

ACP ADVICE TO EIOPA ON PROPORTIONALITY AREAS IN AWP 2024

In accordance with Article 1(7) of Regulation (EU) No 1094/2010, EIOPA established, as its integral part, the Advisory Committee on Proportionality (the “ACP”). The ACP shall advise EIOPA as to how, in full compliance with applicable rules, EIOPA’s actions and measures should take account of specific differences prevailing in the sector, pertaining to the nature, scale and complexity of risks, to business models and practice as well as to the size of financial institutions and of markets to the extent that such factors are relevant under the rules considered.

The Committee shall assess the proportionality aspects set out in Article 1(7) of Regulation (EU) No 1094/2010 concerning the applicable regulatory framework and shall advise EIOPA in which specific areas proportionality can be improved or prioritised and give advice on possible elements to be explored by EIOPA.

The Committee may provide ad hoc advice to EIOPA on its own initiative and shall review how EIOPA has taken into account the Committee’s advice.

The ACP Advice is a key opportunity to raise awareness on proportionality aspects, both from regulatory perspectives as well as implementation aspects, before policy or supervisory work is initiated by EIOPA. Consideration of proportionality will support the reduction of unnecessary operational complexity and burden in EU law.

After consideration of EIOPA planned activities for 2024 the ACP decided to address in its Advice proportionality considerations on the Recovery and Resolution area in view of the new Directive under negotiation and on the Product Oversight and Governance requirements.

As established in Articles 18, 25 and 29 of EIOPA's Regulation, EIOPA shall promote common supervisory approaches and practices in the field of crisis prevention, management and resolution.

The Advice regarding Recovery and Resolution is written considering the content of the COM proposal and should not anticipate any discussion at political level. The ACP may revise its Advice in the future considering the development of the discussions.

The ACP identified the following areas to provide advice. The areas proposed reflect the priorities identified but as well resources availability and the regulatory developments on-going.

1. Insurance Recovery & Resolution (IRR) in view of the new Directive

The IRR is currently under political negotiation and should apply in the future to insurance and reinsurance undertakings complementing the Solvency II Directive. The IRR has the objective of ensuring an orderly failure of insurers and minimising its effect and impact on policy holders, beneficiaries, insured parties and affected business, ultimately ensuring financial stability. When addressing proportionality these objectives must be taken into consideration.

The IRR introduces several new requirements for undertakings and authorities. Recovery plans are to be developed by undertakings, while the resolution authorities develop resolution plans and apply the resolution tools. The framework should be based on the principle of proportionality and give

competent and resolution authorities the opportunity to apply proportionality with regard to specific requirements for certain undertakings under their jurisdiction. Proportionality is a principle which seeks to ensure that the recovery and resolution framework delivers its objectives while limiting excessive (administrative) burden and ensuring an efficient use of the existing resources both for authorities and undertakings.

The application of the proportionality principle, however, should not lead to a situation in which policy holders of smaller or less risky companies (e.g. when the entity is material for the public interest) are less protected than those of riskier ones.

The specific nature of the undertaking (e.g. in case of a mutual or captives) should particularly be taken into account.

The IRRD already includes a number of proportionality elements by addressing the scope of recovery and resolution planning, simplified obligations and the use of the tools.

- Scope: The IRRD applies to the same scope of undertakings as defined in Solvency II. However, for proportionality reasons, the scope of undertakings subject to recovery and resolution planning is lower (covering a market share of at least 80% for pre-emptive plans and 70% for resolution plans). Additionally, the legal text provides several factors to allow for a risk-based decision:
 - o For pre-emptive plans, the supervisory authority should consider the size, business model, risk profile, interconnectedness, substitutability and, in particular, cross-border activity of the undertaking.
 - o In similar terms, for resolution plans, the resolution authority should consider size, business model, risk profile, interconnectedness, substitutability and the likely impact of the failure on policy holders. The draft also indicates the need to take into account, in particular, the cross-border activity of the undertaking.
 - o In addition, undertakings to be classified as low-risk profile (or similar) as a result of the current review of Solvency II are exempted from pre-emptive recovery planning requirements or resolution planning on an individual basis.
- Simplified obligations: article 4 of IRRD on simplified obligations for certain undertakings are a key aspect to ensure proportionality. They are proposed in relation to the contents and details of pre-emptive recovery plans, the date by which the first pre-emptive recovery and resolution plans are to be drawn up and the frequency for updating them, the content and level of detail of the information required from undertakings or the level of detail for the assessment of resolvability.
- Use of the resolution tools and the removal of resolvability impediments: authorities should adopt a proportionate approach when deciding on the resolution tool to be used and the actions to be taken to ensure resolvability of undertakings.

