

Response to the Central Bank of Ireland's Discussion Paper CP116 - Intermediary Inducements - Enhanced Consumer Protection Measures

Submitted via email to consumerprotectionpolicy@centralbank.ie

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1. Introduction

We very much welcome the publication of the consultation paper focusing on enhanced consumer protection measures and agree with the Central Bank of Ireland ("CBI") that it should be possible to properly design arrangements for remuneration of intermediaries by product producers to significantly reduce conflicts of interests. This can only be achieved by significantly increasing the level of transparency currently provided for in the intermediated market.

The Retail Intermediary sector in the Republic of Ireland is primarily remunerated by way of commission from product producers in relation to single member pension products and investments.

Remuneration by way of commission can be a potential conflict of interest in many facets,

- Clients financial needs and objectives may be secondary to remuneration concerns of the intermediary.
- Remuneration may be linked to volume based incentives for intermediaries which influences intermediary behaviour.
- Remuneration backed arrangements may create post-sale disincentives such as exit penalties and commission clawbacks which could affect subsequent advices if client circumstances change.
- Remuneration arrangements may not be fully disclosed, and clients may be unaware of the value of the financial advice provided, and therefore be unable to benchmark or measure the value of the advisory service.
- There may be obfuscation of product features to facilitate remuneration arrangements which creates information asymmetry between advisor and client.
- Soft commissions may also be in place which may influence intermediary behaviour.

Whilst the above may not result in a client getting an inferior recommendation or advices, it clearly illustrates a number of potential conflicts which sit squarely within the Agency-Principal problem – in that the Principal in this situation (the Client), is being serviced by an Intermediary who they believe is acting as their agent, but who is legally the Agent of the product producer, given that the current legislation governing this relationship, the Investment Intermediaries Act, 1995 (as amended) ("IIA") and the Insurance Mediation Directive (IMD) requires regulated intermediaries to only submit orders to product producers for which they have a letter of appointment in place, which will involve a formalised Agency agreement to be in place between the intermediary and the product producer.

This enshrined legislative position and the industry practice built around it has resulted in an Intermediary sector which has adopted a role of intermediation where the intermediary contractually and legally act as agent of the product producer.

Agency problem is an aspect of financial economics that looks at conflicts of interest between parties with different interests in the same assets. The theory explains that Principals delegate work to Agents, typically for remuneration, and then the problem arises when attempting to align the goals of the agent so they are not in conflict with that of the principal.

In most professional services industries, the Principal is the Client, and the Agent is the Advisor. This is evident in accountancy practices, legal practices or trustee practices. In these industries there are less issues in relation to Principal-Agent conflicts of interest; remuneration is typically quoted at the outset, remuneration are typically set-out independently of other parties to which remuneration may be due, and remuneration is typically subject to a bi-lateral contract between client and advisor. In the case of Trustees, there is a requirement that the trustee with fiduciary duties will not profit secretly from any arrangement which involves the assets of the beneficiary.

To a large extent, this solves the agency problem in the relationship. However in financial services intermediation, the agency problem is much more pronounced due to the legal agreement the agent has in place with product producers. i.e. the agent may be motivated to act in their own self-interest due to commission arrangements. In a very simple way – the intermediary is acting for two parties – the client and the product producer, which enhances the potential for conflicts of interest significantly. As stated by Yusuf in 2011¹, “this becomes possible owing to the challenge of satisfying the interests of two differing principals in a single transaction: the interests of client-customers on the demand side and the interests of insurers on the supply side”.

The obvious solution to this problem is that of regulation – i.e. where the potential for conflicts of interest is reduced or eliminated entirely through the use of principles based regulation. However, we acknowledge that the cost of this regulation is significantly high, due to the high numbers of intermediaries relative to product producers in the market. As such, we would posit particularly in the Irish market and under the Central Bank’s PRISM system of regulatory engagement, historically regulators have focused the weight of regulation on product producers, further enshrining the role of the intermediary as a ‘product seller’ and not as an advisor. This would appear to be dramatically different to the roles of other professionals such as accountants or solicitors, who contract directly with their clients. The role of intermediation by definition – is a role that must deal with conflicts of interest by design.^{2 3}

Following on from this - “information asymmetries result in hidden characteristics, hidden action and hidden information”, as described by Eckardt in 2002⁴. Information asymmetry is a situation in which one party in a transaction has more or superior information compared to another.

