



FRAMEWORK FOR ASSESSING CONDUCT RISK THROUGH THE PRODUCT LIFECYCLE

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European Insurance and
Occupational Pensions Authority

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PDF	ISBN 978-92-9473-119-7	doi:10.2854/600949	EI-05-18-104-EN-N
Print	ISBN 978-92-9473-120-3	doi:10.2854/2585	EI-05-18-104-EN-C

Luxembourg: Publications Office of the European Union, 2019

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1. INTRODUCTION

EIOPA places particular emphasis on an effective and efficient conduct of business supervision that is risk-based, pre-emptive and proactive, so as to tackle consumer detriment issues at an early stage, rather than only reacting following the emergence of problems. These objectives are at the heart of EIOPA's overarching framework for conduct of business supervision.¹

In 2017 EIOPA's Board of Supervisors committed to further strengthening the work of EIOPA in the area of supervisory convergence, including explicitly in the area of conduct of business. It was acknowledged that **addressing conduct risk requires looking beyond the direct interaction with consumers at the point of sale** (i.e., disclosures and advice). Poor conduct outcomes may result from the characteristics of insurance products, how products are brought to the market and from interactions with customers subsequent to the conclusion of the contract. **This aggregate set of risks is generally referred to as product lifecycle risks.**

¹ Please refer to EIOPA's Strategy towards a comprehensive risk-based and preventive framework for conduct of business supervision; available at: https://eiopa.europa.eu/Publications/Reports/EIOPA-16-015_EIOPA_Strategy_on_Conduct_Supervision_Framework_sanitised.pdf.

2. PURPOSE AND SCOPE

The purpose of this framework is to **identify drivers of conduct risk** and the **implications of these in the emergence of consumer detriment**. The aim is to provide an aid for taking stock of the issues faced by consumers and provide input to the types of risks EIOPA and NCAs should focus on. It can set a common starting point for more practical supervision of particular products, services or market segments, for instance, through “deep dive” thematic work or for policy development in the future – essential for an evidence-based and risk-based preventative approach to conduct of business supervision.

The framework **does not set out supervisory processes or how a risk-based, prospective and proportionate approach to supervision should be put into practice**. In other words, it does not take the place of a risk assessment, and is neither restrictive nor binding on how NCAs should build their own conduct risk assessment capacities. It is critical that supervisors have the flexibility to take into account each market’s own specificities and respond as appropriate, also recognising differences in national legal frameworks, including NCA competences.

The framework **focuses on conduct risk throughout all stages of the product lifecycle**. That is, from the point before a contract is entered into through to the point at which all obligations under the contract have been satisfied.

Key market failings in financial services for retail customers are a critical part of the context in which this framework has been developed. Notably, these include asymmetries of information and principle-agent problems, but it is critical also to understand these market failings in the context of behavioural perspectives, which have increasingly shown some of the challenges faced by regulatory and supervisory interventions aimed at effectively addressing these market failings. Conduct risks arise in the context of consumer and firm behaviours that are constrained in ways that traditional economic analysis did not fully grasp.

The framework considers a **broad definition of conduct risk** to embrace an all-encompassing perspective. It assumes conduct risk to be, as defined by the International Association of Insurance Supervisors (IAIS), “the risk to customers, insurers, the insurance sector or the insurance market that arises from insurers and/or intermediaries conducting their business in a way that does not ensure fair treatment of customers”.²

The analysis is restricted to conduct risk although EIOPA **recognises the interrelationship between conduct and prudential issues**. Furthermore, in keeping with EIOPA’s Regulation which places “fostering protection of policyholders, pension scheme members and beneficiaries” at the core of EIOPA’s purpose, the framework **focuses on conduct risk from the perspective of retail customers**. Also, considering the EU-wide focus of the analysis, **no country-specific conduct issues are included**, though conduct risks are likely to cluster in different ways in different EU Member States.

The focus on risks from a product lifecycle perspective is only one perspective on conduct risks. Business model or value chain analysis are two alternative perspectives (though some aspects of these are already included in the framework). All of these perspectives can be complementary and valuable in identifying risks and their drivers. A holistic approach incorporating different methodologies and perspectives is ultimately more likely to be robust than a single perspective. Further work on business models and value chain analysis in the context of conduct risk is anticipated.

² International Association of Insurance Supervisors – Issues Paper on Conduct of Business Risk and Management, 2015; available at: <https://www.iaisweb.org/page/supervisory-material/issues-papers>.

3. APPROACH AND METHODOLOGY

The analysis and description of the drivers of conduct risk is purposely high-level but aims to be comprehensive. This stems from the purpose of the framework – identify and map drivers of conduct risk – and the diversity of insurance and pension products which are impacted by the identified risk drivers to varied extents.

The risks considered in this framework can be grouped as follows:

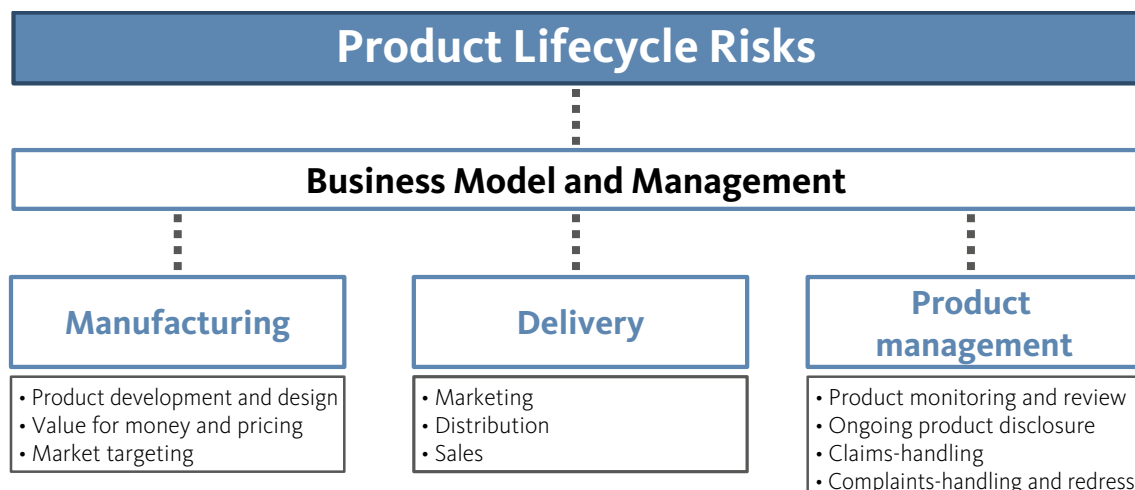
- **Business model and management risks** – risks arising from how undertakings structure, drive and manage their business and from relationships with other entities in the value-chain;
- **Manufacturing risks** – risks arising from how products are manufactured by insurance undertakings (product manufacturers) prior to being marketed and how they are targeted to customers;
- **Delivery risks** – risks arising from how products are brought to the market and from the interaction between customers and insurance undertakings or intermediaries at the point of sale;
- **Product management risks** – risks arising after the sale of the insurance product relating to how products are managed and how insurance undertakings or intermediaries interact with and service customers until all obligations under the contract have ceased.

