Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Distorting incentives paid to intermediaries in the credit market

Colm Kincaid
Central Bank of Ireland

Introduction

- Role of the Central Bank
- Some relevant rules in an Irish context
- Factors we have witnessed distorting the proper operation of these rules
- Intermediation and arrears
- Some conclusions

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Role of the Central Bank of Ireland

Role of the Central Bank of Ireland

- Regulator of banks and other lenders, but only of mortgage intermediaries (not other credit intermediaries)
- Domestic and EU-based rules
- Statutory objective: Regulation of financial service providers while ensuring that the interests of consumers are protected
- Risk-based approach to supervision (means an individual intermediary will typically rate low risk and impact for prudential purposes)

Some recent/current relevant work

- Updated Consumer Protection Code 2012
- Ongoing themed review of sales incentives in banks, insurers and stockbrokers
- Extensive redress scheme for sales of payment protection insurance

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Relevant Rules

General requirements

- Where a regulated entity distributes its products to consumers through an intermediary, the regulated entity must not require the intermediary to introduce a specified level of business from consumers in order to retain an appointment from that regulated entity.
- Where a product producer distributes its products to consumers through an intermediary and pays commission to an intermediary based on levels of business introduced, the product producer must be able to demonstrate that these arrangements:

  a) do not impair the intermediary's duty to act in the best interests of consumers; and

  b) do not give rise to a conflict of interest between the intermediary and the consumer.
- A regulated entity must ensure that its remuneration arrangements with employees in respect of providing, arranging or recommending a product or service to a consumer, are not structured in such a way as to have the potential to impair the regulated entity's obligations:

  a) to act in the best interests of consumers; and

  b) to satisfy regulatory suitability requirements.

(Consumer Protection Code, Provisions 3.30 to 3.32)

Gifts

- A regulated entity must take reasonable steps to ensure that it or any of its officers or employees does not offer, give, solicit or accept any gifts or rewards (monetary or otherwise) likely to conflict with any duties of the recipient.

(Consumer Protection Code, Provision 3.35)

Soft Commissions

- A regulated entity must not enter into a soft commission agreement unless such agreement is on paper or on another durable medium.
- Where a soft commission agreement is in place, the following conditions apply:

  a) any business transacted under a soft commission agreement must not conflict with the best interests of consumers;

  b) where a regulated entity considers that a consumer may be affected by the soft commission agreement, the consumer must be made aware of the soft commission agreement and of how the soft commission agreement may affect them;

  c) a copy of the soft commission agreement must be made available to the consumer on request;

  d) 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; and

  e) a regulated entity must provide to any affected consumer details of any changes in its policy on soft commission agreements promptly after implementation of any such changes.

(Consumer Protection Code, Provision 3.36)

"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

Forthcoming EU rules

Capital Requirements Directive: focus to date on internal staff with material impact on risk profile

Mortgage Credit Directive: creditors and mortgage intermediaries not to remunerate in a manner which would impede their obligation to act honestly, fairly, transparently and professionally, taking account of the consumer's rights and interests and their specific circumstances

Insurance Mediation Directive (IMD2): requirements for disclosure of remuneration

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Distorting Factors

Issues

- Variable remuneration with poor qualitative brakes or claw back where things go wrong
- Sale of credit in order to cross-sell more lucrative products
- Regulated intermediaries also being engaged in non-regulated activities

Weak incentive structure

Distortion: intermediary's incentives mis-aligned with longer term interests of the product producer

Structure	Terms	Controls
Incentive bias between products	Accelerator features	Strong qualitative metrics
Disproportionate rewards for marginal sales	Non-use of lapse/persistency metrics	Penalisation and clawback
Inappropriate requirements for incentive accrual (e.g. min sales thresholds)	Unrealistic targets	Segregation of monitoring from the sales function

Cross selling

Distortion: incentive to sell ancillary product becomes the driver for the credit sale

- Example: payment protection insurance
- Central Bank review has shown to date approx. one in five of files reviewed in breach of Code (approx €25 million refunds identified to date)
- Focus of review is non-compliance with Code suitability requirements, but genesis was in level of commission from insurers to sell the insurance

Unregulated activities

Distortion: intermediary incentivised to keep a level of regulated sales going when of little real importance to their customer proposition

- Example: estate agent with mortgage and insurance intermediary authorisations
- Use of regulated status as a brand for unregulated activities
- Confusion in the mind of the public about what is regulated and what is not
- Conflict of interest aggravated where intermediary also has a financial interest in the underlying transaction

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Intermediation in Arrears – a new frontier

Debt Management Firms

- New category of regulated entity in Ireland: a person who for remuneration* provides debt management services to one or more consumers

  *means:

  - any commission or other payment,
  - whether paid directly or indirectly, and
  - includes a payment made in respect of the provision of other services as a result of which debt management services are provided

- "Debt management services":

  (a) giving advice about the discharge of debts (in whole or in part), including advice about budgeting in connection with the discharge of debts,

  (b) negotiating with a person's creditors for the discharge of the person's debts (in whole or in part), or

  (c) any similar activity associated with the discharge of debts

Debt management firms – Incentive issues

- Conflict of interest where they receive remuneration from a creditor (especially where multiple creditors)
- Often combined with a payment service for making payments under the negotiated settlement – clarity about what fee is for what service
- Taking fees up front (including capturing subsequent payment services)
- Use of credit to pay their fees (eg by credit card)

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

To conclude

Some Conclusions

➢ **Conflicts of interest:**	Heart of the issue = tripartite conflict between the interests of the consumer, the interest of the intermediary and the interests of the product producer
➢ **Commercial oversight:**	• Commercial oversight by the product producer is just as important as regulation by the regulator • Potential for problems is aggravated where the intermediary does not stand to lose financially if the product sold does not perform as planned
➢ **Product Development and Governance:**	Need to look beyond commission on one product to: • overall product producer strategy • product development governance • sales strategy • incentives to cross sell
➢ **Arrears Intermediation:**	Issues still emerging

Thank you