Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

2016

Discussion Paper on the Payment of Commission to Intermediaries

Contents

Section 1: Overview

Financial products and services play such an important part in the everyday lives of consumers from paying for goods and services, to insuring against future risks, saving for retirement, transferring money and borrowing to meet short and longer term needs. While they can deliver consumer benefits, they can undoubtedly also present risks if the right product is not sold to the right consumer in the right way. Firms who produce financial products ('product producers') often sell their products through third parties ('intermediaries') and pay these intermediaries a sum of money ('commission') for arranging the sale. This commission can take the form of a single once-off payment at the point of sale or an initial payment at the point of sale followed by further payments ('trail commission') at intervals during the period of time that the product is held by the consumer. Commission arrangements can also include other benefits such as access to software or other facilities to assist the business ('soft commissions') and other non-financial rewards such as entertainment or marketing budgets.

The purpose of this Discussion Paper is to stimulate discussion and obtain feedback from interested parties on the risks and benefits to the consumer of this practice of product producers paying commission to intermediaries for the sale of their products. This work seeks to build on our recent examination of variable remuneration practices where product producer employees and tied agents are concerned, in recognition that, as stated in our 2016 Consumer Protection Outlook Report, "*by their very nature and intent, incentive schemes seek to drive the behaviour of individuals who are engaging with consumers and reflect the inherent culture within a firm*."

The Central Bank is embarking on its examination of this topic against the background of an increasing focus internationally on the role of remuneration structures as a key driver of culture in firms and of how they treat their customers. Indeed, the importance of this topic is now enshrined in the G20/OECD High Level Principles of Financial Consumer Protection which state:
"*The remuneration structure for staff of both financial services providers and authorised agents should be designed to encourage responsible business conduct, fair treatment of consumers and to avoid conflicts of interest. The remuneration structure should be disclosed to customers*

where appropriate, such as when potential conflicts of interest cannot be managed or avoided."

In many respects, this concept of responsible business conduct, fair treatment of consumers and avoiding conflicts of interest is at the heart of the current framework for consumer protection in financial services in Ireland, which requires that regulated entities act in the best interests of their customers at all times and have in place appropriate and effective systems and controls to ensure this is the case. These requirements also include more detailed rules on the provision of information to the consumer in advance of recommending a product, assessment of suitability, disclosure of how an intermediary is remunerated (including where this is by commission) and requirements to have systems in place to avoid and manage conflicts of interests as well as a complaints resolution process where the consumer is dissatisfied. This is underpinned by specific minimum competency requirements for sales staff and a robust fitness and probity regime for individuals in the industry. Properly applied by firms, this represents a strong framework of protections for the consumer, regulated by the Central Bank with a credible threat of enforcement where contraventions occur.

The objective of this Discussion Paper is to stimulate discussion on the benefits which properly designed commission arrangements can present, as well as the risks to consumers from commission structures currently in operation in Ireland and any additional measures that may be appropriate to eliminate or manage these risks. The Paper does so by describing the current practices of paying commission observed by the Central Bank (Section 2), the current regulatory framework for consumer protection (Section 3) and finally the benefits and risks to consumers arising from the practice of paying commissions to intermediaries (Sections 4 and 5).

The responses to this Discussion Paper will inform our ongoing consideration of our policy position in relation to the practice of paying commission to intermediaries, our engagement in domestic, EU and international fora and any technical advice to Government on the legislative framework in the State for the regulation of financial services (including any such advice on the exercise of Member State discretions under measures such as the Markets in Financial Instruments Directive II (MiFID II)[1] and the Insurance Distribution Directive (IDD)[2]), as well as

[1] Directive 2014/65/EC

informing our next revision of the Consumer Protection Code which will commence in 2017.

Questions are listed throughout the Discussion Paper to stimulate your views, and we also welcome more general observations and evidence on this topic.

Questions:

1. In your view, what aspects of how intermediaries are paid commission work well to deliver responsible business conduct, fair treatment of consumers and avoidance of conflicts of interests when consumers are sold financial products?

2. In your view, what aspects of how intermediaries are paid commission do not succeed in delivering responsible business conduct, fair treatment of consumers and avoidance of conflicts of interests when consumers are sold financial products, or present particular risks in this regard?

3. In your view, are there any changes needed to commission arrangements in Ireland, regulatory or otherwise, to do more to encourage responsible business conduct, fair treatment of consumers and avoidance of conflicts of interests when consumers are sold financial products?

[2] Directive 2016/97/EC

Section 2: Commission Landscape

What is Commission?

For the purpose of this Discussion Paper, commission is the payment to intermediaries from a product producer[3] for selling a financial product to a consumer. Commission is generally directly related to the quantity or value of the products sold. Commission is paid by suppliers of financial products to intermediaries across the banking, insurance and investment sectors, and includes the payment of non-financial incentives, such as contributions to marketing budgets, entertainment or other resources, where the granting or amount of the non-financial incentive is dependent on or related to sales volumes. For the purpose of this Discussion Paper, intermediaries include investment intermediaries, insurance intermediaries and mortgage credit intermediaries. The cost of paying the commission is built into the overall cost of the product.

The majority of intermediaries are remunerated for their services to consumers through commission on the sale of financial products. The Central Bank has observed that intermediaries can sometimes charge the consumer a fee for advice as well as receive a commission for selling a product. There are a small number of independent advisors who charge fees to customers and do not take commissions.

The Central Bank has observed that there are two main models for commission payments in operation in the financial sector[4] in Ireland, as follows:

Single commission payment to the intermediary shortly after the sale is completed

The first model involves a single commission payment to the intermediary which is paid shortly after the sale is completed. The commission is generally based on a percentage of the value of the product. For example,

[3] The Central Bank also recognises that, in some cases, a longer supply chain exists and it is possible that an intermediary may receive commission from another distributor who acts as an agent for a product producer.

[4] The Central Bank observations are based on a limited desk-based review of the commission structures paid by product producers in the banking, insurance and investment sectors, and are indicative only.

when a consumer takes out a mortgage, the mortgage credit intermediary will receive a commission based on the amount borrowed. For insurance products the commission is based on a percentage of the annual premium and for investments, it is based on a percentage of the total amount invested.

Single or "standard" commission models are generally used for shorter term products such as annual insurance contracts or short-term deposits, and are also the most prevalent commission model which is applied to the sale of mortgage products by mortgage credit intermediaries.

Initial commission paid to the intermediary directly after the sale with further smaller increments paid at intervals throughout the life span of the product (the trail commission model)

The second prevalent commission model is where an initial commission is paid to the intermediary directly after the sale, and further smaller payments at intervals are paid throughout the life span of the product. These ongoing payments can be referred to as trail commission, bullet commission, renewal commission or fund-based commission (in cases where the commission payable is based on a percentage of the total value of the amount invested).

Set out below are the key types of commission structures observed by the Central Bank in each of the financial sectors under examination and the level of commission paid.

Credit Products

Commission can be paid to intermediaries for arranging credit for consumers. The Central Bank observed the following commission structures in consumer credit products which are sold through intermediaries.

Product	Examples of commission details observed by the Central Bank
Mortgages	1-1.2% of the amount borrowed, paid on drawdown of the mortgage. Some providers impose clawbacks if the mortgage account is closed within 3 years of drawdown.

Structured Deposits

At a basic level, structured deposits are deposit accounts where funds deposited with the bank are invested by the bank and the return for the consumer depends on the performance of some other underlying assets.