Business model and management risks are risks at the level of insurance undertakings and, to some extent, intermediaries, that **relate to aspects that can impact customers at the various stages of the product lifecycle**. In this regard, these risks are distinct from the other risk categories considered in the lifecycle continuum and are positioned above them.

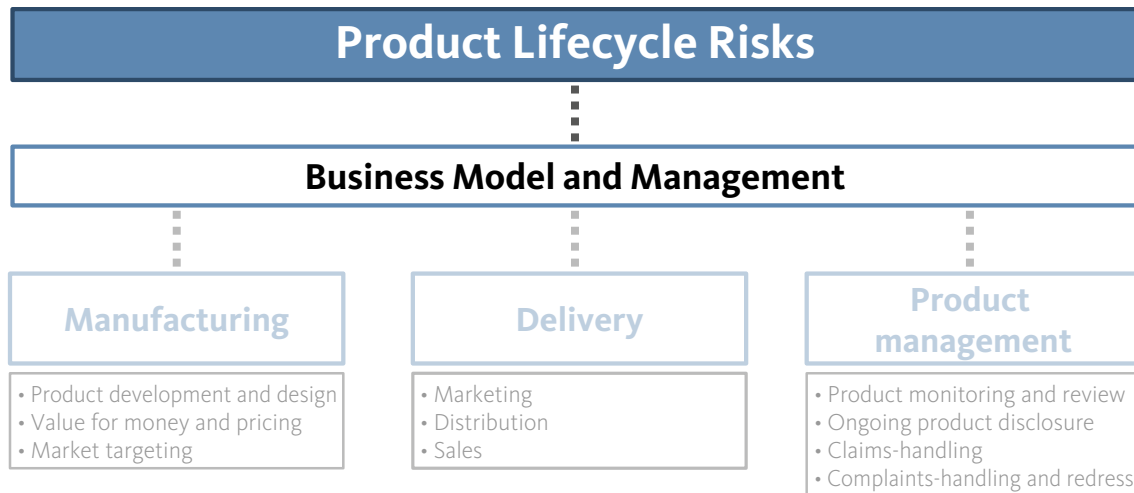
Risks are grouped in the four categories and discussed separately. It is recognised that the **risks are seldom independent**. They can be highly **correlated and interrelated, making it difficult to isolate their effects or root drivers or causes**. For illustrative purposes, examples of conduct risk for certain insurance products are presented.

For ease of reading and simplicity, the paper generally refers to “insurance undertakings” or “undertakings”. It does not distinguish between insurance undertakings and insurance intermediaries that manufacture insurance products where issues are the same. In a similar vein, the paper refers to “insurance distributors” or “distributors”, not distinguishing between insurance intermediaries, ancillary insurance intermediaries or insurance undertakings that carry out insurance distribution. Distinctions are nonetheless made when relevant for the analysis.

The next diagram depicts the mapping of the risks described above.



4. BUSINESS MODEL AND MANAGEMENT RISKS



Business and management risks are those risks arising from the way undertakings structure, drive and manage their business and from relationships with other entities in the value-chain.

accelerating growth, both of which, as discussed in this paper can negatively impact customers. Where conduct risk is identified, it is important for undertakings to (i) implement effective mitigating action, (ii) create adequate controls and (iii) regularly reassess it, as the business model itself or external factors evolve. As a last resort, insurance undertakings could refrain from the activity or practice originating conduct risk.

BUSINESS MODEL

Business model³ risks can arise from the various conceptual elements that make up the structure supporting a business, including the value proposition of the business, its purpose and goals and plans for achieving them. From a practical perspective, a business model determines, among other, the core products and/or services, marketing, distribution and sales strategies, business processes and policies and the interrelated architectural, co-operational, and financial arrangements with other entities in the value-chain.

Conduct risk may be inherent to the business model and/or business strategy and its execution. For instance, the business rationale for private equity investments in the insurance sector can potentially be a source of increased consumer detriment. Private equity funds have historically leaned heavily on a combination of cost cutting and

VALUE-CHAIN AND GROUP STRUCTURES

The **nature, scale and complexity of value-chain structures in financial services can increase conduct risks.**

Of particular relevance for customers is the existence of **conduct risk resulting from the business relationships among the various entities and players in the value-chain that may indicate potential conflicts of interest.** These include (i) business relationships between undertakings and other parties in the same group⁴ and (ii) business relationships between undertakings and third parties, including intermediaries or third party service providers not belonging to the same group, or entities handling outsourced functions.

³ A business model can be broadly defined as the method or means through which a company captures value from its business, or in other words, how it plans to make a profit.

⁴ A group of companies that shares a holding company or have a subsidiary relationship and that function as a single economic entity through a common source of control by virtue of shareholding or directorship.

The expanding range of activities that many insurance undertakings carry out simultaneously or are provided within the same group has increased the potential for conflicts of interest between those different activities and entities in the same group and the interests of their customers. For instance, conflicts of interest between two entities within the same group or two external entities in the value-chain may result from a provider-client relationship. The conflict may be intensified where the provider-client relationship co-exists alongside with competition between the two entities such as in cases where undertakings distribute their products through insurance intermediaries as well as directly.

However, the **greatest potential of consumer detriment arguably comes from situations where the various entities in the value-chain cooperate** (work with each other), rather than work against each other; often where there is no clear “ownership” of the customer relationship and customer outcomes.

This includes, for instance, situations of vertical integration, e.g. where non-insurance entities sell insurance from undertakings belonging to the same group or bundle products and services of different markets.⁵ This is also the case where insurance companies opt or push for in-house services or products, benefiting from cross subsidization⁶ which can lead to detriment for consumers (higher costs, lower quality, inappropriate products being sold).

