

Brokerage in Financial Services

1. Introduction

On 18 October 2002 the Social and Economic Council (SER) adopted the advisory report Brokerage in Financial Services, its response to a request for an opinion from the Minister of Finance on 16 April 2002.

The key point in the report is that the Council feels that the government should introduce a framework act covering all intermediaries in financial services. In addition, there should be a single regulator whose task would be to register intermediaries and issue licences to them to practice as an intermediary if they meet certain criteria. Self-regulation could be worthwhile as a supplement to legislation for certain aspects of the industry.

2. Current situation

A patchwork of laws and regulations

Intermediaries in financial services deal with various types of financial product: consumer credit, mortgages, savings, investments, insurance and financial advice and planning. Different laws apply to each of these products in the Netherlands. There are differences between the various laws with respect to the degree of regulation – and hence the degree of market regulation and competition – and of consumer protection. Insurance and investment are the most tightly regulated sectors, whereas almost nothing is regulated by law for the financial planning sector. The trade associations have drawn up agreements on self-regulation for some products but in other sectors there are none. The terms of these agreements differ greatly. Some agreements cover a number of trade associations and relate to expertise and training, while others concern quality marks as a guarantee for the quality of service. The problem, however, is that these agreements are difficult to compare and regulate something different in each market. Moreover, not all market participants are bound by them. The result is that consumers no longer know where they stand. Some self-regulation agreements cover practically the entire market (such as the Code of Conduct for Mortgage Financing), and the participants in others are actively trying to extend their coverage (for example, the Code of Conduct for the Provision of Information about the Service Provided by Intermediaries). The conclusion is that brokerage in financial services is a patchwork of statutory rules and agreements on self-regulation.

A heterogeneous market

The important role that intermediaries play in transactions between the suppliers of financial services and consumers is apparent from the fact that in 2000 more than half of the premium income for insurance policies in the Netherlands was generated by intermediaries. For mortgages the proportion was around half, and for consumer credit just over a third. The total turnover of intermediaries was almost €70 billion in 2000.

Intermediaries generally work on a commission basis in the Netherlands; the supplier pays the intermediary. In the case of insurance brokerage, the legally binding structure underpinning the payment of commission by the supplier to the intermediary was abolished on 1 April 2002. This will create more scope for other forms of remuneration, such as working for an hourly rate, which only occurs sporadically at the moment.

By contrast with the legislation, which is targeted at individual sectors, the trend in the market has increasingly been towards greater integration in both the supply and the distribution of financial services. Financial products are increasingly sold in combinations: a mortgage is linked to a life insurance policy, and it might also be based on an investment construction. On the distribution side, an intermediary no longer handles just a single product but increasingly mediates for a range of products, including insurance, mortgages and securities. In addition, financial services brokerage is increasingly a subsidiary activity rather than a principal activity.

The market for financial brokerage services is an open market; entrants have to invest in knowledge and in building up a customer base, but otherwise they can enter the market with relatively modest funds. Another characteristic of financial services is that it is difficult to secure advantages of scale. There are few tools available that would enable intermediaries to reduce the average costs of production by increasing scale. Consequently, most firms in the sector fall into the category of small companies (2-10 employees).

3. Background to the Council's advisory report on financial intermediaries

The request for an opinion

In the summer of 2001 the Ministry of Finance published a consultation document which included a description of the market for financial intermediaries. This description was based on four quality criteria: transparency/provision of information, expertise, integrity/conduct and financial security. This consultation document led to the request for the Council's opinion in the spring of 2002. In that request the government announced that it intended to establish general duties of care in law in order to guarantee the quality criteria. The government wants the Authority for the Financial Markets (see box) to supervise compliance with these duties of care.

In defining the duties of care, the government also wants to leave room for self-regulation. Consequently, the general question it posed to the Council is: to what extent can the statutory duties of care be implemented through self-regulation? The answer to this question must take account of the requirements of cross-sector consistency (consistent rules for the different types of financial service) and distribution consistency (consistent rules for the various methods of distribution).

Supervision of the financial market sector

At the beginning of 2002 it was decided that supervision of suppliers in the financial markets would be reformed in phases. The key to the reforms is a shift from a sector-driven model of supervision to a functional model of supervision. The functional model recognises two types of supervision, each with a different objective: prudential supervision and supervision of conduct. Prudential supervision is concerned with safeguarding the financial solidity of financial institutions. The purpose of supervision of conduct is to promote the orderly and transparent operation of the market and fairness in relations between market actors and, in that context, to protect the consumer.

Prudential supervision has been assigned to the Netherlands Central Bank and to the Pension and Insurance Supervisory Authority. The Authority for the Financial Markets is responsible for supervising the conduct of market participants. Because supervision of the intermediaries in financial services will primarily be concerned with their conduct, the government proposes making the Authority for the Financial Markets responsible for supervising intermediaries as well.

