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### Marktfalen bij tussenpersonen: Onderzoek naar marktfalen in de intermediaire bedrijfstak voor financiële dienstverlening

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## Summary

The intermediate sector in financial services plays an important role in Dutch society. Many consumers and businesses base their financial decisions on the advice of an intermediary or broker. Especially when purchasing complex financial products, a good opinion is of great importance, since most consumers (and businesses) do not properly assess their form on the right product for them and because the impact of financial products on the welfare and prosperity of consumers and businesses can be great. The intermediate industry, and other parts of the financial sector, is under the suspicion of market failure. This thesis is primarily about the current role and position of the intermediary as a distribution channel for financial products. Market failures in the context of the intermediary industry occur when consumers (or businesses) purchase wrong financial products, because the financial adviser who mediates the client does not fully inform and advise (*De Jong, 2007*). This leads to market failure and welfare loss.

Financial intermediation in the Netherlands is undergoing a transformation phase. The government has intervened to the functioning of the market and particularly to protect consumers. Since 2000, many legislative measures were taken to regulate the intermediary industry and to reduce the risk of market failure. The most drastic measure is the introduction, in 2006, of the Financial Services Act (amended the Act on Financial Supervision in 2007), by which all intermediaries were placed under supervision and the Financial Markets Authority (AFM), was introduced. In addition, the primary existence of intermediaries is under pressure by technological changes and market conditions are a threat to the intermediary.

This thesis describes the research, which is done into the existence and the risk of market failure in the intermediate sector. It is assumed that the intermediary industry is failing and that the intermediary industry itself has a role to play in reducing the market failure. For this thesis there are four research questions of interest.

1. Is there a market failure in the market for financial advice?
2. Is the existence of intermediaries necessary in reducing market failures?
3. What role can intermediaries play in minimizing the market failure?
4. Intermediaries lead to market failure or intermediaries reduce the market failure?

To understand the functioning and operation of the intermediary industry, the new institutional theory and the theory of financial intermediation is mainly used. In addition, the Structure-Conduct-Performance paradigm (SCP) is used to

describe the market and for the causes (and thus the possible solutions) of market failure analysis.

The intermediate sector is at the mercy of market failure. In a perfectly functioning market intermediaries have no function. The intermediate sector derives its value from the existence of transaction costs and information asymmetry. Because of transaction costs for consumers and businesses it is often cheaper to switch to an intermediary for the conclusion of financial products like mortgages and insurance. In particular this applies to complex financial products. The intermediate sector is also characterized by the existence of principal-agent relationships. The intermediary acts as the agent between the principals providers (banks and insurers) and buyers (consumers and businesses) in financial products.

The Netherlands has approximately 9,400 intermediaries, who together represent half of the existing mortgage and insurance sales. The industry consists mainly of small companies who depend for their sales heavily on mediation in non-life insurance. In addition, the intermediary industry is also active in life insurance and mortgages. An important feature of the intermediate system in the Netherlands is the commission system. Almost all intermediaries are being paid for their service through commission by the provider of financial products. Until eight years ago, the only form of remuneration authorized by the law, was commission. The commission is a percentage of the premium or monthly mortgage payments. Only a small proportion of intermediaries is directly paid by the customer, through a fee or subscription. Because the intermediaries can hardly affect the amount of the commission, they cannot themselves determine prices for their own services. In addition to the typical charging system, commission based advice provides a degree of cross-subsidy and commission has three forms of bias. That is a supplier, a product and a final price bias. Through the commission system the relationship between providers and intermediaries is very close. Between providers and intermediaries there are contractual arrangements made through cooperative agreements. Conversely, between intermediaries and consumers, hardly any contractual arrangements are being made. That is not necessary because the amount and payment for the intermediary services in the commission system, is an agreement between providers and intermediaries. However, the legislature determined that intermediaries should be transparent about the service on all products and the amount of the reward for complex products and mortgages. The close relationship between suppliers and intermediaries is striking because the same providers compete with intermediaries through direct sales channels. Especially the direct selling of insurance over the Internet provides a lot of competition for the intermediary, with figures showing that the intermediary in this market is losing market share.

In this thesis, the structure, conduct and outcome of the industry is being reported, is analyzed whether there is market failure and is considered what role the intermediary could or should play in reducing market failures. This thesis shows that there is market failure in the intermediate sector. The table below shows where the market fails.