These can be arranged for consumers through investment intermediaries. The Central Bank observed various commission structures in operation for these products.

Commission model	Examples of commission details observed by the Central Bank
Standard Commission	A once-off commission payment of between 1.5-2.5% of the amount deposited or an up-front payment of 35% of the fees that the bank expects to earn during the lifetime of the product.
Fund-based trail commission	The intermediary will receive a trail commission of between 0.25-0.3% of the value of the fund per annum for the time that the consumer continues to hold the product, or 35% of the fees earned by the product producer on an annual basis.

Insurance

General insurance products, such as motor, home or travel insurance, are typically subject to a standard commission model based on the amount of premium charged for the insurance product. Better rates of commission have been negotiated individually by some intermediaries and the Central Bank also observed some profit-share arrangements between general insurers and some larger intermediaries, as well as additional commission being ceded back to the consumer in order to compete on price or retain business.

Typical rates observed were as follows:

Product	Typical Commission rates
Motor Insurance	7.5-10% *
Household Insurance	12-15%
Travel Insurance	20%
Health Insurance	6%

* Pro-rata clawbacks are applied by some providers if the policy is cancelled before it expires.

The Central Bank also observed that override commission can be paid to intermediaries by some general insurers and this is generally an uplift of 3-5% of their total commission earned.

Life Assurance

The trail commission model is the most prevalent model observed in the life assurance sector where the products tend to be held by consumers over a longer term than general insurance. The initial commission tends to be of higher value than the payments at intervals that follow. The increments are generally based on the value of the annual premium for life protection products. Where an investment fund is being built up though an insurance-based investment product or a pension product, the increments can be based on a percentage of the value of the fund or the annual premium. For a single premium/lump sum product, the increment is generally based on the value of the fund.

Many life assurance product producers offer a range of commission options to the intermediary where the intermediary can choose between a higher/lower initial commission and the value of the deferred increments can be higher or lower depending on how much upfront commission is paid. Contract terms can vary depending on the option selected.

Examples of some of the commission structures that follow this model are as follows:

Product	Commission Structure Examples
Life Protection Products	The Central Bank observed initial commissions ranging from 0-250% of the annual premium spread over a period of 5-6 years. Some options observed include the following: - 100% in year 1, 20% in years 2-6, 3% thereafter - 140% in year 1, 3% from year 2 onwards - 168.5% in year 1, 3% from year 6 onwards - Flat rate of 22% per annum in year 1-6 Clawbacks are applied in initial and increment periods if the consumer lapses the product. The ongoing increments will also cease if annual premiums are not received. The Central Bank observed broker loyalty schemes where brokers were rewarded for persistency (that is, where policies remain in force without lapsing or being replaced) of over 93% of the previous period's sales. Payments can be based on a percentage of annual commission earned or the total premium value.
Regular Premium Life Assurance Investment Products	Initial commission rates of up to 7% of the value of the first year's annual premium have been observed with an increment of up to 1.5% per annum, based on the value of the investment fund.
Single Premium (lump sum) Insurance-based Investment products	Initial commission rates ranging up to 5.5% of the amount invested can be paid to intermediaries. Further increments of up to 1% of the value of the fund are paid annually thereafter.
Single Premium Pensions	Initial commission rates of 0% - 7.5% of the value of the premium and between 0.5% and 1% per annum in

	fund based commission depending on the initial commission rate selected by the intermediary.
Recurring Premium Pensions	A range of options were observed for recurring premium pension products, where the intermediary selects the commission option. Initial commissions of between 15% and 50% of the first year's annual premium with either a trail commission or a fund-based commission thereafter. Fund-based commissions between 0.05-1% of the fund value and trail-based commission up to 7% of annual premium has been observed, depending on the level of initial commission rate selected by the intermediary.

Investments

Investment firms, which fall within the scope of the European Communities (Markets in Financial Instruments) Regulations 2007 (the MiFID Regulations)[5], offer both standard commission and models involving initial and trail commission, although generally not as options for the intermediary to choose from. Each product appears to have its own set commission structure. Increments can be based on a percentage of the investment management fees as well as based on the value of the fund. The following rates were observed in this sector.

Product	Standard	Initial	Trail	Fund based
Collective Investment Schemes	Up to 3%	None observed	0.25-0.75% of value of investment fund (no initial commission)	0.5-1%
Structured retail products	1-4.3%	2% of fund value and/or 50% of investment management fees	2% of fund value and/or 50% of investment management fees	None observed

The Central Bank also observed commissions for portfolio management services, whereby the intermediary could receive a commission of up to 2% of the aggregate value of cash or assets (new business) introduced to the provider in a given period of time. Intermediaries also receive an increment of 0.5% per annum of total cash and assets on all accounts that were introduced by them.

[5] SI 60/2007

Other incentives

Other incentives also exist across the industry sectors which are linked to the volumes or value of the products that are sold by intermediaries. For example, product producers can offer an advance on commission to assist an intermediary with set-up or business development costs. This may, however, be offset against future commissions. We have also observed in the health insurance sector that a small percentage of premiums are ceded back to brokers for the marketing budget as well as standard commission. A number of product producers will also fund incentives such as entertainment, trips, etc., although this is not necessarily always linked to the volume or value of sales.

Questions:

4. Are there other features or types of commission arrangements that the Central Bank should take into account in considering this topic?

5. Are there practices or features of commission arrangements in other jurisdictions to which you think the Central Bank should have regard to?

6. Are there any changes to these practices which you consider necessary or appropriate to better promote responsible business conduct, fair treatment of consumers and avoidance of conflicts of interests when consumers are sold financial products?

Section 3: The Consumer Protection Framework

In a regulated environment such as financial services, commercial arrangements such as commissions sit within (and must be consistent with) the framework of rules to which regulated financial service providers are subject. By way of both general requirements and specific rules, this framework places duties on both product producers and intermediaries to act in consumers' best interests and, in their day-to-day dealings, to treat them fairly, with dignity and respect and support them in making good financial decisions.

The main body of rules for conduct of business, which includes giving advice, offering and arranging financial products for consumers, are contained in the 2012 Consumer Protection Code (the Code). Some rules on pre-sale disclosure are contained in the Life Assurance (Provision of information) Regulations 2001 (the Life Assurance Disclosure Regulations)[6]. The Code is not applicable to firms that provide investment services and that are regulated under the MiFID Regulations. Instead, the MiFID Regulations are the main framework for conduct of business regulation for investment activities. Finally, the Minimum Competency Code 2011 (the MCC) imposes fitness and probity requirements on those who provide advice and offer or arrange financial products for consumers, as part of the Central Bank's wider suite of fitness and probity requirements for managers and sales staff.

The European Union also continues to develop standards in relation to conduct of business across Europe and is in the process of implementing updated directives on financial conduct of business. The Mortgage Credit Directive (MCD)[7] was transposed into Irish law in March 2016 and the forthcoming IDD and the MiFID II will be applicable from 2018.

In this Chapter, we highlight some of the key consumer protections of the existing regulatory framework which we believe inform the consideration of the benefits and risks of commission payment arrangements, as well as

[6] S.I. 15/2001
[7] Directive 2014/17/EU

the consideration of how those commission arrangements should best be designed in order to align with these requirements. These key protections are described below under the following headings:

- Duty to act in the consumer's best interests
- Duty to avoid and manage conflicts of interest
- Duty to ensure a sale is suitable
- Requirement to fully disclose all relevant information
- Specific requirements on remuneration
- Obligation on sales staff to be fit and proper, including minimum competency requirements
- Complaints

We also outline the powers available to the Central Bank to supervise and enforce these requirements.

