks, insurance companies) are open to disclosing their remuneration schemes and figures on sales commissions and fees. FSUG strongly recommends greater transparency regarding the cost of intermediation in order to prevent potential conflicts of interest and to raise consumer awareness about the costs of insurance and investment products. **Transparency requirements** have to be imposed not only on the cost of intermediation, but also on the cost of the products themselves. It is worth discussing how these costs should be disclosed in terms of consumer-friendly form, content and structure

FSUG does not ask for a ban on commissions in all Member States, but some remuneration schemes which are particularly detrimental to consumers' interests should be banned. This is the case of remuneration linked to target sales (related to one product, one category of products or to the entire sales amount of products from one insurance undertaking), or remuneration linked to the number of claims from clients of the intermediary.

- *Contingent commissions linked to the amount of sales* create per se a conflict of interest with the potential client: it induces the intermediary to sell that product or products from the same insurance undertaking even if the intermediary could propose more suitable products to the client. This is particularly the case when the level of commission is linked to a threshold to be reached by the intermediary.
- *Contingent commissions linked to the global amount of sales of products from the same undertaking*, when applied by the most important undertakings on a local market, create more difficulties for other undertakings proposing other products to enter the market. This has been highlighted by the Commission (DG

Competition) in its Communication and the Work Document accompanying this communication⁹. Such a restriction to competition should be avoided.

- *Contingent commissions linked to the number of claims from clients* should absolutely be banned. It induces the intermediary not to act in the best interest of his clients who are discouraged to declare their claims. Defending the interests of his clients can be directly detrimental to the intermediary's remuneration, which is not acceptable.

Particularly high commissions should also be banned as they incite some intermediaries to distribute products which would not be distributed by an intermediary acting fairly (see the PPI scandal UK: these insurances were easily distributed because of high commissions offered to intermediaries (until 87% of the premium) although they were expensive and with limited benefits).

Disclosure on demand is not acceptable. There is no serious reason why the intermediary should only disclose the commissions they receive to those consumers who ask for it. A lot of consumers will not ask for it because they fear that such requests could irritate the intermediary and affect the quality of the service they will receive. Information must be disclosed by intermediaries even if the client ignores the commission scheme or does not ask for it. Transparency should not be an optional right only for the most informed or assertive clients.

To address conflicts of interest in the financial supply chain, disclosure is necessary but not sufficient. This is important to keep in mind. FSUG stated in its position paper on MIFID 2¹⁰: *“Disclosure of status and inducements of course can be helpful in alerting consumers to the potential for conflicts of interest. However, the evidence from Member States such as the UK suggests that information solutions per se have had a very limited success in actually constraining the behaviour of intermediaries.”*

So, if **conflicts of interest** are to be addressed, **other interventions** are needed. They could include, for example:

⁹ See detailed information in our introduction

¹⁰ http://ec.europa.eu/internal_market/finances/retail/docs/fsug/opinions/mifid-2011_03_015_en.pdf

- Requiring product providers to introduce more robust risk management procedures during the product development stage if they continue to distribute products through intermediaries who are rewarded with variable commission payments or other such inducements;
- Introducing a much clearer definition of intermediary status;
- Requiring sales agents to justify orally and in writing why they have chosen to recommend a product (within the range of products they cover) that pays them higher commissions/rewards even though a similar product within the range would satisfy the same purpose.

To sum up the conclusions in the study on remuneration structures, FSUG proposes the following initiatives:

- Regulatory activity should focus on regulating the actual product causing the harm (for example, Payment Protection Insurance - PPI in the UK is a systematic example of a severe design flaw). Regulatory measures should be focused instead on potential conflicts of interest in distribution at the expense of product regulation.
- Impose clear liability rules on the producers for mis-selling (whether policies are sold through agents or through brokers with fiduciary duties).
- Work to improve access to independent and affordable advice. Competition should be all about the level of product quality and price and not about distribution channels and remunerations. Neither of the latter is related to service quality. However, remuneration and conflicts of interest are just one factor for encouraging mis-selling and poor advice quality. A ban on commissions and the adoption of fee-based advice as an alternative would not necessarily guarantee better quality advice. The *iff*-study also indicated that quality of advice would be influenced by several parameters (and not exclusively by regulation).
- Mandate financial supervisors to investigate business models and remuneration structures (sources of profitability should be the object of scrutiny).
- Have regulators collect data from the industry on premature cancellations of contracts and the reasons for them.

- Some forms of distribution seem to be more problematic than others but more because of their inherent characteristics (dependency, restricted offer) rather than their remuneration structure. Some channels of distribution need special monitoring (e.g. bancassurance).
- Target consumers by enhancing information and education. FSUG stresses the importance of public campaigns to promote the acceptance of fee-based advice.