SUMMARY

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*Risk of market failure intermediary industry*

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|                       |     |
|-----------------------|-----|
| Externalities         | +/+ |
| Market power          | -/- |
| Public goods          | -/- |
| Information asymmetry | +/+ |
| Transaction costs     | -/+ |

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(De Jong, 2010)

The results of the theoretical analysis of market failure are supported by the description of research with has appeared in respect to the intermediary industry. The causes of market failure are based on both theoretical and practical underpinnings, primarily sought in the relationship between providers and intermediaries and their compensation structure. A deeper analysis of the market failure shows that the risk of market failure is greater in the market for complex products and mortgages, than in the market for non-complex products. This is partly due to the fact that the reputation mechanism in the market rarely plays a role. Another found result is that the market failure in the intermediate sector is less than in a market where no intermediaries exist. This is because in a market without intermediaries there is a greater risk of developing market power with suppliers than in a market with intermediaries. In addition, a continuous risk of market failure exists because of the low involvement of consumers when purchasing financial products and the fact that consumers do not directly pay for intermediary services. The field research further shows that in addition to the intermediary sector, especially banks and insurance companies have contributed to market failure. Moreover, the government and consumers themselves are partly responsible to the emergence of market failure. The market failures of the intermediate sector are therefore not by itself but is part of the failure of the entire financial sector. This thesis is however primarily on the role and function of the intermediary industry.

The market failure in the intermediate sector is problematic for the welfare of consumers and businesses; mainly by the effect that giving bad advice can have on the income of recipients. The conclusion is therefore that action must be taken to minimize market failure and to reduce the risk of market failure in future. Because research into the market failure demonstrates that a market without intermediaries is an even greater risk of market failure, this does mean that intermediaries are necessary to reduce the risk of market failure.

The government also recognized the existing market failure and the risk of continued market failure in creating the instruments of legislation and supervision deployed. It is noted that the legislation is very extensive and recent, and costs of supervision is threatening to go out of control. Then there is the risk of regulatory failure. Both the government and the regulator formulate a target for the intermediary industry to a better functioning market through effective competition. Yet the result of the government policy is that good market functioning has not been realized. The commission system is still dominant and causes of market failures are only partially addressed.

Although most effects of the regulation of the intermediary industry have yet to be observed, the conclusion is that the intermediary industry should lower market failure itself. In addition, the role of intermediaries must change to minimize the risk of market failure. The intermediary is threatened in its primary *raison d'être*, reducing transaction costs and reducing information asymmetry. This is because the technological developments have made directly purchasing of financial products easier and because the knowledge of the purchasers of mortgages and insurance has increased. In addition there is a reorganization going on in the intermediary market and there is strong competition. This makes it necessary for intermediaries to clarify their position towards consumers and businesses, in particular their relationship with suppliers, the degree of independence and the mode of calculation and amount of remuneration.

This thesis ends with the conclusion that intermediaries both increase and reduce the risk of market failure. The government should stimulate the latter role of intermediaries. This means that within clear legal frameworks, the intermediary industry should be given tools to fulfill the function to serve the public interest. Improving quality of service is priority. This thesis calls for a ban on commission to all complex or risky products. Among them are also consumer and mortgage loans and insurance income rallied. A commission ban is the most effective measure for the public sector, providers and intermediaries, since caused by introduction of this statutory provision, other remuneration rules can be abolished. In addition it is found that even in the market for non-complex products, there is market failure, because there is barely price competition in this market. This thesis calls for transparency of remuneration in the market for non-complex products. It is further recommended to work on an independence score, to allow consumers to get clear insight into the degree of independence of intermediaries. Due to the current fragmentation within the broker channel, the organization rate is low despite the multitude of associations, the government could consider to oblige intermediaries to organize into a recognized industry association, so self regulation can actually become a factor of significance. This thesis seeks a balance in order to get a better market for financial advice. And where there is less reason for government intervention and supervision. This balance is found by letting go of the commission system completely with complex financial products, to introduce transparency of remuneration in non-complex products, and closing contracts between intermediaries and customers. In this approach, the industry should itself work towards a better functioning market.

In summary, the conclusion, based on the analysis of the research questions, is as follows.

1. There is market failure in the intermediate sector.
2. The intermediary is needed to reduce market failures.
3. Better a market with than a market without intermediaries.
4. Intermediaries lead to market failures and intermediaries reduce market failures.
5. As products become more complex, the risk of market failure increases.

## SUMMARY

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6. The added value of intermediaries changes from reducing transaction costs and information asymmetry to risk bearer and risk manager.
7. The structure of the intermediate sector is the main cause of market failure.
8. The legislator and the supervisor are influencing the proper functioning of the market.

Based on the above findings, this thesis has the following policy recommendations:

1. A ban on commission to all complex, risky products is necessary to structurally reduce the risk of market failure.
2. The role and position of the intermediary should be more transparent for the customer. The degree of independence must be made tangible and measurable.
3. The quality of intermediaries should be measurable and should be an important part of the reward. Transparency leads to greater quality of advice.

Based on the above findings and recommendations, the transformation of the intermediary industry is to take shape. To eventually establish a future-proof industry that is characterized by transparency, independence and effectiveness.

*Veenendaal, 2010*