



FINANCIAL REGULATOR
Rialtóir Airgeadais

Review of Remuneration Structures and Transparency

Public Response to CP9

November 2006



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REVIEW OF REMUNERATION STRUCTURES AND TRANSPARENCY

Public Response to CP9

Introduction

In January 2005, Consultation Paper CP9, Review of Remuneration Structures and Transparency, was issued. It sought views in relation to remuneration structures in the insurance market and also in relation to non-insurance investment products. It looked for suggestions as to how the charging structures could be made simpler and clearer for the consumer. It also looked for suggestions as to what would be an appropriate measure of the impact of those charges and a means of comparing one product with another. It asked whether certain types of commission, such as override and indemnity commission, should be banned or restricted. The paper also questioned whether current life assurance disclosure requirements are useful and easy for the consumer to understand and whether they enable the consumer to compare products of different companies. The closing date for receipt of submissions was 31 March 2005 and twenty-four submissions were received: twelve from financial services providers, two from individuals, two from consumer groups and eight from industry professional and representative bodies. We would like to express our appreciation to all those who made submissions.

This consultation has produced one of our major strategic goals for the next three years, which is to take initiatives to improve the transparency of the market. We are undertaking a programme of work on transparency issues, which will continue over the next two years and we anticipate that industry involvement will be a key feature of this programme. Our proposed changes to the current system mainly relate to disclosure requirements and the submissions received in response to



Consultation Paper CP9 will inform our further work in this regard. However, further research to address the needs of consumers and amendments to current legislation will be required before any changes can be implemented.

All of the responses received to the Consultation Paper, many of which are very detailed, are available on our web-site. This paper contains a brief outline of the responses received in respect of each topic.

This paper has been divided into three sections:

Section 1: Product Charges

Section 2: Fees and Commissions

Section 3: Disclosure.

Each section contains a summary of the questions from Consultation Paper CP9, an outline of the responses received and our response.

Not all respondents considered every question. Therefore, references such as 'the majority of respondents' or 'half of the respondents' relate to the number who provided an answer to the relevant question, not to the total number of submissions received.

We have also included a summary of the relevant recommendations contained in the Competition Authority's final report on Competition Issues in the Non-Life Insurance Market and in the Joint Oireachtas Committee on Enterprise and Small Business Third Interim Report on Reforms to the Irish Insurance Market.

Section 1

Product Charges

CP9

Consultation Paper CP9 sought views in relation to the level of understanding of product charges among consumers and looked for suggestions as to how charges could be made simpler and clearer. [Questions 1, 2 and 3]

CP9 also asked whether it is necessary for the consumer to know all the separate charges or whether it is enough to know the total of all charges and the impact of those charges. Views were sought in relation to the 'Reduction in Yield' as a measure of the impact of charges and a means of comparing products. The Reduction in Yield expresses the impact of charges in terms of the reduction in the investment return over a particular period compared with the return which would have been provided if the policy carried no charges. [Questions 4, 5, 6 and 7]

Responses received

Level of understanding and simplification

The majority of respondents who considered this issue indicated that consumers generally do not understand the charging structure of financial products. Other comments were that it is more important to focus on the impact of the charges and that the level of understanding depends on the quality of advice and documentation, the complexity of the product, and the willingness and ability of the consumer to understand.

Although some respondents considered that simplification of the charging structure is not necessary, a number of specific suggestions were received as to how the charging structure could be made simpler and clearer. These included the provision of a concise document summarising key information, use of the Reduction in Yield, limiting insurers to using a maximum of two charges per product, and banning certain types of charges, such as bid/offer spread and nil

allocation periods with high initial commission. The majority of submissions supported the introduction of standard definitions and the use of plain English.

Impact of charges and Reduction in Yield

There was no clear majority in favour of either providing details of all charges or providing the total of all charges.

All the respondents who considered this issue agreed that the Reduction in Yield is a useful measure. Some submissions suggested that its usefulness to the consumer could be improved by the use of plain English, giving it greater prominence, educating the consumer in what the figures mean and using euro terms rather than percentages.

Some submissions suggested that the projected breakeven point [which is the point at which the projected value of the policy first equals or exceeds the premiums paid to date] should be used in conjunction with the Reduction in Yield but others considered that this approach would risk providing too much information and further confusing the consumer.