Resolution authorities need to consider whether the condition for resolution laid down in Article 19 are met (including the public interest), in order to decide whether an insurance or reinsurance undertaking needs to be resolved or wound up under normal insolvency proceedings. In practice, this means that not all insurance and reinsurance undertakings may qualify for resolution if the resolution action is not necessary in the public interest.

However, the IRRD will require the development of several Implementing Technical Standards (ITS), Regulatory Technical Standards (RTS) and Guidelines. This means that the IRRD is a framework

directive and regulatory and implementing issues will be addressed at the level of technical standards to be drafted by EIOPA as well as EIOPA Guidelines.

Possible areas for enhancement/review:

- **Simplified obligations for certain undertakings (Article 4)**

Of those undertakings which are subject to recovery or resolution planning, simplified obligations are supposed to be applied to certain of these undertakings. When developing the Guidelines referred to in Article 4¹, EIOPA should perform a quantitative and qualitative impact assessment to ensure whether the definition of the eligibility criteria will lead to an adequate application of the simplified obligations on an individual basis.

- **Pre-emptive recovery plans (Article 5)**

As stated above the application of the pre-emptive recovery plan applies only to at least 80 % of the market share. In any case, EIOPA is requested to develop draft RTSs further specifying the information that an insurance or reinsurance undertaking is to include in the pre-emptive recovery plan, including the remedial actions and their implementation. Already under Article 4 a simplified pre-emptive recovery plan is foreseen. On an annual basis, EIOPA shall publicly disclose the number of insurance and reinsurance undertakings and groups subject to pre-emptive recovery planning and resolution planning; the number of insurance and reinsurance undertakings and groups benefitting from simplified obligations; quantitative information on the application of the criteria; a description of the simplified obligations applied on the basis of the eligibility criteria; and an assessment of the divergences regarding the implementation.

From a proportionality perspective it is important that room is left for different implementations of the content and the detail of the pre-emptive recovery plans that achieve the same result, considering the scope of entities that will still be covered by Article 5.

It is important that the way EIOPA will develop the RTSs still allows for proportionality for the information to be submitted to the authorities in the pre-emptive recovery plan by the entities that will be covered by Article 5 as such entities are still expected to be very different in terms of nature of their business, their shareholding structure, their legal form, their risk profile, size and legal status, their interconnectedness to other regulated undertakings or to the financial system in general, the scope and the complexity of its activities, and whether its failure and subsequent winding up under normal insolvency proceedings would be likely to have a significant negative effect on financial markets, on other undertakings, on policy holders, on funding conditions, or on the wider economy.

- **Resolution planning (article 9)**

Resolution authorities shall draw up resolution plans for insurance and reinsurance undertakings to be selected on the basis of their size, business model, risk profile, interconnectedness, substitutability and the likely impact of the failure on policy holders. When selecting the insurance and reinsurance undertakings subject to resolution planning, the resolution authority shall in particular take into account the cross-border activity of the insurance or reinsurance undertaking and the existence of critical functions.

From a proportionality perspective the specification of further criteria for the identification of critical functions to be developed by EIOPA under Guidelines will be key.

However, the specification of “critical functions”¹ should respect the general definition of critical functions and aim to assess de facto criticality of some functions and should not be employed with the aim of limiting the scope of resolution planning if that is not justified by proportionality.