Duty to act in the consumer's best interests

It is important that how intermediaries are paid is aligned with the regulatory framework in order to promote responsible business conduct, fair treatment of consumers and avoidance of conflicts of interests when consumers are sold financial products. Chapter 2 of the Code contains high level principles which impose an obligation on regulated firms to ensure that consumers' interests are protected before, during and after the sale of a financial product. The Code requires that a regulated entity must ensure that, in all its dealings with customers, the regulated entity acts honestly, fairly and professionally in the best interests of their customers and the integrity of the market. Regulated entities are also required to act with due skill, care and diligence in the best interests of their customers, and not recklessly, negligently or deliberately mislead a consumer as to the real or perceived advantages or disadvantages of any product or service. The recent European Union (Consumer Mortgage Credit Agreement) Regulations 2016 (Mortgage Credit Regulations)[8] also place a general obligation on creditors and mortgage credit intermediaries to act honestly, fairly, transparently and professionally, taking account of the rights and interests of consumers. The MiFiD regulations also have an explicit requirement for investment firms to act honestly, fairly and professionally, in accordance with the best interests of the client, when providing investment services.

[8] S.I. 142/2016

Duty to avoid and manage conflicts of interest

Poorly designed, the fact that an intermediary is remunerated by commission based on sales creates a conflict of interest between the intermediary's desire to maximise its profit and the consumer's interests, which could lead to consumer detriment if the sales incentive is attractive enough to persuade the intermediary to put its own interests first. The Code specifies that regulated entities must ensure that they seek to avoid conflicts of interest in their dealings with customers. The Code requires that:

- a regulated entity must have in place a written conflicts of interest policy which must set out, with reference to its regulated activities, circumstances which constitute or may give rise to a conflict of interest entailing a risk of damage to the interests of consumers and specify procedures to be followed and measures to be adopted in order to manage the conflict of interest; and
- if a conflict of interest cannot be avoided, the regulated entity must disclose the nature and/or source of the conflict of interest to the consumer and must require the consumer to acknowledge that he or she is aware of the conflict of interest and still wants to proceed. There is a specific provision prohibiting requirements for specified levels of business in order to retain an appointment as an intermediary to a product producer.

The MiFID Regulations provide that investment firms must take all appropriate steps to identify and to prevent or manage conflicts of interest[9]. Investment intermediaries, authorised under the Investment Intermediaries Act 1995, must comply with the Code[10]. The European

---

[9] MiFID II (which will apply from 3 January 2018) places greater emphasis on the prevention of conflicts of interest, with disclosure of conflicts being a measure of last resort. Conflicts of interest caused by the receipt of inducements from third parties or by the investment firm's own remuneration and other incentive structures are specifically highlighted in the MiFID II provisions on conflicts of interests. Further changes made under MiFID II are set out in the section on specific requirements on remuneration. At the time of writing, the Department of Finance is consulting on the exercise of a number of national discretions under MiFID II, including discretions relating to inducements including commission – See Department of Finance Consultation Paper http://www.finance.gov.ie/what-we-do/banking-financial-services/consultations/public-consultation-transposition-markets

[10] The Investment Intermediaries Act 1995 does not contain direct and specific requirements on conflicts of interest. However, Section 37 of the Act requires supervisory authorities to draw up and issue a code of conduct for investment business which seeks to ensure that, among other requirements, an investment business firm "*makes a reasonable effort to avoid conflicts of interests and, when they cannot be avoided, ensures that its clients are fairly treated*".

Communities (Insurance Mediation) Regulations 2005[11] (Insurance Mediation Regulations) which are applicable to insurance intermediaries only, do not contain detailed requirements in relation to conflicts of interest[12]. Insurance intermediaries, however, are required to comply with the Code.

Duty to ensure a sale is suitable

Ensuring that a product is suitable for the individual consumer is arguably the most important criterion to fulfil when acting in the consumer's best interest. A properly designed commission structure should encourage a thorough and robust suitability assessment and should not, in any way, impair the intermediary's objectivity when carrying out this assessment. The Code requires that, before offering or recommending a product to a consumer:

- a regulated entity must obtain relevant information from the consumer so that it can assess whether a product is suitable for the consumer;
- information obtained should include, where relevant, the consumer's needs and objectives, personal circumstances, financial situation and attitude to risk;
- if a consumer refuses to supply the relevant information, then the regulated entity must inform the consumer that, as it does not have the relevant information necessary to assess suitability, it cannot offer the consumer the product or service sought;
- a regulated entity must assess, on the basis of the information provided by the consumer, whether the product or service meets the consumer's needs and objectives, the consumer is likely to be able to meet the financial commitment associated with the product, the consumer is financially able to bear any risks attaching to the product or service and the product is consistent with the consumer's attitude to risk.

---

[11] SI 13/2005

[12] The IDD, which will apply from 23 February 2018, also contains requirements on conflicts of interest, which are applicable in relation to insurance-based investment products. It requires that insurance intermediaries and insurance undertakings take all appropriate steps to identify conflicts of interest between themselves and their customers or between one customer and another that arise in the course of carrying out any insurance distribution activities. Where the organisational and administrative arrangements to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to customer interests will be prevented, the insurance undertaking or insurance intermediary shall clearly disclose to the customer the general nature or sources of the conflicts of interest, in good time, before the conclusion of the insurance contract.

In addition, a statement of suitability must be drawn up and given to the consumer explaining why the product or service being offered or recommended is considered to be suitable for the consumer. This statement of suitability must be issued in advance of providing the product to the consumer.

Knowing the customer and suitability requirements do not apply where the consumer has specified both the product and product producer by name and has not received any assistance from the regulated entity in the choice of the product and/or product producer (referred to as an 'execution only' transaction).

The MiFID Regulations impose similar requirements for investment firms providing investment products to ensure that investments are suitable or appropriate for retail investors. These requirements will continue under MiFID II. The Insurance Mediation Regulations provide for a demands and needs test when offering insurance products. New requirements in relation to suitability and appropriateness for insurance-based investment products, similar to those in the MiFID Regulations, are contained in IDD. When providing advisory services, the Mortgage Credit Regulations impose requirements to obtain information about the consumer's circumstances in order to enable the recommendation of a suitable credit agreement.

Requirement to fully disclose all relevant information

Disclosure of a commission arrangement to a consumer will not in itself prevent detriment to that consumer. Nor is disclosure a substitute for a properly designed sales incentive arrangement. Nevertheless, done properly, disclosure can assist a consumer in developing a better understanding of financial products and to make informed decisions concerning financial products. A regulated entity must therefore make full disclosure of all relevant information, including charges in a way that seeks to inform the consumer.

Chapter 4 of the Code contains general requirements to this effect around the provision of information but also, specifically, information that must be provided to the consumer prior to offering or arranging a financial product. The consumer must be provided with information on the main features and restrictions of a product and on the terms and conditions attached to the product in advance of entering into a contract. The Code then sets out detailed information that must be provided to consumers for various financial products. The Code also requires that consumers are provided with particular information containing highlighted warnings on the potential risks attached to lifetime mortgages, home reversion agreements and investment products specifically.

The Code also requires that consumers are given information in relation to charges, including third party charges which will be passed on to the consumer. Regulated entities must display their charges in their public offices and on their websites.