Our Response

We believe that transparency in relation to product charges is not only in the interests of the individual consumer but also improves competitiveness in the market. We do not wish to introduce changes to charging structures that would impact negatively on the competitiveness of products. We agree that due to the complexity of some charging structures, it is difficult to disclose all the individual charges in a simple and easy to understand format. We believe that it may be more useful to consumers to disclose the impact of the charges on their investment. We consider that the best way to achieve this may be for consumers to become accustomed to a single measure. We are examining the possibility of using the Reduction in Yield to show the impact of charges on investment products and disclosing this figure at a number of intervals during the course of the investment. We believe that the Reduction in Yield would be particularly useful for medium- and long-term durations but it may be more useful to focus on surrender value in the early years. We do not propose using any other measure in conjunction with the Reduction in Yield as we agree that this would add to the volume of information without adding further clarity for the consumer.

CP9

CP9 asked for views in relation to whether the practice of differential pricing should be allowed to continue. [Question 8]

Responses received

None of the respondents suggested that 'differential pricing' should be prohibited, pointing out that costs can vary by distribution channel and that there should be flexibility in relation to price and remuneration. They also pointed out that if one method of distribution is significantly cheaper than others the buying public should benefit.

However, concern was expressed in relation to the possibility that differential pricing could be used to distort competition and in relation to the use of competitive spot pricing by product providers to make certain products appear better value than their competitors.

Our Response

The public should benefit from differences in pricing structures and competition between distribution channels. We believe that consumers should be able to compare products and prices regardless of the distribution channel and that competition should be encouraged for the benefit of consumers. We are undertaking a programme of work on transparency issues which will consider issues across all distribution channels. We believe that the requirements in the new Consumer Protection Code in relation to acting in the best interests of the customer and providing the most suitable product represent significant progress in this regard.

Section 2

Fees and Commissions

CP9

CP9 sought views in relation to the most appropriate method of payment for the Irish market and consumer, the level of understanding among consumers as to how an intermediary is paid for his/her services, and whether the remuneration system conflicts with the obligations set out in the existing codes of practice. [Questions 11, 12, 13 and 14]

CP9 asked for suggestions as to how the commission structures could be simplified and made more transparent, and whether certain types of commission structures should be banned or restricted. It also sought views in relation to the IIF Code of Practice on Intermediary Incentives. [Questions 9 and 10]

CP9 asked whether the current life assurance disclosure requirements provide the consumer with sufficient information to compare products or to identify product or company bias, whether consumers should be informed of all types of remuneration and whether the various types of remuneration should be disclosed separately. [Questions 15, 18, 19, 20 and 24]

Responses received

Level of understanding and method of payment

In general, the respondents considered that there is some awareness among consumers that intermediaries are remunerated by way of commission although they may not be aware of the level of remuneration. The majority of respondents considered that this is relevant information, although some suggested that it is only relevant for investment products.

The majority of respondents favoured the continued availability of both methods of payment. Some respondents suggested that certain products or services should be paid for by fee, e.g., financial advice, while commission is more appropriate for others. The submissions also referred to the reluctance of

consumers to pay fees, the different tax treatment of fees and commission, and the cross subsidisation from higher to lower premium cases which allows the provision of financial advice to consumers with limited financial means.

Most respondents did not consider that the remuneration structure conflicts with codes of practice. Those who thought that a conflict of interest arises because commission is paid by a product producer suggested that this conflict could be managed or addressed by, for example, disclosure, simplification and transparency.

Simplification of commission structures

Most of the responses did not suggest specific ways in which commission structures could be simplified but referred to the benefits to consumers of transparency and disclosure. Some suggestions recommended the use of plain simple language. Other suggestions included the use of the Reduction in Yield and the elimination of commission structures where the amount attributable to an individual contract cannot be precisely determined at the time of the sale, e.g., contingent commission and non-cash payments.

The majority of respondents considered that indemnity commission [which means that most or all of the first year's commission is paid to the intermediary on receipt of the first month's premium] should not be banned or restricted. Respondents stated that it allows an intermediary to better manage cashflow and facilitates the entry of new intermediaries into the marketplace. Other comments were that it does not involve any risk of loss for the consumer and it does not involve any increase in the level of commission that would otherwise be payable. There were differing views in relation to the disclosure of indemnity commission.

Only two responses considered that override commission should be banned. A number of submissions considered that certain types of override should not be permitted, i.e., those linked to specific targets, as they could lead to company or product bias and may not be in the consumer's best interests.

Half of the respondents considered that the IIF voluntary Code of Practice on Intermediary Incentives should not be imposed by the Financial Regulator, commenting that it works well and does not need to be strengthened. Others commented on the need to strengthen the Code and the belief that statutory codes would be more effective than voluntary codes.