Furthermore, when part of a cross-sectoral financial conglomerate, other **entities within the group may attempt to benefit from existing relationships with customers to channel their own products and services**. *Per se*, such business practices are not an issue. However, in some cases, such practice could lead to insurance sector distributing financial instruments from credit institutions of the same group to their customers who may sometimes be less aware or informed of the risks involved with these products (see box 1).

Box 1 Placement of financial instruments with policyholders

Self-placement occurs when financial institutions sell to their customer base financial instruments that they have issued or that have been issued by entities within the same group as the insurance undertaking.

This practice should be viewed as a conflict of interest, in particular in cases where the issuer would need to pay a higher “price” (i.e. interest rate) if it was to place debt on the market, operating on the basis of the relationship of trust already established.

The risk for consumers is particularly significant in the case of self-placement of bail-inable debt. Retail customers may be unable to judge the insolvency risk of

undertakings/groups with some degree of certainty or to draw conclusions as to what this means to the products in their portfolio.

Moreover, bail-inable products themselves would carry an intrinsic information asymmetry. Where bail-inable products appear and are marketed as securities/debt, retail customers will view them as such. Where consumers try to have a diversified portfolio, bail-inable products would need to be treated as equity in disguise, but would most likely appear as debt products, therefore contorting one’s view of the true diversification of the portfolio.

⁵ E.g. credit providers selling Payment Protection Insurance from a company belonging to the same group.

⁶ This is a business practice where the financial support for a product or service comes from the profits generated by another product or service.

INNOVATION

InsurTech⁷ and, more broadly, digitalisation is expected to have a significant impact on business models. This is likely to transform the way products and services are provided with benefits for consumers (in terms of products/services better tailored to consumers' needs, better quality or cost-effective services/products) and insurance undertakings (for instance in terms of more efficient processes and decision-making or better management of risks or fraud situations). However, the use of new technologies is raising a wider range of consumer protection issues, which could result in potential detriment. These are described throughout this paper, where relevant, however EIOPA's separate work on InsurTech can be expected to lead to further refinements in this picture.

In addition, digitalisation is also expected to impact the competitive and distribution dynamics of the market. The shift is leading to the emergence and consolidation of new distribution channels, new ways of engaging with customers and, of potential significance for consumers, a new breed of competitors and disruptors of the traditional business models, (see box 2).

Box 2 Business models used by new large entrants in insurance distribution

The increase in online distribution is expected to be further boosted as large technological/internet companies play an increasing role in insurance distribution. Companies in other sectors with a distribution network and a large pool of clients (e.g. supermarket chains) are also potential contenders to entering the insurance market as intermediaries.

GAFAs⁸ are already providing financial services to their customers and have been starting to take steps to enter the insurance market.⁹ Due to their financial capacity, large scale, trusted reputation, brand recognition and access to a large client base and personal data, they have the capacity to be important disruptors.

Rather than operating as conventional insurance intermediaries, new entrants may operate as business

The incremental use of Big Data brings many benefits for the financial industry and consumers which may ultimately outweigh identified risks.¹⁰ Nonetheless, the potential for data quality issues in Big Data tools can threaten market integrity to some extent – and customers over the longer-term. While the utilization of algorithms to make use of growing volumes of data should promote competition, it also has the potential to encourage “herding” behaviours or lead to data being mis-used if underlying algorithms are not fully understood by undertakings. EIOPA is separately examining in much more detail the cluster of conduct risks arising in the context of Big Data through a thematic review.

originators and aggregators. They are in a position to leverage their large customer base and market power and squeeze business margins, possibly driving down premiums. In addition, they may also be able to set the terms of the distribution agreement with insurance undertakings by setting upfront their commission rates when putting up their “distribution business” for tender among competing insurance undertakings.

While, on the short-term, consumers might see a drop in premiums, consumers may be negatively impacted over the long-term due to the possibility of (i) products competing mainly on price, (ii) excessive market power for distributors and (iii) a high commission-based distribution model.

⁷ InsurTech refers to technology-enabled innovation in insurance, regardless of the nature or size of the provider of the services.

⁸ GAFAs – Google, Amazon, Facebook and Apple.

⁹ E.g. Amazon Protect provides accidental damage insurance to product bought via Amazon; Apple offers limited insurance for its own products via Apple Care; Google Compare, which was discontinued in 2016, was an online comparison tool for, among others, car insurance.

¹⁰ Joint Committee of the European Supervisory Authorities report on Big Data; available at: <https://esas-joint-committee.europa.eu/Publications/Reports/Final%20Report%20on%20Big%20Data.pdf>.

USE OF THIRD PARTIES – OUTSOURCING

There is a continuous trend in the insurance sector to use outsourcing arrangements. Third parties can provide a vast array of services to customers in activities prior to, during and after the sale of insurance.¹¹ The use of third party service providers can support cost-cutting efforts and provide insurance undertakings with additional expertise and more up-to-date services and systems (see box 3). Independently of the substance of governance arrangements or the relevance of the services provided, undertakings remain fully responsible for discharging all legal obligations and the use of third parties does not absolve regulatory responsibility.

However, the use of third party service providers should not lead to harm to consumers from the manner in which third parties conduct business on behalf of the insurance undertaking. Harm may be most noticeable in those cases where third parties carry out activities that involve some level of interaction with consumers.

If not properly implemented and managed, outsourcing arrangements can make it harder for firms to exercise effective control, oversight and governance of consumer outcomes. To avoid potential misconduct of third parties, undertakings must operate and maintain formal policies, processes and procedures. These should relate to:

- The selection of third party service providers;
- Governance arrangements;

- Control and oversight of outsourced functions.¹²

When selecting third party service providers, undertakings should carry out a thorough due diligence of third parties prior to entering into the arrangement. The selection process should aim to assess the overall capacity of third parties and consider, among other aspects:

- Resources;
- Scalability and flexibility;
- Knowledge and experience;
- Track record, reputation, etc.

At a second level, undertakings and third parties must have adequate governance principles in place. These should set clear and well defined roles and responsibilities for each party and should be included in a written agreement defining the conditions, scope and limits of contracted services.

A proactive approach to oversight of third parties should ensure compliance with contractual terms and conditions but, most importantly, contribute to identifying and correcting conduct issues as they arise and before they result in violations of law or harm to consumers.

Box 3 Use of third parties in travel insurance

Undertakings commonly use third parties to facilitate the distribution but also the administration of travel insurance. It is not uncommon for various third parties to be involved in the delivery of services to customers; while there is no or little direct interaction between the undertaking and customers.