Information about investments must be provided in advance of offering or arranging a product for a consumer and information on capital security, risks, liquidity, restrictions on access to funds, impact of early exits, the minimum recommended investment period, projected returns and volatility.

Further requirements on providing information on life assurance policies are set out in the Life Assurance Disclosure Regulations. Providers are required to provide information about the product, its projected benefits and charges, intermediary or sales remuneration payable under the policy, and information on early withdrawal.

Many of the disclosure requirements of the Code and the Life Assurance Disclosure Regulations will shortly be superseded by the European regulation on key information documents for packaged retail and insurance-based investment products (PRIIPs) which sets out uniform ways of calculating and presenting key information on investments to ensure consumers are informed of all relevant information and that consumers will be able to compare products based on the same information.

The MiFID Regulations, Insurance Mediation Regulations and Mortgage Credit Regulations each contain provisions to ensure consumers are being given adequate information before entering into a contract for a financial product. The forthcoming IDD and MiFID II[13] also contain requirements for provision of information to customers and retail clients, respectively.

---

[13] Under MiFID II, investment firms must aggregate all costs and associated charges charged by the investment firm or other parties and all costs and charges associated with the manufacturing and managing of the financial instruments. In addition, third party payments received by investment firms in connection with the investment service

Specific requirements on remuneration

In addition to the general requirements above, the current consumer protection framework contains a number of additional requirements which are specific to remuneration.

Under the Code, product producers must be able to demonstrate that any commission arrangements based on levels of business introduced do not impair the intermediary's duty to act in the best interests of consumers and do not give rise to a conflict of interest between the intermediary and the consumer. Regulated entities are also required to ensure that any remuneration arrangements with their employees for providing, arranging or recommending a product or service to a consumer are not structured in such a way as to have to potential to impair their obligations to act in the best interests of consumers and comply with the suitability provisions of the Code.

The Code also requires that, if a regulated entity enters into a soft commission agreement[14], it must be in writing and must not conflict with the best interests of consumers and any consumers who are affected by the soft commission agreement must be made aware of its existence and how it may affect them. Goods or services received by a regulated entity under a soft commission agreement must be used to assist in the provision of services to consumers.

The Code requires investment intermediaries to advise customers in writing of the existence, nature and amount of any fee or commission received or to be received in relation to the product or service concerned. If ongoing commission is to be received, the intermediary must disclose to the consumer, prior to the arrangement of the product, the nature of the service to be provided in respect of this remuneration.

The Code also requires that independent intermediaries can only use the term 'independent' in their legal or trading name if they allow the consumer the option to pay in full for their services by means of a fee. Insurance intermediaries providing non-life insurance products must

---

provided to a client must be itemised separately and the aggregated costs and charges must be totalled and expressed both as a cash amount and as a percentage.

[14] A *"soft commission agreement"* means any agreement under which a *regulated entity* receives goods or services, in return for which it agrees to direct business through or in the way of another *person* (Consumer Protection Code 2012). This is also known as a 'non-monetary' benefit.

disclose in general terms that they are paid for their services through a remuneration arrangement with a product producer, and inform the customer that the amount of remuneration in respect of his/her product of service is available on request.

The Life Assurance Disclosure Regulations require that the remuneration to the intermediary be disclosed in a table detailing projected total intermediary/sales remuneration/brokerage fee payable in specified years, up to maturity, and in the year of maturity for certain life and pension products.

The MiFID Regulations also impose requirements on when fees or commission can be paid to investment firms by third parties. The payment must satisfy the following conditions:

- the existence, nature and amount of the fee, commission or benefit is clearly disclosed to the client, in a manner that is comprehensive, accurate and understandable prior to the provision of the relevant investment or ancillary service;

- the payment of the fee or commission, or the provision of the non-monetary benefit is designed to enhance the quality of the relevant service to the client and does not impair compliance with the firm’s duty to act in the best interests of the client.

The Mortgage Credit Regulations require a mortgage credit intermediary to provide information on a durable medium to the consumer in advance of carrying out credit intermediary services. This includes, where applicable, the existence and, where known, the amount of commissions or other inducements payable by the creditor or third parties to the mortgage credit intermediary for its services in relation to the credit agreement. While the MCD contains a discretion for Member States to impose a ban on commission payments from creditors to credit intermediaries, this discretion was not exercised in Ireland.

Both MiFID II and IDD contain specific requirements in relation to commission payments and both also contain discretion for Member States to impose further requirements or restrictions in relation to the payment of fees or commissions[15].

Obligation on sales staff to be fit and proper, including minimum competency requirements

In addition to compliance with the rules, strong internal systems and controls within firms and the proper design of commission arrangements, it is of paramount importance that managers and sales staff are fit and proper, including having the technical competencies needed to ensure that the consumer's best interests are protected. To this end, any person who provides advice to consumers on retail financial products or who arranges or offers to arrange financial products for consumers must meet the standards of fitness and probity specified by the Central Bank. The Central Bank has powers under this Fitness and Probity regime to prohibit individuals from performing controlled functions (CFs) and pre-approval controlled functions (PCFs), or prevent individuals from taking up and performing PCF roles and potentially CF roles, where they do not meet the fitness and probity standards set by the Central Bank.

Furthermore, under the MCC, firms have to ensure that their staff who provide financial advice or arrange or offer to arrange retail financial products for consumers, hold recognised qualifications (unless exempted because they meet the criteria laid out in grandfathering arrangements). All persons involved in providing advice or who arrange or offer to arrange

---

[15] Under MiFID II, an investment firm can only pay or be paid any fee or commission or any monetary or non-monetary benefits where the payment or benefit is designed to enhance the quality of the relevant service to the client and does not impair compliance with the investment firm's duty to act honestly, fairly and professionally in accordance with the best interest of its clients.

In addition, investment firms that provide advice on an independent basis, shall not accept and retain fees, commissions or any monetary or non-monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the service to clients.

The IDD will require Member States to ensure that if insurance undertakings or intermediaries pay or are paid a fee or commission by a third party in relation to distribution of an insurance-based investment product or an ancillary service, the fee or commission must not have a detrimental impact on the quality of the relevant service to the customer and does not impair compliance with the insurance undertaking's or intermediary's duty to act honestly, fairly, and professionally in accordance with the best interests of its customers.

At the time of writing, the Department of Finance is consulting on the exercise of a number of national discretions under MiFID II, including discretions relating to inducements including commission – See Department of Finance Consultation Paper http://www.finance.gov.ie/what-we-do/banking-financial-services/consultations/public-consultation-transposition-markets.

financial products or services for consumers are required to complete at least 15 hours of continuing professional development per annum.

Complaints

A key part of the consumer protection framework is ensuring that, where a consumer is dissatisfied, there is an avenue for him/her to complain and have that complaint dealt with effectively. Regulated entities are required to have a procedure for handling complaints from consumers in an effective manner within a specified period of time. The Code specifies the steps a regulated entity must take and the required timeframe in which it must handle a consumer's complaint. If the consumer is not satisfied with the regulated entity's response to the complaint, he/she can refer the complaint to the Financial Services Ombudsman who will facilitate mediation or make adjudication on the complaint. The Code also requires a regulated entity to undertake an appropriate analysis of the patterns of complaints from consumers on a regular basis. This analysis must include investigating whether complaints indicate an isolated issue or a more widespread issue for consumers (as can be the case where a systematic feature such as remuneration is an underlying cause of the behaviour complained of).