Increased complexity and obfuscation of remuneration arrangements in products often causes this, and coupled with the agency problem in intermediated services as described above, this can increase the reliance of a consumer on their advisor. However, where a lack of regulation around disclosure and without strong and principled regulatory controls around conflicts of interest, the environmental variables for systemic conflicts of interest exist and prosper.

¹ Yusuf, T.O. 2011, "Brokers' incentives and conflicts of interest in the control of opportunism", *The Journal of Risk Finance*, vol. 12, no. 3, pp. 168-181.

² Fama, E.F. (1980), "Agency problem and the theory of the firm", *The Journal of Political Economy*, Vol. 88 No. 2, pp. 288-307.

³ Jensen, M.C. and Meckling, W.H. (1976), "Theory of the firm: managerial behavior, agency costs and ownership structure", *Journal of Financial Economics*, Vol. 3, pp. 305-60.

⁴ Eckardt, M. (2002), Agent and Broker Intermediaries in Insurance Markets - An Empirical Analysis of Market Outcomes, Universität Rostock.

2. Further Irish Context

The application of national discretions in Ireland are important for consumer protection, given our small population, which in turn provides that domestic consumption of financial investment products is relatively small by international standards, with a small number of product producers but a large number of urban and rural intermediaries servicing consumers.

Retail investment options and single member pension arrangements, including PRSAs, Buy Out Bonds/Personal Retirement Bonds, Personal Pensions and Approved Retirement Funds are dominated by a small number of product producers, mainly Life Companies, who are dominant in distribution channels relative to investment firms subject to MiFID.

Further consolidation in the industry and a lack of functional equivalency between consumer disclosure and transparency provisions under the Insurance Distribution Directive (“IDD”), the Packaged Retail and Insurance-Based Investment Products (“PRIIPS”) Regulations and the Markets in Financial Instruments Directive (“MiFID 2”) creates competitive distortions in the market, in particular in relation to financial products and investments accessed via intermediary channels.

The Consumer Protection Code plays an important part in consolidation of behaviour in intermediated markets. As it stands currently, within the Consumer Protection Code, the application of more onerous MiFID rules than that is required under insured investment products creates competitive distortions, reduces competition, reduces perceived choice in intermediated markets, and prevents access for clients to benchmark the value provided by providers and understand the roles and value ascribed to each provider providing services to them.

3. Background

Conexim Advisors Ltd (“Conexim”) was established in 2010 and regulated under MiFID in 2012. Since formation, the firm has provided regulated intermediaries with conflict free and wholesale access to investment products, where all charges are unbundled and fully transparent.

This model has been welcomed in the Irish market, and as of March 2018, 130 intermediaries and 38 trustees have used the Conexim investment platform to provide services to their clients.

Crucial to the Conexim model has been fee transparency and unbundling of charges. Since inception the firm has not had to process a single retail complaint, which we attribute largely to transparency of arrangements, clear identification of the roles of each party providing the services to the client (advisor, investment platform and investment fund manager), and the clear ability for consumers to understand the exact amount which is paid to each party. This allows the consumer to understand and ascribe value to each of the service providers.

Conexim has built this service offering in the Irish market without ever having to pay a 3rd party an inducement to use its service, and the business has grown on merit and demand from intermediaries, trustees and consumers who crave transparency and simplicity. In particular, there is an emerging sector of intermediaries who wish to provide their services on a more transparent basis and provide services in a way which allows them to enhance and demonstrate the value they provide to their retail clients. Conexim assists advisors in providing this. For the avoidance of doubt, very few of these advisors are classified as independent under the MiFID 2 definition due to

legacy or current arrangements with other providers, but what they are is fully transparent and conflict free in the consumers they service on the Conexim platform.