For instance, third parties acting as the travel insurance program administrator can provide almost all of the program's functions *in lieu* of the insurance

undertaking throughout the product's lifecycle. The program administrator can be responsible for product development and design, sales, underwriting, claims handling and customer service. Given the specificity of travel insurance, other third parties tend to provide specialized services as part of the product's cover that are not within the undertaking's core business capabilities. These normally include services such as 24/7 emergency call centre support services, or emergency evacuation/air ambulance services.

¹¹ These activities often include policy servicing and administration during the product lifecycle (e.g. premium collection, reporting to customers, claims management, complaints handling, etc). In addition, insurance undertakings can outsource to third parties different aspects of their business operations. These arrangements may raise additional risks such as operational risk, but are beyond the scope of this framework.

¹² Please note that the aspects specifically relating to insurance distributors are considered later in the paper.

BUSINESS MANAGEMENT

Business management risks are those risks arising from an undertaking's:

- Culture;
- Governance and internal structures;
- Systems and processes.

These **three elements are strongly connected and equally important. Failures in one of the elements put at risk the overall capacity to identify, manage and mitigate business management risks.** For instance, undertakings may have a strong consumer-centric culture but if they lack the internal support structures to incentivise the right behaviour and hold people accountable for improper behaviour, such strong culture may fall short of its objectives.

CULTURE

Culture is often singled out as a key driver of consumer detriment. It refers to a set of values and behaviours that drive and influence how employees think and act. Poor conduct outcomes can arise when undertakings are guided by a “culture of profit” or concerned with “what sells the most” rather than ensuring the fair treatment of customers. Having the “right” culture requires more than simply complying with existing regulation; it is often said that it requires undertakings to “put themselves in the customers' shoes” or develop a “customer-centric culture/business model”. This implies that undertakings' Senior Management is ultimately responsible for promoting and ensuring a customer-centric business model.

However, developing and implementing the “right” culture goes beyond the use of *buzz words*. **Culture has a practical dimension to it and must be reflected in the undertaking's governance models and structures and in its policies and procedures.** It's not what is said, but what is done.

GOVERNANCE AND INTERNAL STRUCTURES

Positive consumer outcomes are at risk when governance models and structures fail to promote the required behaviours across all aspects of the organisation, to develop a culture where it is clear that there is no room for misconduct and where people are accountable for their behaviours.

Promoting behaviours should be reinforced in all the key stages of the employment lifecycle:

- Recruitment;
- Induction programmes;
- Ongoing training;
- Individual performance management;
- Remuneration policies;
- Disciplinary processes, if required.

Incentive and remuneration schemes are particularly relevant since they can incentivise or deter the wrong type of employee behaviour. When poorly designed, these schemes can promote wrong behaviours or drive employees to “play the system” to achieve targets. This can be the case when schemes are exclusively based on short-term financial metrics¹³ or when these do not take into account conduct of business/qualitative aspects.

When designed properly and intentionally, incentive schemes can reinforce desired behaviours. These may include metrics to reward long-term customer retention, suitability of the products or customer satisfaction. To ensure that incentive and remuneration schemes promote the right behaviours, these should be approved by Senior Management not only with input from human resources and finance, but possibly also by the risk management and compliance functions.

Staff at all levels should be aware of the conduct risk and customer treatment policies and their obligations under them and, from a practical perspective, what they need to do to ensure it is achieved. Instilling a culture where conduct risk is seen as relevant requires that the undertaking's structure is appropriately designed to allocate roles and responsibilities the effective management of consumer protection risks. From a governance perspective, it is particularly important that the Board and Senior Management set the example (walk the talk) but also that they are ultimately accountable for poor conduct.

SYSTEMS AND PROCESSES

Efficient systems and processes must be in place to ensure that conduct risk is (i) identified and (ii) reported with a view to be managed and mitigated.

¹³ E.g. sales or profit margins.

As an initial step, control systems and functions should allow for the systematic identification and ongoing monitoring of risks of unfair treatment of customers. This identification and monitoring should be across all products and services, all relevant business units and throughout all stages of the product lifecycle.

Systems and processes should be sufficiently granular to capture the fact that the potential sources of consumer detriment may, for the same product, vary depending on the distribution channel used or on the characteristic of the target market (e.g. level of financial literacy, particularly vulnerable customer base, etc.). These should also be sufficiently granular to identify individual behaviour such as trends or patterns in individual sales staff which may point to misconduct. For instance, sales staff with abnormal rates of surrenders and new policies may indicate sales staff unnecessarily replacing existing life insurance policies for the sole purpose of earning incentives without visible benefits to policyholders or even at the detriment of policyholders.¹⁴

Employees should be familiar with existing systems and processes and these should be incorporate as standard and customary and not seen as worthless bureaucratic roadblocks. Such wrong perception may, ultimately lead to a generalised disrespect of the systems of governance where employees ignore controls designed to prevent misconduct.

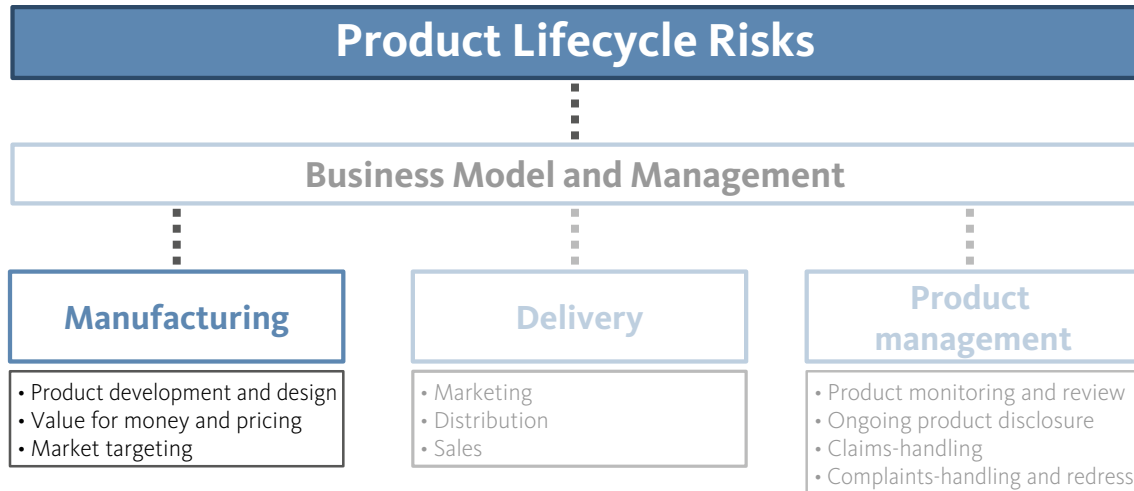
Internal reporting of potential conduct risk and risk of unfair treatment of customers or of existing/recent cases of misconduct is critical. Systems should allow for clear reporting up the chain so that the Board and Senior Management is aware and can act accordingly. While internal reporting should be of a regular nature, the organisation should also foster an environment where employees are encouraged to identify and escalate concerns and report wrongdoing, for instance, through an effective internal whistle-blowing procedure.¹⁵

On a regular basis, or whenever failures and malfunctions are detected, undertakings should evaluate the design and operating effectiveness of the organisation's systems and processes. If needed, these should be adjusted.