Central Bank Supervision and Enforcement Powers

The Central Bank has broad powers to supervise and enforce the above requirements. These include powers to demand information and conduct on-site inspections, power issue directions and power to require redress. Where requirements have not been complied with, the Central Bank also has powers to administer sanctions and to revoke the authorisation of a firm where appropriate.

Questions:

7. Are there features of the current consumer protection framework that you would highlight as strengths in the context of commissions specifically?

8. Are there weaknesses or gaps in the current consumer protection framework in the context of commissions specifically?

9. Do you have any other observations on the current domestic framework as it relates to the practice of paying commissions in Ireland?

Section 4: Potential Benefits to Consumers of Properly Designed Commission Structures

Commissions drive behaviour and a properly designed commission structure can potentially drive behaviour which promotes responsible business conduct, fair treatment of consumers and avoidance of conflict of interests. In this Chapter, we describe the potential benefits that commission arrangements may present to consumers under the following headings:

1. Suitability
2. Encouraging participation in financial markets and better competition
3. No fees to pay upfront for advice
4. Subsidised cost of advice
5. Access to advice
6. Choice of products

These are the potential benefits the Central Bank has identified in the course of its work, including through our engagement with consumer groups, industry representative bodies, other national regulators and international bodies.

Suitability

Clawback arrangements for the payment of commission can help bring about high-quality sales by tying the payment of commission to the quality of the sale. Since the intermediary's commission would be taken back if the consumer cancels or exits the product at an early stage, the intermediary is motivated to ensure that the product is suitable for the consumer and thus reduce the risk of clawback.

Some product producers operate a loyalty bonus for intermediaries which is based on more qualitative criteria rather than the value of sales, such as persistency rates, which can be an incentive to the intermediary to provide good quality advice to consumers.

Certain features of commission can influence an intermediary to ensure that products are suitable for consumers. The payment of some types of commission, such as renewal or trail commission, could, in theory, incentivise the intermediary to provide financial advice on an on-going basis in order to justify the on-going income stream and without the need for consumers to initiate requests for a review or to pay fees for on-going advice. These types of commission should also help to ensure a continuous review of the suitability of the product for the consumer.

Encouraging participation in financial markets and better competition

It could be argued that some financial products which are beneficial to consumers (e.g., pensions), the economy and society at large are sold to consumers rather than being sought by consumers. Consumers tend to focus on their current rather than future needs and this is particularly true if they are unwilling to pay for advice.

Commission enables (and can motivate) financial advisors to provide advice. Availability and access to advice encourages consumers to enter into contracts that provide protection and investment for their long-term needs which they may otherwise not purchase. Products such as health insurance, income protection, life assurance and pensions can provide economic protection for consumers. Investments help clients build wealth. Commission payments can incentivise intermediaries to reach out to consumers. This, in turn, leads to consumers making financial decisions that benefit themselves, society and the economy, that they otherwise would not have made if the option had not been brought to them.

The practice of paying commission can also be seen to facilitate the existence of a standing network of sales intermediaries which can make it easier for a new entrant to launch its products into the Irish market, decreasing barriers to entry.

No fees to pay upfront for advice

There is anecdotal evidence to suggest that consumers may prefer to pay for advice and arrangement of financial products by way of commission rather than paying a fee directly to the intermediary. A fee would amount to an upfront outlay versus commission which is built into a product cost which the consumer is willing to pay and may be seen as a more "painless" option by the consumer. Consumers will ultimately fund the cost of commission through what they pay for the product they purchase. Nevertheless, the practice of paying commission allows them to do so over a period of time.

The European Commission undertook behavioural economics research in November 2010[16] where an experiment was carried out involving 6,000 consumers online from eight Member States and found that between 20% and 30% of consumers displayed an aversion to paying fees upfront.

The Financial Services Board (FSB) in South Africa carried out a retail distribution review (RDR) in 2014[17]. The objective of the review was to develop policy proposals which would ensure that financial products are delivered in a way that ensures fair treatment of consumers. The RDR recognised that one of the benefits of a commission-based remuneration system for intermediaries is that consumers are more willing to seek or obtain advice if it is free of charge. The FSB further stated that any new regulatory requirements should flexibly cater for various ways that customers pay for advice, in order to avoid direct payment for advice becoming a barrier to investing or taking out insurance.

Subsidised cost of advice

Many intermediaries do not charge a fee for providing advice since they are remunerated by means of commission when they arrange a product for a consumer. Therefore, the cost of advice is subsidised by the commission.

According to the '*Guide for Developing Business Strategy for Financial Brokers*'[18] published by the Professional Insurance Brokers Association (PIBA), research in the UK showed that an intermediary typically spends eight to nine hours providing advice on investment business. It is likely, PIBA argues, that the cost of advice on an hourly basis may be higher than what the intermediary earns in commission. On this basis, it is contended, paying by commission makes the cost of acquiring the product more proportionate for the consumer.

[16] Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective, November 2010 - http://ec.europa.eu/consumers/consumer_evidence/behavioural_research/index_en.htm

[17] In total, 55 recommendations were made concerning the distribution of financial products which the FSB intend to introduce on a phased basis, with the first phase due to begin implementation towards the end of 2016.

[18] http://www.stepchange.ie/wp-content/uploads/2013/01/PIBA-Broker-Strategy-guide.pdf

Intermediaries may sometimes cede some of their commission when negotiating prices with consumers, driving down the cost of advice further.

Payment for advice by way of commission rather than by fee also allows the consumer to benefit from free advice if a product is not purchased, whereas one could expect that a fee for advice would be charged regardless of whether or not the consumer decided to purchase the product.

Access to advice

The payment of commissions to intermediaries subsidises the cost of advice and therefore gives them more access to financial markets, particularly for less wealthy consumers, who may be unable or unwilling to pay for advice.

The FCA published a report in March 2016 on the Financial Advice Market Review (FAMR)[19] which was carried out as a response to concerns that the market for financial advice in the UK was not working as well as it could for all consumers after the implementation of the RDR measures. The Report found that there are indications of an 'advice gap' emerging post RDR. This advice gap cannot be solely attributed to the removal of commission payments[20], but it may have had an impact. The number of independent financial advisors declined from 40,566 to 31,220 at the end of 2014. Towers Watson carried out some modeling analysis for the FCA[21] and reported that, according to their models, 25,000 independent financial advisors was the optimal number of advisors needed to meet the demand for advice in the UK, and they concluded that an advice gap is emerging because *"Advisor capacity may not be aligned at customer segment level".* Towers Watson suggest that UK advisors may be focusing on customer segments that are most likely to be able to afford such an offering, or where the benefits of taking advice are most cost-effective and large-scale alternative services focusing on the needs of less affluent consumers have

---

[19] FCA (2016), Financial Advice Market Review – Final Report, https://www.fca.org.uk/static/fca/documents/famr-final-report.pdf

[20] The FAMR Report in the UK (page 18) makes the following comment in relation to the decline in advisor numbers: "The majority of advisers exiting the market during this period were those employed by the banks and building societies. There are a number of reasons for these exits, including declining profitability of branch-based distribution models, a lesser role for branch-based activity, anticipation of the RDR and the consequences of episodes of mass mis-selling ".

[21] Advice Gap Analysis: Report to the FCA https://www.fca.org.uk/static/documents/research/advice-gap-analysis-report.pdf

not yet been developed. Prior to the RDR there was a concern about the removal of the implicit cross subsidisation between customer groups. It was considered that it could lead to a situation where firms consider that customers with lower levels of wealth to invest and simple on-going advice needs are no longer profitable, or at least not profitable at fee levels that customers would be willing to pay.