To a large extent, the classification of “independent” is a bit of a red-herring. Being transparent and avoiding conflicts of interest is more important than the concept of independence and we believe would have stronger resonance with consumers seeking to engage advisors and reduce information asymmetry. We therefore welcome many of the proposals put forward in the consultation paper as they reinforce a model which investors using our platform via intermediaries already benefit from.

4. Answers to Questions

Section 3.1 Acceptable inducements

Question 1: Do you see any reasons why the Code should not be amended as set out above?

Answer: We agree with the proposed amendments.

Question 2: Do you see any reason why, for example, insurance intermediaries should not be subject to the requirement that inducements must enhance the quality of the service rather than the requirement that an inducement is not detrimental to the quality of the service as is required under the IDD? If so, please set out those reasons.

Answer: We believe that insurance intermediaries when providing advice on investment products or single member pension requirements should have full functional equivalency exists with MFID. Simply having a life wrapper around an investment product should not alter the level of protection and transparency afforded to a consumer.

Question 3: Do you agree with the conditions in schedule 5 of the MiFID Regulations 2017, as set out above, that describe how an inducement enhances the quality of the service? Please explain your answer.

Answer: We agree with these conditions, in particular that an enhancement should create a tangible benefit to the relevant client and that for an ongoing payment to be received, an ongoing service should be provided.

Question 4: What other examples do you consider would enhance the quality of the service? Please set out those examples in detail.

Answer: We believe only services that result in an actual direct benefit to the client can enhance the quality of the service. i.e. it should be a tangible and demonstrable benefit to the client, capable of being documented in the client’s statement of suitability.

Question 5: Do you foresee any practical difficulties arising from the implementation of this proposal? Please set out those difficulties in detail.

Answer: Given the ability for product producers to break down the components of payments to providers as well as the aggregation of charges (as is required under MiFID 2), we see no reason that full transparency around charges and inducements cannot be achieved on an industry wide basis.

The only practical difficulties in this would arise from IT requirements, but this obligation would be largely placed on the product producer and not the retail intermediary, and therefore would not burden the intermediated sector with additional costs.

Question 6: Do you have any views on what, if any, unintended consequences may arise in implementing this proposal? Please explain your answer.

Answer: We believe there is a potential for conflict between reporting of inducements across various regimes, in that IDD, PRIIPS and MIFID disclosures may look different and be difficult to interpret by intermediaries and consumers. Ideally, disclosures on fees and charges and inducements should be harmonised as much as possible across all financial product types. The consumer protection code could be used to template this to provide guidance for retail intermediaries.

In particular with PRIIPs, we already see this, in that single member pension products provided via life wrappers fall long short of similar single member pension products provided under MiFID 2. Ultimately, a retail consumer should be given full disclosure of fees, charges and inducements, regardless of the wrapper used to access an underlying investment product.

Section 3.2.1 Inducements linked to targets that do not consider the consumer's best interests

Question 7: Do you have any views on the proposal that inducements contingent on achieving targets that do not consider the consumer's best interests, including profit targets, volume targets, and targets linked to business retention, are deemed to be conflicts of interest and must be avoided? Please explain your answer.

Answer: We believe it to be absolutely critical that inducements as described above be deemed conflicts of interest and should be avoided entirely and not merely mitigated. We agree with the statement that "commission that is paid upfront and subsequently clawed back is effectively a target".

Advice should be provided to an individual client based on their individual financial circumstances, needs and objectives, and there is a risk that a recommendation may be made to prefer one product producer over another to achieve or retain business volume targets for the intermediary, which effectively collectivises the interests of clients without their knowledge or agreement.

Post-sale arrangements manifesting as exit penalties (for clients) and clawbacks of commissions (for the intermediary) means if a client's financial needs and objectives change within the term of the investment, there may be a punitive disincentive for the intermediary to recommend a revised financial strategy for a client which may involve a different product producer, as the intermediary may have to return commission to the product producer.

This also has the effect that an intermediary could have commission from another client withheld due to the changed requirements of the original client – thus reinforcing the concern that the agency agreement with the product producer is interfering with the individual Client-Advisor relationship.