2. Product Oversight and Governance (POG)

The ACP has discussed the proportionality principle in the context of conduct supervision focusing on POG Delegated Regulation as a key area to provide advice, reflecting ongoing supervisory priorities as well as resources availability and the ongoing regulatory developments.

Most significantly, assessing the application of proportionality in the context of POG will contribute to EIOPA’s recent and ongoing work on POG-related aspects and to EIOPA’s supervisory convergence objectives. EIOPA has recently or is currently developing various pieces of work on POG requirements which are expected to bring clarity on how the proportionality principle is applied in practice and contribute to possible recommendations.²

The processes of product manufacturing and product governance measures should be chosen and applied in a proportionate and appropriate manner under POG requirements. The IDD explicitly stipulates, “the product approval process shall be proportionate and appropriate to the nature of the insurance product.” As such, insurance undertakings and intermediaries have to determine whether the product approval process is appropriate for the nature, scale and complexity of products when they manufacture them.

Furthermore, the POG Delegated Regulation⁽³⁾ states that “in light of the requirements of Directive (EU) 2016/97, product oversight and governance measures should be chosen and applied in a proportionate and appropriate manner, depending on the complexity of the product and the degree to which publicly available information can be obtained, taking into account the nature of the insurance product and the risk of consumer detriment related to it, the characteristics of the target market and the nature, scale and complexity of the relevant business of the manufacturer or distributor.”⁽⁴⁾

In addition, proportionality must be considered through all stages of the POG process. Article 4 of the POG Delegated Regulation states that when designing, monitoring, reviewing, distributing and taking corrective actions for insurance products, the manufacturer must select processes that are

¹ ‘critical functions’ means activities, services or operations performed by an insurance or reinsurance undertaking for third parties that cannot be substituted within a reasonable time or at a reasonable cost, and where the inability of the insurance and reinsurance undertaking to perform the activities, services or operations would be likely to have a significant impact on the financial system and the real economy in one or more Member States, including by affecting the social welfare of a large number of policy holders, beneficiaries or injured parties or by giving rise to systemic disruption or by undermining general confidence in the provision of insurance services.

² Chapter on Product Oversight and Governance – EIOPA’s Supervisory Handbook; EIOPA’s approach to the supervision of Product Oversight and Governance; Union-wide Strategic Supervisory Priorities; Peer Review on Product Oversight and Governance.

³ Commission Delegated Regulation (EU) 2017/2358 of 21 September 2017 supplementing Directive (EU) 2016/97 of the European Parliament and of the Council with regard to product oversight and governance requirements for insurance undertakings and insurance distributors.

⁴ Recital 3, POG Delegated Regulation.

proportionate to the complexity and the risks associated with the products as well as to the nature, scope and complexity of the manufacturer's business.

Possible areas for enhancement/review

Four possible areas for enhancement/review have been identified. These are detailed below. Applying the proportionality principle considering these four factors must not lead to a lower level of consumer protection. Accordingly, the four factors should be jointly assessed and POG requirements differently applied only if all criteria is met.

- Product complexity

It is important to differentiate straightforward and non-complex products from complex products. The POG Delegated Regulation seems to consider straightforward and non-complex products, the products that are compatible with the needs and characteristics of the mass retail market, including current non-life insurance products with a limited, easily understandable scope. Complex products are usually linked to products with a higher risk of consumer detriment, including insurance-based investment products (IBIPs) not covered by Article 30 (3) IDD Directive, such as unit linked.

Applying the proportionality principle implies that POG processes should be relatively simple for straightforward and non-complex products, whereas for more complex products with a higher risk of consumer detriment, including insurance-based investment products (IBIPs) more complex measures are required. In particular, the POG Delegated Regulation states that for more common products, the target market should be identified with less detail while for more complicated products or less common products, the target market should be identified with more detail taking into account the increased risk of consumer detriment associated with such products.