Economics Europe[22] carried out research in 2014 on behalf of the FCA. On the cost of advice, they note the increasing trend, backed up by research from a number of other organisations, for financial advisors to segment their customers in accordance with the amount they have to invest. Under this trend, a majority of firms still charge fees based on a percentage of the amount to be invested. If firms are unwilling to cross-subsidise, they are imposing minimum thresholds. However Economic Europe's report goes on to say that the impact had been quite small and that many firms were finding ways to reduce the cost of advice at the lower end, such as the use of platforms to drive efficiencies in the advice process.

In the Netherlands, since a ban on commission for certain financial products was implemented, financial service providers have changed their business models and are now charging fees for advice, making the cost of advice more transparent. One report[23] suggests that there is anecdotal evidence of an increase in consumers who are opting for execution-only purchase of products such as mortgages and annuities possibly because they are not willing to pay for advice.

Choice of products

Commission models facilitate the existence of intermediaries as an alternative to direct sales and help to sustain distribution of products. Intermediaries can provide a wide choice of product from multiple product producers and are well positioned to provide holistic advice to consumers on all of their financial needs. This facilitates the comparison of similar

[22] Economics Europe Report, see page 50. https://www.fca.org.uk/your-fca/documents/research/rdr-post-implementation-review-europe-economics

[23] Oxera: Regulating Remuneration Systems: effective distribution of financial products. January 2015

The German Insurance Association commissioned Oxera Consulting to conduct an independent study into how the distribution of financial services can be impacted by the way in which distributors are paid. Oxera carried out reviews of jurisdictions who had implemented regulatory restrictions on the payment of commission. http://www.oxera.com/getmedia/c28539cd-c6dc-42e4-9940-a624b0ff47ea/Remuneration-systems_Final-report_Jan2015.pdf.aspx?ext=.pdf products from different product producers in order to ensure that the most suitable is selected. It also leads to enhanced competition in the market. Commission can be a model of payment for services which is proportionate for the consumer, regardless of affluence, which enables access to a wider range of products and services for all consumers.

Naturally, by comparison to an intermediary who offers a range of products from different providers, direct sales staff only offer the products of the product producer on whose behalf they are acting (or those endorsed by the product producer). While there may not be any commissions or fees payable by the consumer to acquire the product from these sources, the cost of advice and distribution cost will be built into the cost of the product. In some jurisdictions that have banned the receipt of commission, such as the UK and the Netherlands, there has been a contraction in the number of independent financial advisors which may be attributable, at least in part, to the ban on commissions, although other factors may also be relevant.

Questions:

10. Do you have any general views on the potential benefits to consumers of properly designed commission structures outlined in this section?
11. Are you aware of any additional potential benefits to consumers? If so, please describe them.
12. Have you observed any of these potential benefits? If so, please provide examples and describe the kind of benefit that has accrued.
13. Would you weight any of these potential benefits over others as requiring special consideration or attention, and if so why?
14. Do you have any suggestions as to how the current regulatory framework could be improved or changed so as to enhance the potential benefits to consumers that arise from the payment of commissions to intermediaries so as to better promote responsible business conduct, fair treatment of consumers and avoidance of conflicts of interest when consumers are sold financial products?

Section 5: Potential Risks to Consumers of Commission Structures

Commission, based on sales volume, by its very nature and design, exists to encourage sales of financial products which, in turn, gives rise to conflicts of interest between intermediaries and consumers. It may be possible in some cases to eliminate or mitigate these risks by changing the design in commission schemes or through regulation. In this Chapter, we describe the potential risks that commission arrangements may present to consumers under the following headings:

1. Product bias
2. Producer bias
3. Quality of advice
4. Long-term suitability
5. Overselling
6. Fund erosion
7. No ongoing benefit to consumers for ongoing payments
8. Transparency and consumer comprehension
9. Higher costs of products
10. Less than optimal terms and conditions for consumers
11. Risks specific to commission on credit products

These are the potential risks the Central Bank has identified in the course of its work, including through our engagement with consumer groups, industry representative bodies, other national regulators and international bodies.

Product bias

In its desire to generate increased income, an intermediary may be motivated to recommend to the consumer the product which generates the most commission, rather than the product that is best suited to the consumer's needs.

If an intermediary allows itself to be influenced by the commission payable, product bias can occur within a range of similar products. Here, the product which offers the highest commission is recommended or a consumer may be advised to buy a particular type of product over another because the commission structure in that type of product generates more revenue for the intermediary than other types of product. For example, in the area of investment products, there is a wide variety of products and commission models, and the sale of some product types generates significantly more commission for intermediaries than others[24].

In the UK, the Financial Services Authority (FSA)[25] carried out an RDR comprising a long term review of how financial products were being distributed, motivated by long-running issues around advice to consumers. As a result of this review, the FCA, among other measures, implemented a ban on commission payments on investments, effective from the beginning of 2013. Initial reviews of the measures were published in December 2014[26] and one of the findings was that product bias had decreased since the implementation of the prohibition. This was evidenced by a decline in the sale of products which paid higher commissions prior to the RDR and an increase in the sale of products that traditionally paid lower commissions prior to the prohibition.

A ban on commission[27] was also introduced in the Netherlands in 2013. After an evaluation of the previous inducement rules in place, the Ministry of Finance concluded that these rules were not strong enough to negate the incentives generated by commission payments to intermediaries and reduce the risk of product bias and mis-selling[28]. The FSB in South Africa identified product bias as one of the key risks to consumers arising from the payment of commission to intermediaries in their 2014 RDR[29] which was carried out due to significant concerns about poor customer outcomes and mis-selling of financial products. The FSB consider that any new requirements should seek to ensure that the remuneration that an intermediary receives for providing advice should not be influenced by the

[24] See also the specific provisions in this regard in MiFID II.

[25] The FSA was the predecessor to the FCA.

[26] FCA (2014), Post-implementation review of the Retail Distribution Review –Phase 1, December 2014 http://www.fca.org.uk/news/post-implementation-review-of-the-rdr

[27] The ban in the Netherlands covers complex financial products, (for example unit-linked insurances, annuities), mortgages/home loans, payment (protection) insurance products to consumers, funeral insurance products, life assurance products and MiFID investment services that are rendered by financial service providers that are exempted from the MiFID regime under article 3 MiFID (national regime). It does not apply to simple risk products, such as travel insurance and house/homebuilding insurance.

[28] FinCoNet (2016), Report on Sales Incentives and Responsible Lending, http://www.finconet.org/Report_Sales_Incentives%20_Responsible_Lending.pdf

[29] FSB (2014), Retail Distribution Review, http://www.fsb.org.uk/docs/default-source/Publications/reports/fsb-retail-distribution-review-2014.pdf?sfvrsn=0

product supplier, but should be agreed between the advisor and his/her client. This should lead to advisors who are neutral as to the product supplier and product type, making it more likely that consumers should receive the right product for their needs and circumstances, irrespective of product supplier relationships.

Producer bias

Arrangements with product producers can incentivise intermediaries to recommend one product producer over another if the sale of the product would result in a higher commission for the intermediary, even though the favoured producer's product range may not be the most suitable for a consumer. The incentive may occur because there is override commission, broker loyalty or other incentives available from that producer. Soft commission arrangements, such as loans, holidays, golf trips and other forms of entertainment may also cause producer bias when the attainment of the commission is based on sales targets.