National and European regulation

New regulations governing intermediaries in financial services must fit into the framework of existing national and European legislation. The principal national legislation in this context is the Competition Act, which imposes restrictions on the scope and content of self-regulation. Self-regulation can lead to undesirable market protection, which might in fact make the market more rigid instead of creating the hoped-for increase in the efficiency of the market. To this end the Competition Act includes a ban on forming cartels; companies may not make agreements that prevent, restrict or distort competition. But the Competition Act does offer the possibility of an exemption from the ban on cartels if a number of conditions are met. The advisory report concludes that in principle the Competition Act does leave room for agreements on self-regulation which include conditions obligating companies in the financial sector to meet quality criteria with respect to information, expertise, integrity and financial security.

The European Union has drafted directives for various financial services, which the Netherlands must also comply with. In particular, the recently amended directive for insurance brokerage will impact the policy on brokerage in financial services, as the directive includes a number of binding provisions relating to the quality aspects of insurance brokerage, which will have to be implemented in Dutch legislation. Given the requirement of cross-sector consistency, in the Netherlands these provisions will also apply for intermediaries in mortgages, loans and securities. In this way the European directive on insurance brokerage in fact established the minimum requirements for the regulation of the entire financial services brokerage market.

4. The recommendations

Government intervention?

The first question is whether there is any reason for the government to intervene in the brokerage in the financial markets. The Council's response is a resounding 'yes', since the consumer has a major interest in a financial service and is vulnerable if anything goes wrong. The consumer also has less information than the intermediary and the supplier. Government intervention also serves the general interest that it prevents negative external effects, not only in the sense of financial crashes but also in the sense of bankruptcies and damage to the sector's image. A final factor is the growing integration in supply and distribution.

The Council therefore feels that the government has a clear responsibility to create the institutional framework that will provide a better balance between supply and demand.

Framework act and limited self-regulation

The Council is a fervent supporter of a new framework act for brokerage in financial services. This act must include duties of care for the four quality criteria of the sector: integrity, information provision, expertise and financial and legal certainty. The advantage of guarantees embodied in legislation is that they are generally binding; the entire market is bound by the same rules and that improves the transparency of the market. The statutory duties of care must provide assurances for adequate consumer protection in the market for financial services and should improve the operation of that market by creating an impetus for the quality of the service.

The Council gives a qualified answer to the central question in the request for an opinion, namely to what extent the statutory duties of care can be implemented through self-regulation. The balance between legislation and self-regulation will differ from one quality criterion to the next. For the criteria integrity and financial and legal security, the public interest is so evident that they should be governed mainly by legislation. For these quality criteria self-regulation will remain limited to the standard of prudence to be shown towards the consumer and the creation of a scheme for settling complaints. For the other two quality criteria, information provision and expertise, the Council feels there is more room for self-regulation. This would involve codes of conduct, certification schemes and quality marks which specify the duties of care of the intermediary.

On balance the Council feels that there are limits to cross-sector self-regulation in this industry. This is because it will be difficult for agreements on self-regulation to meet the condition of full market coverage that the Council stipulates for the protection of the consumer. Another point is the competition aspect. The Council feels that it cannot be left to the industry itself to determine access to the industry.

Finally, the Council feels that the requirement of consistency of distribution means that the suppliers of financial services will have to meet the same demands as intermediaries.

Licensing and Supervision

The Council observes that at the moment there are gaps in the supervision of financial services because the legislation is targeted at sectors. Only intermediaries in securities are directly supervised and require a permit. A necessary step towards effective supervision is that all intermediaries should be required to have a licence and to be registered. A licence would be issued if the intermediary shows that he meets the requirements and standards of the quality criteria. In firms with more than one employee, the de facto management must be able to show that the requirements of the permit are met.

The Council feels there should be one regulator for all intermediaries in financial services and that it should issue the licences. This regulator should be the Authority for the Financial Markets. Besides granting licences and registering intermediaries, the regulator should also conduct spot checks to see whether intermediaries are still complying with the terms of the licence ('repressive supervision'). In this way the Authority for the Financial Markets would assess the conduct of intermediaries against the standards set out in law or in the agreements on self-regulation. The Authority for the Financial Markets must have the power to impose sanctions in the event of infringements, such as a fine, publicity about the offence or withdrawal of the licence.

Advisory and consultative body

The Council feels there is a role for a new Consultative Forum on Financial Services to work out the specific standards for the four quality criteria. This body should stimulate and oversee the consultation between the parties in the market aimed at developing cross-sector forms of self-regulation. The body can also act as the voice of the intermediaries in financial services and advise the government as it prepares and drafts legislation in the area of financial services.