Question 8: Do you have any views on what, if any, unintended consequences may arise in implementing this proposal? Please explain your answer.

Answer: We do not believe there is any negative consequences from an outright restriction on volume based or target based incentives.

Question 9: Do you foresee any practical difficulties arising in the implementation of this proposal? Please set out those difficulties in detail.

Answer: The only practical issue we foresee is the requirement for a gradual phase-out of exit penalties and clawback arrangements to honour existing arrangements.

Section 3.2.2 Inducements linked to size of mortgage loan

Question 10: Do you have any views on the above proposal? Please explain your answer.

Answer: As Conexim is not a regulated mortgage broker, it not a relevant stakeholder for this question.

Question 11: Do you have any views on what, if any, unintended consequences may arise in implementing this proposal? Please explain your answer.

Answer: As Conexim is not a regulated mortgage broker, it not a relevant stakeholder for this question.

Question 12: Do you foresee any practical difficulties arising in the implementation of this proposal? Please set out those difficulties in detail.

Answer: As Conexim is not a regulated mortgage broker, it not a relevant stakeholder for this question.

Section 3.2.3 Soft Commission

Question 13: Do you have any views on the proposed deletion of provision 3.36 of the Code, relating to soft commission agreements? Please explain your answer.

Answer: We agree it should be dropped in favour of the inducement/minor non-monetary benefit definitions which are inherently more useful.

Section 3.2.4 Recommendations where conflict of interest exists

Question 14: Do you have any views on the above proposal? Please explain your answer.

Answer: We firmly believe that the price to be paid for advice should be a bi-lateral agreement between the consumer and the advisor, and agreed in advance. We firmly believe that any arrangements that would incentivise the broker to favour one product over another should be eliminated, and the cost of advice should be independent of a product recommended to avoid a conflict of interest.

Question 15: Do you have any views on what, if any, unintended consequences may arise in implementing this proposal, including any impact on consumer choice? Please explain your answer.

Answer: We are currently operating this model with 130 advisors and 38 trustees, with thousands of underlying accounts being serviced in this manner. We do not believe it would have any impact on customer choice, and if anything, would enhance consumer protection as objectivity would be enhanced in recommendations.

Question 16: Do you foresee any practical difficulties arising in the implementation of this proposal? Please set out those difficulties in detail.

Answer: We suspect this may require adjustment to intermediaries and product producer operating models, which may result in a short term additional overhead for intermediaries and product producers to re-align their processes, but we would not see this as a long-term difficulty.

Section 3.2.5 Conflicts of interest policy and record-keeping requirement

Question 17: Do you have any views on the proposal that a written conflicts of interest policy should also specify procedures to be followed, and measures to be adopted, by the regulated entity, in order to avoid conflicts of interest relating to inducements? Please explain your answer.

Answer: We believe that a policy is meaningless without procedures to operationalise the policy, so would agree with this suggestion.

Question 18: Do you have any views on the proposal that records must be retained to demonstrate how conflicts of interest arising from inducements have been avoided for each transaction?

Answer: We believe a practical solution to this is to demonstrate how the conflict of interest has been avoided could be placed into the consumers statement of suitability report, rather than as a standalone documentation requirement.

Question 19: Do you foresee any practical difficulties arising from the implementation of this proposal? Please set out those difficulties in detail.

Answer: We see no practical difficulties in this.

Question 20: Do you have any views on what, if any, unintended consequences may arise in implementing this proposal? Please explain your answer.

Answer: We see no unintended consequences in this.

3.3 Independence

Question 21: Do you have any views on the proposal that an intermediary may only describe itself or its regulated activities as independent, where it does not accept and retain a third party inducement for the provision of advice, other than a minor non-monetary benefit which is capable of enhancing the service to a consumer? Please explain your answer.

Answer: We argue that at a minimum, there should be harmonisation between MiFID and IDD on the use of such a term so as not to create competitive distortions or reduce competition. However, we also believe in both a MiFID and IDD context, the use of this term is not an effective deterrent to mitigate conflicts of interest. The proposals presented in this paper are much more achievable in terms of reducing conflicts of interest in a systemic and principled based approach, rather than hanging a hat on a single phrase.