The majority of respondents were in favour of retaining commission payments on automatic premium indexation increases because indexation benefits the consumer and such payments contribute to the cost of the ongoing service to the client. The argument against such payments was that it does not necessitate additional work on the part of the intermediary.

Comparison between products and identifying company or product bias

The majority of respondents considered that the customer is provided with enough information to compare products but that comparison is difficult due to the complexity of the products and the volume of information provided.

Differing views were received in relation to the adequacy of the information to identify company or product bias. Some respondents considered that the information provided does not enable the client to identify company or product bias saying that it would not be practical and would be very costly for insurers to provide sufficient information to address this. The difficulty with disclosure of override commission was highlighted and it was suggested that the development of new criteria for granting overrides would facilitate improved intelligibility of disclosure information to the consumer.

Other submissions suggested that bias does not occur, and that the current disclosure requirements and reason-why statement are sufficient to enable a consumer to spot any potential product or company bias.

Disclosure of various types of remuneration separately versus total remuneration

The majority of responses indicated that consumers should be informed of the total remuneration. They agreed that it would not benefit the consumer to show the various types of commission separately, that it would lead to further confusion and that it would add a layer of complexity.

Recommendations of the Competition Authority in relation to non-life business

The Competition Authority recommended that we should not limit the forms of compensation that intermediaries can receive but instead that all forms of compensation should be disclosed in any written communications offering to supply insurance to customers.

Our Response

We do not intend to make any changes to current commission structures at this stage. We agree that limiting the forms of compensation that intermediaries can receive could inhibit competition and propose that the current situation where firms can choose to be remunerated either by fees, commission, or a combination of both will continue. We accept that a fee-only structure would provide greater clarity for consumers and eliminate some potential sources of conflict of interest. However, we are also of the view that some consumers would prefer to pay for certain types of financial products over a longer period of time and that this choice should be available to them. Of course, the total amount to be paid should be transparent. Potential conflicts of interest that may arise from commission-based remuneration must be dealt with in the context of our new Consumer Protection Code which requires firms to act in the best interests of their customers. The Code also requires firms to ensure that any product or service offered to a consumer is suitable and that, where they recommend a product, the recommended product is the most suitable product for the consumer. Compliance with the requirements of the new Code will be a major focus of our inspections process and we have also undertaken to commence a review of the intermediaries market in 2007.

We have carried out consumer research which indicated that there is confusion among consumers in relation to the remuneration of intermediaries. We believe that consumers should know how much they are paying for financial products. In order to increase awareness, we are currently undertaking a detailed programme of work on transparency issues which will include a review of the current disclosure requirements. We will focus in particular on using the Reduction in Yield for investment products where commission reduces the amount available for investment. We will also consider additional requirements in relation to non-standard commission arrangements such as indemnity commission, override commission and payment of commission on automatic premium indexation increases.

While the IIF voluntary Code of Practice on Intermediary Incentives applies to members of the IIF only, this currently includes the vast majority of those operating in the domestic market. In addition, the Financial Regulator's Consumer Protection Code contains provisions in relation to inducements and soft commissions. Inducements may not be accepted if they conflict with the firm's duties. Soft commission agreements must be in writing, must be used in the provision of services to consumers and must not conflict with the best interest of the consumer. We believe that there is sufficient protection for the consumer contained in these two Codes and therefore we will not introduce a statutory code on incentives at present.

Section 3

Disclosure

This section considers disclosure under three headings:

- Current life disclosure regulations
- Life assurance protection products and non-life assurance
- Non-insurance investment products.

CURRENT LIFE DISCLOSURE REGULATIONS

CP9

CP9 asked whether the information included in the current disclosure requirements is useful to the consumer and easy to understand. It also asked whether too much information is provided or whether the information should be presented in a different way. [Questions 17, 21 and 22]

Responses received

The majority of respondents agreed that the volume of information provided should be reduced or consolidated. Suggestions included a series of simpler more customised Key Features documents or a one-page standardised format, in plain English, providing details such as benefits, the premium, charges, the Reduction in Yield, and commission. Annual statements should include details of ongoing charges and possible future penalties and bonuses.

Our Response

We acknowledge that the introduction of the current life disclosure requirements was a significant development and provides consumers with useful information. However, we believe that they should be made more consumer friendly and that the relevant information should be provided in a more concise and easy to understand format. We believe that if the consumer is provided with relevant information in a well presented, easy to read format, he/she is more likely to read and understand the content. The responses to this consultation and our consumer survey information have resulted in transparency of financial products being a key feature of our next strategic plan. This major project will require considerable consultation with the relevant stakeholders, including industry representative and professional bodies. In order to ensure that the revised requirements are consumer friendly, further appropriate consumer research will also need to be carried out. This programme of work will continue over the next two years.