In 2009 in the UK, the FSA published details of a mis-selling case[30] concerning a mortgage intermediary. One of the infringements concerned the promotion of a particular product producer's mortgage product to consumers over other products, because the product producer had advanced a loan to the mortgage intermediary and commission earned could be offset against that loan.

Quality of advice

The quality of advice to consumers can be compromised if the advisor is motivated to make recommendations based on the prospect of earning commission rather than the best advice for consumers. For example, after obtaining information from a consumer, an advisor may recommend an investment to a consumer, in order to earn commission, even in circumstances where it would be in the consumer's better interest to pay down debt.

In Australia, shadow shopping exercises were conducted in 2006 and 2012 on the quality of financial advice[31]. In a 2006 report[32], the Australian

[30] http://www.fca.org.uk/static/pubs/final/black-and-white-group.pdf.

[31] ASIC announced on 12 July 2016 that they intend to do a further review of commission and payments made to bank staff and third parties in relation to the sales of financial products such as transaction accounts, general insurance products, consumer credit insurance, mortgages, personal loans, credit cards and small business loans

[32] REPORT 69 Shadow shopping survey on superannuation advice http://download.asic.gov.au/media/1347026/shadow_shop_report_2006.pdf

Securities & Investments Commission (ASIC) concluded that "*unreasonable advice was three to six times more common if the adviser had an actual conflict of interest over the advice given to the client. These conflicts were commonly created where ….. the adviser stood to get higher remuneration if the recommendation was followed….".*

Based on its research, ASIC made the following comment in its submission to the Parliamentary Joint Committee on Corporations and Financial Services (PJC) *Inquiry into financial products and services in Australia*[33] in 2009:
"Commission payments can create real and potential conflicts of interest for advisers. They could encourage advisers to sell products rather than give strategic advice (e.g. advice to the client that they should pay off their mortgage), even if the advice is in the best interests of the client and low-risk. Commissions also provide an incentive to recommend products that may be inappropriate but are linked to higher commissions."

ASIC considered that it was not possible to draw correlations between poor advice because of the small sample size in the 2012 shadow shopping exercise[34]. However, where reward for advice was contingent on a product recommendation, ASIC found that there were numerous examples where the advice appeared to be structured towards recommending or selling financial products. In some cases, ASIC concluded, this was at the expense of optimal strategic advice.

At the time that the 2012 study was completed, Australia had similar regulatory requirements as those in Ireland, to obtain information from the consumer and to consider that information to ensure that the advice given is appropriate[35]. The Australian authorities imposed a ban on paying or receiving conflicted remuneration[36] which came into effect in July 2013.

Long-term suitability

---

[33] http://download.asic.gov.au/media/1311547/ASIC-submission-PJC-Financial-Products-and-Services-Inquiry-2009.pdf

[34] REPORT 279 Shadow shopping study of retirement advice http://download.asic.gov.au/media/1343876/rep279-published-27-March-2012.pdf

[35] S945a of the Corporations Act, 2001 Australia

[36] Conflicted remuneration is any benefit given to an Australian Financial Services (AFS) licensee, or its representative, who provides financial product advice to retail clients that, because of the nature of the benefit or the circumstances in which it is given, could reasonably be expected to influence:
a) The choice of financial product recommended to clients by the AFS licensee or representative; or
b) The financial product advice given to clients by the AFS licensee or representative

There is a risk with commission that is paid over the lifetime of the product, that an intermediary may recommend a product with a longer term which may not be suitable for the consumer's needs, in order to keep the commission stream for as long as possible.

Similarly, with commission that is paid up front, an intermediary is not incentivised to take the consumer's longer-term needs into consideration, as all the benefits accrue to the intermediary at the point of sale. This risk can be mitigated by imposing clawbacks. Also, some product producers have developed broker loyalty bonuses based on persistency rates or impose longer delays in the payment of trail commission, which may encourage intermediaries to focus on the long-term needs of the consumer.

Some higher-risk investment products have commission structures which pay significantly more than other lower-risk investments. This creates a conflict of interest for the intermediary between its desire to maximise earnings and making recommendations to consumers that are suitable and aligned with their attitude to risk.

Overselling

Overselling is an issue that can occur as a result of an intermediary trying to maximise revenue from commissions. The sale of most credit product types observed by the Central Bank is rewarded by a standard commission based on a percentage of the amount advanced within a short time of concluding the contract. Intermediaries may recommend consumers to apply for more credit than is necessary in order to increase the commission on the loan. Credit products are particularly vulnerable to overselling because a consumer receives the benefit immediately and more tangibly than other types of financial products. Behavioural economics suggest that consumers may be particularly vulnerable to overselling when applying for credit because they tend to focus on the present and on the immediate benefit that they will receive, rather than the longer-term impact that repaying credit will have.

Cross-selling can also be a form of overselling seen with ancillary providers, where one financial product is sold in conjunction with another. The payment protection insurance mis-selling issue is a good example of such a practice where the commission arrangements incentivised intermediaries not to act in consumers' best interests. The commission arrangements for these policies were quite generous and intermediaries could optimise revenues by cross-selling payment protection policies. Some payment protection policies were sold to consumers without providing them with adequate information or ensuring that the policy was suitable for the consumer. There were many cases where policies were sold to consumers who were not eligible to make a claim because of their circumstances. Suitability assessments were of poor quality and sometimes may not have been performed at all.

Another feature of overselling is “churning”, where intermediaries may recommend switching to a different product, claiming it is more advantageous to the consumer. The intermediary may be incentivised to recommend to a consumer to exit a current product and purchase another instead, because the intermediary will receive an upfront commission that is of higher value than the trail commission that it would otherwise earn if the consumer stays with the original product. It is possible that the alternative product may have features that would be more beneficial to the consumer, but the costs of switching in terms of exit and entry fees, as well as further reduced allocation as a result of the upfront commission, may result in losses to the consumer.

Fund erosion

Commissions are taken by an intermediary before an investment made by a consumer is allocated to the chosen investment instrument. Therefore, the amount invested is immediately reduced. Trail commissions paid to intermediaries based on the value of a fund can also deplete the value of the fund. Fund-based commission could erode the value of the investment if the investment does not out-perform the rate of commission being paid.

No ongoing benefit to consumers for ongoing payments

The concept behind trail commission is that the intermediary would continue to oversee the consumers’ financial product and provide advice over the long term. Trail commission is often paid to intermediaries over the full lifetime of a product and the consumer does not, in many cases, receive any benefit in return for this commission. Trail commission can be justified if the intermediary continues to review the consumer’s investments and make recommendations in the best interests of consumers. However, some products, such as term protection policies or structured deposits with fixed terms, continue to generate commission for the intermediary and the need for the provision of further advice in relation to these products before their maturity date is typically very limited.

Transparency and consumer comprehension

There is a risk with commission payments that consumers may not be fully aware of how the intermediary is being remunerated and that the cost of remuneration may be built into the product they purchase. For example, commission payments for investment products can be fund based or based on a percentage value of the annual management fee. Consumers may not realise that they continue to pay a fund-based commission to the intermediary for the initial sale. This can make it difficult for consumers to assess whether they get value for money.

Higher costs of products

Commission costs are built into the price of a product, increasing the cost to the consumer of acquiring that product.

In the UK RDR, it was found that the cost of products to consumers had reduced following the removal of commission. However, the RDR found that the cost of advice has also increased and as such concluded that the outcome on acquisition cost may be neutral to consumers where advised sales are concerned.

