Speech Theodor Kockelkoren, boardmember of the Netherlands Authority for Financial Markets AFM at a conference of the European Money and Finance Forum SUERF in Madrid

Dear Ladies and Gentlemen,

Let me thank my dear hosts, the CNMV and SUERF, for inviting me to this happy occasion: 25 years of regulation and supervision by the CNMV. Feliz cumpleaños!

Perhaps your appetite has been wetted with the ambitious title “Protecting financial consumers and retail products: a case for smart intervention and information”. Within the short amount of time we have, I cannot do justice to the complete title, except then to present one case of a hopefully smart intervention to protect financial consumers. Before I present the case, however, we need to discuss the context of our subject.

The title of this first session today suggests that we may all feel trapped to always provide more information, in one form or another, in order to protect financial consumers. Both scientific research as practical experience learns us that we should be humble when it comes to expecting major impact from ever more information. Naturally, we should become more clever in using our insights in how consumers behave to shape effective information requirements. Obviously, we should feel skeptical about the usefulness of 120 page prospectuses written in legalese, which – just to be utterly clear – no ordinary investor is able to understand. And appropriately, regulators using insights in behavioral science, are aiming to develop Key Information Documents that hit their target better. Still, we can only expect so much from these endavours and that is why we – in addition, I should rush to underline – ought to think about other smart intervention approaches.

We can directly intervene with the products to ensure that products are in the interest of the customer group they have been designed for. For example, teaser rates in mortgage products can restricted, difficult to understand coverage limitations in insurance can be forbidden or products that are fundamentally different to understand for retail customers could be banned (certain structured products fall in this category).

We can also intervene with the sales and advice practices, something which is already done in many countries. The case I wish to present to you today, in the short amount of time we have together, is about intervening to eliminate or at least significantly reduce adverse incentive structures within the financial industry. These incentive structures have been seen in the Netherlands to hold back the industry to develop products and services in the interest of its customers. Indeed, the case zooms in on banning inducements handed out by product manufacturers to advisors or other distributors in order to have their products sold to customers. The aim of the ban in the Netherlands is to enable the industry to provide their customers with high quality financial products and good quality support in their decision making.

The ban has been introduced in 2013 in the Netherlands and I have set out to present you some early experience about the impact of the ban. I will present facts as well as our impressions, using a consumer lens, first looking at services and then products. I will conclude with a brief assessment of the risks of unintended consequences.

Services

Looking at services, a striking feature of the inducement ban is the increased pricing differentiation. Previously, execution only customers in the Netherlands would pay easily 75 bp for a very narrow service, actually as much as customers that receive a fully fledged advice in return. Since the ban, execution only customers pay no more than 25 bp. With 70% of all customers being execution only customers in the Netherlands, who collectively own 40% of the invested assets, this differentiation represents a saving of 300 million euro a year.

Another feature of the inducement ban is the increasing differentiation between service concepts. Whereas in previous times customers had two main choices: doing everything oneself (execution only) and complete bespoke advice; now, customers have more choice. Increasingly, service concepts are introduced that offer significant additional value compared to execution only, yet are not as comprehensive as bespoke advice. For example, self directed advice tools are introduced or automated advice is experimented with. Our impression is that the ban on inducements is allowing the rapid technology developments to have their impact on financial services.

Products

Another impression is that with the introduction of the inducement ban, competition between product manufacturers has increased. This can be seen in the fact that some manufacturers have started to reduce prices, especially in the passive product segment. A number of manufacturers have reduced their prices by roughly 50%. This is probably in part the result of the fact that passive funds have become more popular with retail customers. In the Netherlands the share of retail invested assets allocated to passive funds roughly doubled between 2011 and 2014 – from 8% to 16%.

The increased competition between product manufacturers is probably also due to an increased sensitivity of distributors to product quality. Previously, they were keen to negotiate the most favorable distribution inducement, or retrocession. Indeed, the biggest distributors typically could extract higher inducements from asset managers than their smaller competitors. Since the inducement ban, necessarily distributors are trying to optimize their revenues in other ways. They are now focusing more on their customers, experimenting to find that mix of service concepts that best serves their customers' needs. Part and parcel of this new strategy are efficient as well as high quality investment funds. As we hear from the industry, this has fundamentally changed the discussions between asset managers and distributors.

Risks

Debating the merits of the inducement ban, the risk of a flight to execution only away from advice and portfolio management was discussed extensively. Two years into the ban, we can see a slight increase in the execution only customers (from 70% to 75%). At the same time, we can also see an increase in portfolio management customers (up from 6% to 11%). These increases are indeed at the expense of advice.

To be honest, these developments could be seen also well before the introduction of the ban. This is understandable, since the advice concept is ill conceived, especially in the mass market. Customers are free to deviate from the advice and, at the same time, the advisors have no way of effectively tracking these deviations. As a result, effective advice is not really possible. Also, no clear responsibility between customer and advisor is agreed on. As a result, when portfolios tank, relationships sour very quickly. It is no coincidence that the move away from advice started after the crisis hit in 2008.

To put insult to injury, the way advice typically is executed in the mass market does often time not pass the required quality mark. The investment objective is too often identified in very general terms. The financial position is most often only identified within the scope of the relationship with financial institution providing the advice: deposits or investments elsewhere are not taken into consideration. The identification of the ability and appetite of the client to take on risk is typically a half baked cake: only appetite is identified – sometimes in ill conceived ways. We made this assessment in the Dutch market by looking in detail at well over hundred customer files. And yes, we enforce improper behavior on the level of the firm and in some cases also on individual level.

Having heard this, should we shed tears over the demise of advice? Perhaps not. However, clearly, many customers would benefit from receiving good quality support for their investment decisions. We believe, in the mass market, technology is set to play an critical role. It can realize good quality advice or support concepts at a price that suits the size of the smaller portfolios.

When it comes to tears, however, we should be forgiven if we shed a tear over the Mifid 2 political compromise regarding inducements. In Mifid 2 a ban has been introduced for independent advice as well as portfolio management. At the same time, execution only and tied advice can still receive inducements. This is not entirely different from the inducement ban in the UK, where execution only has been exempted from the ban. As a result, sales through the execution only has grown very strongly since RDR was implemented (55% in the first year and 45% in the second).

I think this should not come as a surprise, given that customers being only charged directly in the case of independent advice and portfolio management, feel that execution only is for free. Thus, we should feel worried, now that execution only and tied advice have been exempted from the inducement ban in Mifid 2, both may gain ground at the expense of independent advice and portfolio management. This is quite ironical, since during the debates so much was made of the risk that customers would flee to execution only. Now, as a result of the compromise, precisely this risk may be realized.

***

This brings me to the end of this case. If anything, I think the case makes clear that designing smart interventions is by no means easy. It requires good thinking and at the same time experimentation. In this case, the inducement in the Netherlands is perhaps an interesting experiment within the European area. It will take another two years, however, before we can seriously take stock.