However, the IDD does not set explicit rules on what product types are considered complex or non-complex. To determine product complexity, emphasis should be placed on the ease with which consumers can understand the key features of the product and the risk to which they are exposed, not necessarily how the product is constructed. For instance, considering an IBIP that offers a guaranteed minimum value at maturity of 90% of invested capital, the customer needs to know that he faces a maximum risk of losing 10% of invested capital but does not need to know how financial derivatives are used by the manufacturer to guarantee this.

While the main criterion to assess whether a product is complex or non-complex is whether the product incorporates a structure which makes it difficult for the customer to understand the risks involved, considering the POG process, other features should also be considered when determining the complexity of a product. These may include the nature of the product (non-life or life products), target market (mass retail market or not), the compulsory nature of the coverage, risk of consumer detriment (lower or high), distribution strategy, product understandability, legal complexity, nature, scale and complexity of the relevant business of the manufacturer and/or distributor.

EIOPA should consider whether the proportionality principle could lead to a different application of POG requirements depending on the complexity of a product and whether, in the context of the application of POG requirements, other measures of complexity should be considered.

- Size of manufacturer or distributor & business complexity

Applying the proportionality principle should continue to ensure a level playing field and should not lead to a lower level of consumer protection (quality of advice, service and information to customer, value for money, etc.) for products manufactured and/or distributed by smaller undertakings or

intermediaries. At the same time, small manufacturers and intermediaries might pose a lower risk due to their size; depending, however, on the nature and complexity of the products that they manufacture and distribute. The IDD states that “This Directive should not be too burdensome for small and medium-sized insurance and reinsurance distributors”.

EIOPA should consider whether the proportionality principle could lead to different application of POG requirements depending on the size of manufacturer or distributor and business complexity and how these criteria should be assessed (e.g. market size, number of lines of business (LOBs), number of products etc.).

- Size and nature of risks for consumers

As a general rule introducing proportionality and reduced regulatory requirements must not increase the risk on consumer detriment. Consumer protection takes precedence over possible administrative burden for insurers and distributors. Any reduced application of POG requirements must therefore meet the joint thresholds of no risk of consumer detriment, as well as the size and nature of the risks in question. An additional element to the consumer detriment threshold is the question of liability. The application of proportionality cannot reduce liability of providers or distributors, although it may reduce the level of regulatory requirements.

EIOPA should assess how proportionality might be applied in specific areas of POG requirements and stages of the POG process while meeting the thresholds of no risk of consumer detriment, thus also simplifying and shedding clarity on POG requirements. The assessment could also consider situation rather than status; assessing whether specific combinations of factors create situations that could meet the thresholds for applying proportionality (e.g. a small intermediary distributing simple non-life products, on a mass-market basis).

- Type of customer

Professional clients, as opposed to consumers, might often be offered tailored products.⁵ In practice tailored products are for example the outcome of an open call for insurance tenders, where the specificities of the products are determined by the customer. Where these clients are medium-sized or larger companies there is arguably little or no risk of customer detriment. These companies are not only receiving a product that has been created to meet their specific demands and needs, but they also are likely to have sufficient legal and financial resources and expertise to ensure they take fully informed decisions. Small or micro companies and entrepreneurs represent a different situation and are likely to be closer to a consumer in terms of their knowledge and expertise, the smaller they are. Here there is still a high potential risk of customer detriment and a need for high levels of protection.

The IDD does not define customers and, in addition, EIOPA did not consider that specific types of customers could directly benefit from an exemption of the POG guidelines. Emphasis should be put on the application of the principle of proportionality.

EIOPA should assess how proportionality might be applied to different types of customers and, if relevant, which criteria should be considered in determining types of customers and classifying them. These proportionality measures should not apply when the final customer of the product is a consumer, for example contracts concluded by companies for the benefit of their employees.

⁵ In this context, tailored products are insurance products that do not fall in the exemption of Article 3(3) of the POG Delegated Regulation and are, therefore, insurance products considered to be manufactured and subject to POG requirements. Article 3(3) states that “personalisation of and adaptation of existing insurance products in the context of insurance distribution activities for individual customers, as well as the design of tailor-made contracts at the request of a single customer, shall not be considered manufacturing.”