Question 22: Do you foresee any practical difficulties arising from the implementation of this proposal? Please set out those difficulties in detail.

Answer: We believe a single word “independent” plucked from the English dictionary is not sufficient, and synonyms and similar language linked to independence should also have the same context to prevent avoidance or circumvention.

Question 23: Do you have any views on what, if any, unintended consequences may arise in implementing this proposal? Please explain your answer.

Answer: As evidenced during MiFID 2 introduction, we would expect many product producers to influence intermediaries to not use this phrase, which dilutes its purpose.

3.4 Transparency of inducement arrangements

Question 24: Do you have any views on the proposal to introduce an obligation for intermediaries to publish comprehensive details of inducement arrangements with product producers with which they have an appointment? Please explain your answer.

Answer: We agree with this proposal. We note that the industry has the ability to offer many variations of conflict free arrangements for remuneration, and consumers are generally unaware of industry practice in relation to inducements. Publishing details in relation to inducement arrangements we would suspect would alter behaviour of both consumers and intermediaries in a positive manner.

Education of consumers in relation to industry practices in relation to conflicts of interest to reduce information asymmetry can only be a positive introduction.

Question 25: Do you think the Central Bank should prescribe the format and content of the inducement arrangements summary document? If so, please provide details of the content you think should be included.

Answer: We agree a prescribed format and content would be useful for consumers, and at a minimum should include:

- Whether the intermediary agrees fees with consumers bi-laterally
- Whether the intermediary accepts inducements and with which product producers
- The range and value of inducements received (low to high)
- Details of any volume based or target based assessments (included details on clawbacks)
- Details of any non-monetary benefits

The document should be limited to 1 pages in length to provide clarity.

Question 26: Do you have any views on the proposal that firms must retain records to demonstrate how the inducement arrangements summary document was brought to the attention of the consumer? Please explain your answer.

Answer: We believe a practical solution to this is to provide this document to consumers as a standalone document annexed to the statement of suitability report.

3.5 Proposed new definitions

Question 27: Do you have any views on the proposed definitions of ‘inducement’? Please explain your answer.

Answer: We agree with this definition. Regulated entities clearly have the ability to agree a fee on a bi-lateral basis with a client and have this levied and collected via the product producer – as is done on the Conexim investment platform, and in many overseas markets in a transparent manner. Any variance from this model – i.e. the provision of bundled or return commissions should be classified as an inducement.

Question 28: Do you have any views on the proposed definition of ‘minor non-monetary benefit’? Please explain your answer.

Answer: Yes, we agree with this definition, in that is practically quite difficult to not provide minor non-monetary benefits in intermediated channels (such as educational seminars, literature etc.).

Question 29: Do you agree with the above examples of minor non-monetary benefits? Please set out your reasons.

Answer: Yes, we agree with these examples. Outside of educational seminars and ancillary hospitality such as meals/lunches associated with such events and access to informational products, it is hard to envision many minor non-monetary benefits that benefit a consumer.

Question 30: Are there any additional minor non-monetary benefits that you think should be included? Please explain your answer.

Answer: Access to information, literature, or systems which aid in provision of information in relation to financial instruments.

Question 31: Would you set a monetary limit, as a guide, on a minor non-monetary benefit? If so, what limit would you consider appropriate and why?

Answer: From a practical perspective, in terms of running a seminar or educational event to spend less than €200 per attendee, so we would suggest that as an acceptable limit.

Summary

We welcome the consultation paper and would reinforce that many of the proposals in the consultation paper are already being achieved as evidenced by the thousands of accounts operated on the Conexim platform and in overseas markets which by and large are operated in a manner consistent with this consultation paper. It should be an overarching requirement to reduce information asymmetry in financial products provided to consumers, and reduce conflicts of interest in a meaningful and systemic manner, and in this, we broadly welcome these proposals.

Should you have any additional queries in relation to our responses to this submission, please feel free to contact Ronan Gahan at [REDACTED]

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