¹⁴ This practice is often referred to as churning and is considered later in the paper.

¹⁵ Whistle-blowing is not exclusively an internal procedure as this could include reporting or disclosing to authorities and/or the general public wrongdoing or illegal activities.

5. MANUFACTURING RISKS



Manufacturing risks are those risks arising from how products are developed by insurance undertakings prior to being marketed to whom they are targeted. The drivers of conduct risk identified and described below are the following:

- Product development and design;
- Value for money and pricing;
- Market targeting.

PRODUCT DEVELOPMENT

The development and design of insurance products, line of products or services¹⁶ is the very first stage of a product lifecycle. It is of paramount importance that product manufacturers (insurance undertakings and insurance intermediaries that manufacture insurance products) apply sound principles and procedures to ensure that (poor) product development and design does not result in customer detriment. **Poor consumer outcome can arise when product development and product design do not take into account customer interests.**

STRATEGIC FIT AND GROWTH

It is important to assess the “strategic fit” of new products. This should consider **broad and strategic questions** such as if new products are aligned with the insurance undertaking’s strategic plan as well as more practical aspects such as the undertaking’s level of expertise and effective ability to deliver the new product to customers in the intended market(s).

The lack of strategic fit may lead to failures in delivering insurance products as promised to customers. This often results from introducing new products without fully understanding (i) the resources needed (e.g. additional staff, training needs, technological infrastructure, and operational capacity), (ii) the characteristics of the risks insured or (iii) the characteristics of new markets (e.g. competitors, value-chain dynamics, drivers of demand, customer needs and expectations). Early signs of insurance undertakings potentially facing such risks include rapid growth in product offering or an expansion into new geographies and markets.

From a conduct perspective, **a (too) rapid growth of product offering or entry in new geographies or market segments may be a source of concern if undertakings run into financial difficulties** as they run out of cash to fund expansion. Financial difficulties may lead to consumer detriment further down in the product lifecycle. For instance, customers may face mis-selling if sales staff has a poor understanding of the new products due

¹⁶ For ease of reading and simplicity we will refer to these simply as “product” or “products”.

to limited training. Most significantly, financial difficulties may impact how claims are handled – denied claims, reduction in the amounts of compensation paid, difficult administrative procedures, etc.

CONSIDERING CONSUMER OUTCOMES

The development and design of products should take customer outcomes into account – how products address customer objectives, interests and characteristics. The integration in the product development process of conduct risk criteria to assess outcomes for consumers should allow identifying potential high risk products from a conduct perspective and take adequate measures. In extreme cases, this could lead to (i) products not being launched at all, (ii) being launched to a restricted target market or (iii) being significantly modified prior to launch.

Appropriate testing of insurance products should take into consideration consumers biases (e.g., over confident target market), attitudes, and behaviours (see box 4). **Inadequate or poor product testing may fail to identify product characteristics that may lead to poor consumer outcomes and to risks of products being sold to wrong customers during the sales process.**

For instance, inadequate or lacking stress testing¹⁷ may fail to identify the expected level of volatility of a particular IBIP which may lead the product to be distributed to market segments for which the implicit level of risk volatility or downside risk is inadequate. This may be critical for savers close to retirement who intend to invest in lower risk assets in a drive to obtain some protection from negative market swings.

Box 4 Product testing requirements under the IDD

The Product Oversight and Governance provisions in the IDD require manufacturers to carry out product testing before a product is brought to the market or in case the target market has significantly changed. The purpose is to assess if the product meets over its whole lifecycle, the identified needs, objectives and characteristics of the target market.

PRODUCT DIFFERENTIATION AND PRODUCT STANDARDISATION

The pressure to differentiate product offering from competitors and to innovate in product development may result in overly complex¹⁸ and opaque products, increasing information asymmetry risks.¹⁹

Product **complexity has an impact on customers' ability to fully understand products, compare products and find an insurance policy that best fits their needs** at the lowest price possible. Although the PRIIPs KID and the IPID ensure that customers are provided with relevant information about insurance products and allow them to easily compare between different products, challenges for customers still remain.

Notwithstanding the above, it should be pointed out that product diversity and/or tailor-made products may be advantageous for customers if these products enhance product choice and are able to better meet specific needs to a greater extent than standardized products.

At the other end, **simpler or standardised products, although easier to understand, also bear risks for consumers, in particular, the risk of under or over-insurance.** This is the case if available products either do not meet specific customer needs or have cover (and consequent costs) above the customers' needs.

Moreover, in markets where products are highly standardised (e.g. motor third party liability) **undertakings may tend to compete and focus on price.** This may lead customers to select products mainly on the basis of the lower price rather than product attributes or service level.

Manufacturers are required to test products in a qualitative manner and, where appropriate, in a quantitative manner, depending on the type and nature of the insurance product and the related risk of detriment to customers. In the specific case of IBIPs, product testing should include scenario analyses to assess the product's performance and the risk/reward profile.

¹⁷ E.g. by considering how the product performs in different scenarios, different markets and different customer segments.

¹⁸ Similar products may display significant variations in the types of risks covered, level of cover, exclusions, etc.

¹⁹ In particular where such products are sold to less sophisticated customers.

CONSUMER BIASES

Positive consumer outcomes are at risk when products are designed to deliberately take advantage of demand side biases or human behaviour. Products may incorporate complex features which may be difficult to understand and assess, even when all relevant information is disclosed.

This risk is particularly relevant for investment products. It may be difficult to fully understand the characteristics, risk level or cost structures of some IBIPs, in particular when innovative elements can only be fully explained with disclosures that use dense technical and legal language. Innovative elements can result from, for example:

- Options or variations;
- Contingent pay-outs;
- Variable maturities.