CP9

CP9 asked for views in relation to the exemption of trustees of occupational pension schemes from the life disclosure regulations. [Question 25]

Responses received

The majority of respondents considered that trustees of occupational pension schemes should not be exempted from the life disclosure requirements. The reasons given included that the employee is the consumer and the information is necessary for informed decisions to be made, failure to disclose inhibits the ability of trustees to carry out their fiduciary duties, it would provide trustees with information which future pension regulation is likely to oblige them to disclose regularly to members, and it would overcome the different competencies of trustees where some may be individuals with little experience or knowledge while others may be corporate trustees.

The concerns highlighted included system changes which would be required to produce the disclosure documentation, additional costs which would be likely to

be passed on to the individual members of the scheme, and the question of whether the increased costs would bring extra benefit.

Our Response

We believe that there may be advantages to the inclusion of trustees of occupational pension schemes within the ambit of the disclosure regulations. The Financial Regulator is currently undertaking work on the simplification of the disclosure regulations and this issue will be considered as part of that project.

LIFE ASSURANCE PROTECTION PRODUCTS AND NON-LIFE INSURANCE

CP9

CP9 asked for views in relation to disclosure requirements for life assurance protection products and non-life insurance. [Questions 16, 23, 26, 27 and 28]

Responses received

Disclosure for life assurance protection products

The majority of respondents considered that commission disclosure is not necessary for term/protection products and non-life insurance. The reasons given included that disclosure of commission would add little value to the consumer and that disclosure should focus instead on price and product features.

Disclosure for non-life insurance

The majority of respondents thought that specific disclosure requirements should not be imposed for non-life business. The reasons provided included: non-life business is better characterised as a service, it would be discriminatory and distort competition, premiums are not affected by commission amounts, and price is the primary concern. Concerns were expressed in relation to the costs of

disclosure, in particular in the non-life sector where policies are renewed annually.

Those in favour of disclosure requirements suggested that disclosure should focus on price and cover provided, should include overall intermediary remuneration and a summary of policy cover, and that disclosure of commission should be on a similar basis to the regime for life assurance. Other factors to be considered included:

- that there should be clear guidelines and transparency regarding types of commission acceptable,
- simplicity and relevance,
- equivalence between intermediate and direct sales,
- a regime that is low-cost, easy to implement and administer,
- how to address non-standard remuneration [e.g., overrides], and
- that disclosure requirements would be proportional to the aim they seek to achieve.

Recommendations of the Competition Authority and the Joint Oireachtas Committee on Enterprise and Small Business in relation to non-life business

The Competition Authority recommended that buyers should be informed of the precise monetary payment an intermediary receives and the basis on which that monetary payment is calculated (e.g., whether the payment is an ad valorem or other payment structure). This information should be included in a breakdown of premium provided with each price quote and each renewal notice. The Competition Authority also recommended that buyers should be informed of the nature and basis of any payments intermediaries may receive in addition to ad valorem commission payments, in an easy to understand format, and that intermediaries should be required to publish on an annual basis the total value of commission overrides received from each insurer, disaggregated by type of policy written.

The Joint Oireachtas Committee on Enterprise and Small Business recommended that all policyholders should, on renewal, receive information on the basis on which the premium is calculated.

Our Response

We agree that the important issues for life assurance protection policies and non-life insurance policies are price and benefits. We also favour disclosure of commission for these products. We believe that greater transparency will enhance competition which will in turn benefit the consumer. We recognise that for policies which are renewed annually the cost of disclosure is an issue of concern. There are currently no disclosure requirements for non-life insurance business. As part of our transparency project, we will now work towards developing an appropriate disclosure regime. The legislative framework allows for requirements to be introduced via a Statutory Instrument. However, the format of the disclosure must be developed before a Statutory Instrument can be put in place.

NON-INSURANCE INVESTMENT PRODUCTS

CP9

CP9 asked for views as to whether similar requirements should be imposed on non-insurance products that are similar in nature to insurance products. [Questions 29 and 30]

Responses received

The majority of respondents agreed that disclosure requirements in relation to insurance products should also be applied to non-insurance products that are similar in nature. One submission raised concerns in relation to the disclosure of charges in respect of Tracker Bonds.

Our Response

We agree that the same disclosure requirements should apply to non-insurance products that are similar to insurance products. The issue in relation to Tracker Bonds has been addressed in the Consumer Protection Code by the introduction of the Key Features Document.



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