Less than optimal terms and conditions for consumers

Life assurance companies offer a range of commission options to intermediaries. They can select a high initial commission and lower increments, or a lower initial commission and higher increments over a period of time. The commission arrangement will have an impact on the terms and conditions of the product in terms of penalties for early surrender and restrictions on early surrender. There is a risk that, rather than the consumer being recommended the terms and conditions that best suit his or her needs, the intermediary will offer the product terms and conditions that are aligned with the commission structure that is most attractive to the intermediary.

Risks specific to commission on credit products

FinCoNet's *Report on Sales Incentives and Responsible Lending (2016)*[37] highlights that sales incentives such as commission payments are especially prone to cause harm in the case of credit products. In the case of credit, the consumer gets the financial benefit of the product up-front but feels the effects of the cost at a later point, making the role of behavioural concepts such as 'present bias' especially relevant. According to the 'present bias', consumers are biased towards current consumption and time-discounting is non-linear.

Behavioural economics studies suggest that people overestimate the beneficial impact of purchasing an item and focus on the benefits rather than the cost when making decisions on credit, so their evaluation of the product tends not to be as rational as it may be when considering other financial products. The risk to consumers is that some incentive schemes may be designed to take advantage of this vulnerability. FinCoNet's report, for example, cites a case study from Australia[38], where car dealers would receive a higher commission on car finance loans they arranged with a higher interest rate.

The FinCoNet report also highlighted that commission payments can cause conflicts of interest to arise not just between the intermediary and the consumer, but also between the intermediary and the product producer, particularly when the intermediary is physically and organisationally remote from the product producer and its commercial interests[39]. In the case of credit, the consumer may feel like his/her interests and those of the intermediary are aligned in order to obtain the loan from the product producer.

Questions:

15. Do you have any general views on the potential risks to consumers of commission structures outlined in this section?

16. Do you consider the potential risks to be accurately described? If not, please explain why.

---

[37] FinCoNet (2016), Report on Sales Incentives and Responsible Lending, http://www.finconet.org/Report_Sales_Incentives%20_Responsible_Lending.pdf

[38] See FinCoNet (2016), Report on Sales Incentives and Responsible Lending, Case Study C, page 32 in Chapter 4

[39] See FinCoNet (2016) Report on Sales Incentives and Responsible Lending, Chapter 6 – The nature of detriment that can be caused. Page 54.

17. Are you aware of any additional potential risks to consumers? If so, please describe them.

18. Have you observed any of these potential risks at play? If so, please provide examples and describe the impact of the risk?

19. Would you weight any of these potential risks over others as requiring special consideration or attention, and if so why?

20. Do you have any suggestions as to how the current regulatory framework could be improved or changed so as to better manage the potential risks to consumers that arise from the payment of commissions to intermediaries?

Glossary

Behavioural economics

Behavioural Economics is a study of psychology as it relates to the economic decision-making processes of individuals and institutions. Consumers do not always make rational decisions on financial matters and behavioural economics attempts to discover why this is through psychological experimentation.

Churning

Churning is the practice of completing excessive transactions on behalf of a consumer, largely for the purpose of generating commission. This could mean regularly changing insurance or investment products held by a consumer or excessive trading on a client's trading account.

Clawback

Clawback is an obligation on the intermediary to repay unearned commission. Commission can be paid directly after a contract is concluded but is not deemed to be 'earned' until after a specified period of time. If the consumer cancels or withdraws from the financial product within the specified time, the intermediary must return commission to the product producer.

Fund-based commission

For investment products, trail commission can be referred to as fund-based commission when the commission is based on a percentage of the value of the fund invested.

Fund erosion

Fund erosion occurs when fees and commissions due to the intermediary are deducted from the fund in an investment product, insurance-based investment product, pension product, or structured retail product, thereby reducing or 'eroding' the value of the fund.

Standard commission

Standard commission is usually based on a percentage of the premium paid/amount invested/amount borrowed. This is generally a one-off payment at the point of sale.

Indemnity commission

Indemnity commission is the term used to describe a commission payment made before the commission is deemed to be 'earned'. Indemnity commission may be subject to a clawback (see above) if the consumer lapses or cancels the product before the commission is deemed to be earned.

Other forms of indemnity commission are advances of commission for future sales granted to intermediaries in order to assist with set up costs or business development. Tied agents sometimes receive a retainer from the product producer in the first few months of their agency until their sales start generating commission. A retainer would eventually be recouped by deducting it from commissions once they are earned.

Initial and trail commission

This commission model is where an initial amount of the commission is paid at the point of sale, based on a percentage of the premium paid/amount invested/amount borrowed. Further increments are then paid at intervals during the first five to six years that the consumer holds the product. These increments are sometimes referred to as 'bullet' commission or renewal commission.

'Non-financial' incentives/ inducements /'non-monetary' benefits

Examples include gifts, assistance with costs, golf trips, IT support, subscriptions, resources being allocated to the intermediary, marketing allowances, whether linked to sales targets or not. See also 'soft commission' below.

Override commission

Override is an additional commission payment or benefit to the intermediary for meeting or exceeding agreed targets. It is generally an increased percentage of commission per unit or it can be a percentage uplift of the commission amount earned. It may also be referred to as accelerated commission.

Soft commission

A soft commission is an agreement under which an intermediary receives goods or services, in return for which it agrees to direct business through or in the way of a particular product producer.

Table of Acronyms

ASIC	Australian Securities and Investment Commission
CF	Controlled function
FCA	The Financial Conduct Authority (UK)
FAMR	Financial Advice Markets Review (UK)
FSB	The Financial Services Board of South Africa
FSA	The Financial Services Authority (UK)
IDD	The Insurance Distribution Directive
MCC	The Minimum Competency Code 2011
MiFID	Markets in Financial Instruments Directive
MIFID II	Markets in Financial Instruments Directive – 2nd Casting
PCF	Pre-approval Controlled Function
PIBA	Professional Insurance Brokers Association
PRIIPs	Packaged Retail and Insurance-based Investment Products
RDR	Retail Distribution Review
RFSP	Regulated Financial Services Provider

Practical information

The purpose of this Discussion Paper is to generate discussion and debate on the payment of commission to intermediaries in the banking, insurance and investment sectors in Ireland.

Comments from all interested parties are welcome. The Central Bank is interested in the views of consumers, financial entities, non-financial corporates, financial advisors, academics and researchers as well as those who work as intermediaries.

There are a number of questions included, but responses should not necessarily be limited to these.

It is important to note that although you may not be able to respond to each and every question, the Central Bank would encourage partial responses from stakeholders on those questions that they believe are most relevant to them.

We intend to make submissions received available on our website after the deadline for receiving submissions has passed. Because of this, please do not include commercially sensitive material in your submission, unless you consider it essential. If you do include such material, please highlight it clearly so that we may take reasonable steps to avoid publishing that material. This may involve publishing submissions with the sensitive material deleted and indicating the deletions.

Despite the approach outlined above, we make no guarantee not to publish any information that you deem confidential. So be aware that unless you identify any commercially sensitive information, you are making a submission on the basis that you consent to us publishing it in full.

This paper will be open for comment until 18 October 2016. Submissions should be made to consumerprotectionpolicy@centralbank.ie

www.centralbank.ie consumerprotectionpolicy@centralbank.ie

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Bosca PO 559, Sráid an Dáma, Baile Átha Cliath 2, Éire
PO. Box No 559, Dame Street, Dublin 2, Ireland