Information asymmetry, poor understanding of all aspects of the insurance product, poor interest and customer inertia²⁰ may lead to unfair terms and conditions. This may include:

- Unbalanced limitations and exclusions;
- Long initial exclusion periods;²¹
- Long-term contracts;
- Automatic renewals;
- Unreasonable barriers to switching or cancelling.²²

Sophisticated Big Data analytical tools can also be used to take advantage of behavioural biases, raising concerns from an ethical perspective. For instance, customers identified as less likely to complain, switch products and shop around or less sensitive to pricing, may obtain less favourable terms and conditions or be offered more expensive products.

²⁰ Customer inertia is defined as those situations where customers tend to perpetrate past patterns, including those situations where customers continue to purchase the same product or from the same provider and take little or no action to change or shop around.

²¹ Initial period during which a claim cannot be made.

²² E.g. high/disproportionate penalties for switching or cancelling, excessive complication and administration for the customer before they are able to switch or cancel or unreasonable risk arising from potential exposure to market risk during the switching/redemption of investment products.

VALUE FOR MONEY AND PRICING

An excessive focus on profitability may fail to consider the product's value for the customer and to integrate the customer perspectives when manufacturing products. The result may be products less likely to be fit for purpose, less tailored to individual needs, or having low to no value for customers. This contrasts with win-win situations where insurance undertakings earn a profit while satisfying customer needs, delivering a good outcome and value, ultimately taking into account both customer interests and their own – alignment of interests.

A major difficulty consumers face in the insurance industry is that **the assessment of price and quality of many products and services often cannot be accomplished at the time of purchase.** The assessment of value for money is arguably subjective, while several factors influence the perception of “value for money” from a customer perspective. These include the brand of the provider, the level of service, a perception of whether the product meets the needs and the (lack of) capacity of customers to assess whether they could obtain an identical (or nearly identical) product at a significantly lower price.

From a supervisory perspective, assessing value for money of insurance products may not be within the competencies of NCAs or it may not be feasible to the extent required to infer on the potential level of consumer detriment. Such assessment may require substantial information on the product (e.g. scales of premiums or technical bases) which is not necessarily gathered by NCAs.²³

Considering the gaps and limitation from a consumer and supervisory perspective, **insurance undertakings are best placed to develop internal procedures at the early stage of product manufacturing to alert to products that may offer poor value for money.**

²³ For instance, Member States should not require the prior product approval or systematic notification of general and special policy conditions, of scales of premiums, of the technical bases, used in particular for calculating scales of premiums and technical provisions (article 22 of the Solvency II Directive).

PROFITS

High profits²⁴ can be a sign of poor conduct at the product development and design stage.²⁵ On the one hand, this may arise from low costs as a result of terms and conditions with high excesses and exclusions leading to lower claims pay-outs in the future. On the other hand, high profits may arise from elements that simply result in high revenue, such as high premiums or triggers for premium increases or high, hidden, or progressive charges.

However, high profits can arise from reasons other than poor conduct during product development. They can arise, for example, due to efficiency gains or as a result newly developed products where the risk involves greater uncertainty.

PRICING

While **products should be fairly priced and offer value for money**, this **does not imply that prices must be “low”** and no profit can be made. It is more a question of the “right policy at the right price” than the “lowest price possible” doctrine. **Low premiums *per se*** may not necessarily be in the best interest of customers. They **may simply reflect lower levels of cover** or customers taking on more risk due to more exclusions, lower limits in cover or higher co-payments or deductibles. From an individual perspective, detriment could be significant in particular as the financial impact of reduced cover or higher co-payments or deductibles could be quite large.

From a supervisory perspective, **what is most relevant is to understand the underlying reasons for high premiums** and to take a holistic standpoint. Where it is difficult to find an appropriate explanation for persistent high premiums, it may be indicative of poor consumer outcomes and increased conduct risk. Unjustified high premiums may be a sign of product mis-selling and can, over the medium to long-term, raise questions about customers' capacity to afford products which may lead to increased lapses in the future.

On the other hand, **persisting low premiums** may also be a supervisory concern. This **may result from an incorrect valuation of the risks covered, giving rise to prudential concerns** or be a sign of insurance undertakings engaging in predatory pricing²⁶ giving rise to market competition.

Pricing strategies, such as price discrimination,²⁷ may also be used for purposes of customer segmentation or customer prioritisation. For instance, insurance undertakings may discriminate between customers who shop around and those that don't or between new and existing customers. To some extent, this practice could benefit both insurance undertakings and a subset of customers. For example, by offering a discount to some specific customer group (e.g. students or senior citizens) insurance undertakings may be able to increase sales and, at the same time, offer lower premiums for specific groups of policyholders.

However, price discrimination raises some concerns from a conduct perspective. Firstly, insurance undertakings could target inexperienced or vulnerable customers with free trial periods or teaser rates and then upcharge them for extra cover. Secondly, price discrimination, in particular when it is carried out at the disadvantage of existing customers is more effective if there are barriers (e.g. high surrender fees) preventing existing customers from benefiting from the new offer. Finally, price discrimination raises concern of certain customer segment being completely excluded.

The use of Big Data in pricing insurance products enables more granular segmentation of risks, increases the effectiveness of risk identification and allows for pricing that is more risk-sensitive. While consumers could benefit from personalised (and cheaper) products, there is the risk that this leaves high-risks or vulnerable customers priced out of the market. This issue is particularly sensitive in the case of compulsory insurance, where such customers have no choice but may face high premiums.

²⁴ In the current context profits are defined as the surplus remaining after total costs (claims paid and administrative/running costs) are deducted from total revenue (premiums and other costs charged to policyholders).

²⁵ In addition, high profits could result from poor conduct practices during the sales process or the post-handling stage (e.g. low claims acceptance ratios).

²⁶ Predatory pricing is a pricing strategy where a product or service is set at a very low price, intending to drive competitors out of the market, or create barriers to entry for potential new competitors.

²⁷ Price discrimination occurs when a firm charges a different price to different groups of consumers for an identical good or service, for reasons not associated with costs of supply.

MARKET TARGETING

As part of the manufacturing of an insurance product, insurance undertakings and insurance intermediaries that manufacture insurance products should maintain, operate and review a process to clearly identify a target market and customer needs for each product.²⁸

PRODUCT AND CUSTOMER CHARACTERISTICS

Market targeting should rely on an adequate process to identify to whom products are aimed at and the group of compatible customers. Such processes should, on the one hand, **take into account the characteristics, risk profile, complexity and nature of each insurance product**. On the other hand, they should **take into account key characteristics of the target market**. These may include elements such as (i) the risk appetite, (ii) financial capacity, (iii) experience with insurance products, (iv) loss/risk tolerance and (v) relevant demographic characteristics (e.g. age, education level, etc.). Adequate market targeting may require customer segmentation and profiling customers according to their key distinctive characteristics.

The risk of consumer detriment can arise whenever processes and procedures lead to a poor identification and definition of the target market and of customer needs for each product. This is often the result of unsophisticated processes and “tick-box” approaches.

A one-size-fits-all approach to market targeting may also contribute to poor outcomes. In more complex circumstances, for instance, where undertakings serve customers across a range of segments with different levels of financial capability, the range of products, distribution channels and customer servicing may need to be differentiated to suit the needs and capability of the different customer segments.

UNSUITABLE AND VULNERABLE TARGET GROUPS

To mitigate the risk of mis-selling, it is also relevant to **identify to whom products are not intended for and ensure that products do not reach those groups of customers** for whose needs, characteristics and objectives the products are generally not compatible. For instance, adequate market targeting may lead insurance undertakings to abstain from distributing long-term or high-risk investment products to customer segments they may not be suitable for such as elderly customers, close to retirement.

Also, the correct identification of a product's target should allow for a clear identification of “vulnerable market segments”²⁹ where additional steps to mitigate risks to consumers resulting from information asymmetry are needed.

LIMITED PRODUCT OFFERING

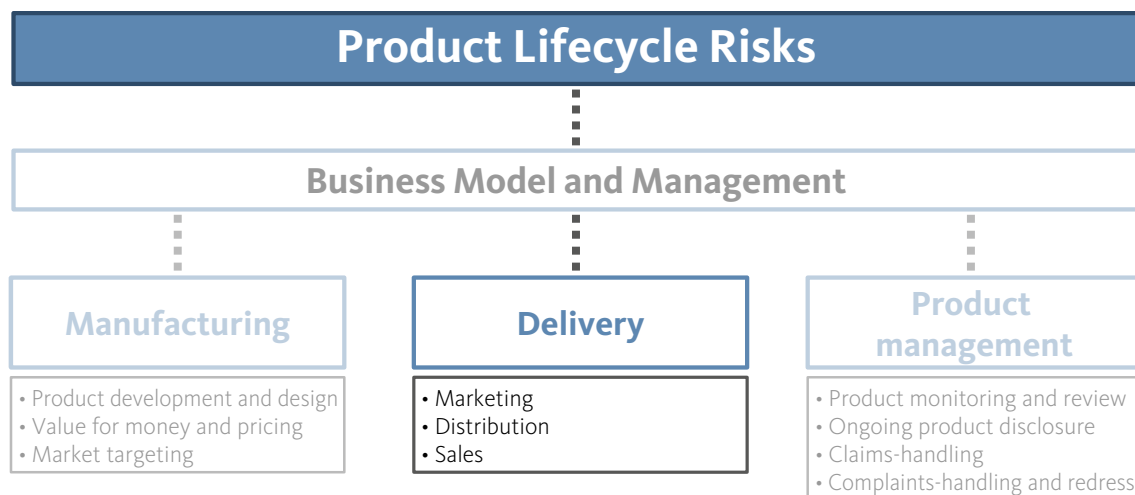
An excessive focus on profitability may also have implications for the range of products on offer, as insurance undertakings may opt to develop products aimed at specific market segments with higher margins. Although it may be argued that insurance undertakings are not required to provide a sufficient range of products which are suitable to different customer needs, a more fine-tuned target market approach looking at profitability may leave certain market segments unserved or underserved.

The use of Big Data to implement strategies that focus on servicing particular consumer groups could result in targeted consumers benefiting from more personalized (and cheaper) products but could also lead to individual customers or groups of customers whose circumstances don't match the product's criteria unable to access products and services. For instance, vulnerable consumers are at higher risk of exclusion by automated services (e.g. due to pre-existing health condition, low income, a criminal background, poor credit history, inadequate documentation, etc.). These risks could be exacerbated if a large number of providers use the same data sources and the algorithms, leading to “herding” behaviours.

²⁸ Article 25(1) of the IDD.

²⁹ E.g. customers in low income, unsophisticated segments or with relatively low financial capability.

6. DELIVERY RISKS



Delivery risks are those risks arising from the interaction between customers and insurance undertakings or intermediaries at the point of sale. The drivers of risk identified and described below are the following:

- Marketing;
- Distribution;
- Sales.

MARKETING

Marketing **involves the business and management processes through which goods and services move from concept to the customer.** Of particular relevance for customers, it includes the development and implementation of a promotional strategy, that is, the techniques used to promote products to a particular market. **Conduct risk may emerge both from poor internal governance and from poor culture.**

Poor consumer outcomes may, for instance, be a result of the marketing strategy not being duly overseen by Senior Management or marketing materials being distributed without being reviewed by compliance staff. In addition, poor culture may lead insurance undertakings to design strategies that take advantage of demand-side biases, human behavior or information asymmetry, rather than competing on price and quality. These may include, for

instance, poor disclosures, deliberately misleading marketing campaigns, teaser rates and making a product easy to sign-up to but difficult to cancel.

PRODUCT BUNDLING

A key potential source of consumer detriment is the excessive reliance on product bundling where insurance products are marketed as add-ons to other “primary” products. Insurance products may be sold through cross-selling as ancillary products to other financial products (such as credit or banking products) or to non-financial products (e.g. motor vehicles, mobile phones, home appliances, travel packages, etc.). They may also be marketed as add-ons to other insurance products. For example, various add-on covers or plans are sometimes offered in addition to own damage and third party liability in motor insurance – gap insurance, roadside assistance, accident cover for car passengers, etc.

Product bundling can bring benefits to consumers in terms of convenience (e.g. effective way to meet multiple needs through a single transaction) but **bundling has real impact on customer behaviour and affects the way people make decisions.** Customers’ attention is normally focused on the purchase of the primary product. In addition, the sale is often made in a “pressure” environment, such as right before payment for the main product. Often the disclosure of the price for insurance cover is done in a way to look significantly low in comparison to the price of the main good.

In many respects, **product tying and bundling can further amplify “traditional” consumer protection issues** and may lead to unfair customer outcomes. These practices may make it difficult for policyholders to understand the products they are buying and take decisions in their own best interest. This is particularly relevant if insufficient information is made available on the features, costs, risks and suitability of the bundled or add-on benefit and increase the risk of customers being confused about what exactly they have bought.

The combination of marketing tactics and consumer behavior may lead to situations where customers are not aware they are buying a product that offers a different cover than expected or even that they are buying an insurance product at all. This “**policy awareness risk**” may imply that customers, while paying for cover, may simply not lodge a claim should the risk event occur. Policy awareness risk also increase the potential for:

- Under-insurance;³⁰
- Over-insurance;³¹

- Double insurance.³²

Product tying and bundling and cross selling may also entail relevant competition issues that affect customers in terms of price and product offering. There seems to be a lack of effective competition in non-life insurance add-ons markets³³ and excessive market power (see box 5). Consumer choice is often restricted at the point of sale whilst, at the same time, customers tend to focus on the primary product and do not generally shop around or carefully study the characteristics of add-on products. Within this context, there seems to be little pressure on insurance undertakings to offer good value while standalone products do not generally constrain sales of add-ons. This could lead to customers paying too much and receiving poor value when buying products marketed in this way.

Cross selling and product bundling can sometimes take the form of “tying”. Product tying arises when the acquisition of a given insurance product is made mandatory to purchase the primary product. For instance, when the

Box 5 Market power in cross-selling of Payment Protection Insurance (PPI)

The most straightforward distribution channel for manufacturers of Payment Protection Insurance (PPI) is through loan providers (banks and other credit institutions) which is likely to result in considerable market power (economic strength) for loan providers.

Customers are often mainly engaging with the loan product offered and not with the PPI product or its cost. They are unlikely to shop around for alternative insurance cover and thus do not drive down costs through competition. This can lead to loan providers having a potentially captive market and being able to exert market power and charge excessive prices for PPI and make above-normal profits from it.

This market power is likely to be further strengthened where loan providers engage in tying or bundling

practices, in particular where PPI, often from the same company or group, is made mandatory to obtain a loan from a given provider or the interest rate of the loan significantly increases if PPI is not purchased along with the loan.

The market power arising from cross-selling of PPI with loans leads to situations where manufacturers of PPI compete for distributors and not directly for customers. This is reflected in business models where loan providers issue tenders for PPI manufacturers. From a consumer perspective, this is perceived to distort or limited consumer choice and result in an upward pressure on the level of commissions and thus premiums. It could also result in mis-selling if the PPI was not needed at all.

30 Under-insurance arises when customers do not possess the proper cover level against a particular risk and are exposed to a high financial impact.

31 Over-insurance arises when the cover level is higher than needed by the customer. This can be a potential source of consumer detriment in the form of higher costs without equivalent cover if the customer is unable to adjust the level of cover to his needs or chose a different product.

32 5.1 Double insurance arises when there is an overlap in cover from different policies held by the same policyholder. In case of subsidiarity, customers end up paying for the same risk twice but are only compensated once. For instance, in travel insurance, double insurance appears to be particularly relevant where annual travel policies are offered as add-ons to credit cards or bank accounts and customers, sometimes unaware they have insurance, buy another policy to cover for a single trip.

33 The FCA's General insurance add-ons market study, 2014, is indicative of this; available at: <https://www.fca.org.uk/publication/market-studies/ms14-01-final-report.pdf>.

customer applying for a loan is required to purchase the insurance product (e.g. PPI) from a designated insurance undertaking, most often from the same group as the bank or loan provider. This leads to situations where consumers have no choice between different providers and sometimes insurance policies, and is likely to result in extremely significant market power for distributors (banks and other loan providers, in the above example) and have an unfavourable effect on consumer prices, possibly also putting an upward pressure on commissions.

DISTRIBUTION

Distribution models and channels are a key aspect of how insurance products reach customers. These **may either increase or mitigate risks of consumer detriment**. From a consumer perspective, two aspects are relevant. Firstly, how distribution models and channels are designed and selected. Secondly, the existence of adequate procedures to mitigate conduct risk arising from different distribution models.

SELECTION OF DISTRIBUTION MODEL AND CHANNEL

When choosing a particular distribution model or channel for an insurance product, insurance undertakings should identify the risks for consumers within each delivery channel and consider the needs and capability of customers and relevant market demographics. For instance, how the distribution channel takes into account the complexity of products or the vulnerability of the customer base may impact the risks associated with information asymmetry.

Where insurance undertakings serve customers across a range of segments with different characteristics (e.g. levels of financial capability), **distribution channels may need to be differentiated to suit the needs and capability of the different segments**. However, while the use of various distribution channels and models may improve and simplify access to insurance, this can add to the complexities faced by customers when assessing the range of products and channels available.

INSURANCE DISTRIBUTORS

Distributors play a valuable but potentially sensitive role in insurance. On the one hand, they help in consumers identifying adequate cover to **address the risks**

they face. On the other hand, **they can mitigate the information asymmetry risks and support customers** in making informed purchase decisions. The service of advice is often critical in view of asymmetries of information and challenges related to financial capabilities.

However, various challenges emerge when products and services are being sold by distributors, which may lead to consumer detriment. Most of these risks emerge from the simple fact that a third party is positioned directly between insurance undertakings and customers and is closely involved in product and service delivery.

To ensure adequate levels of consumer protection, when distribution models rely to a large extent on insurance distributors, it is important to consider:

- › The suitability of distributors;
- › The existence of adequate governance principles;
- › Intermediaries' business conduct practices.

When selecting insurance distributors, insurance undertakings' duties go beyond the mere analysis of whether insurance distributors are licensed. A thorough selection process should be used to assess the overall capacity of insurance distributors. Such process should consider, amongst other aspects:

- › The suitability and fit of the distributor with the products and strategy of the undertaking;
- › The resources of the distributor;
- › The knowledge and experience in selling the specific insurance product;
- › How the distributor will sell the products (e.g. on-line, telesales, etc.);
- › How the distributor will market the product, including what marketing materials may be used.

In addition, conduct risk may emerge if insurance undertakings fail to ensure that distributors understand both the product's characteristics and the product's identified target market or fail to check consistency between the intended distribution strategy and the identified target market. Similarly, conduct risk may emerge if distributors overlook their responsibility to obtain all appropriate information from manufacturers and do not ensure that selected products have been well designed and suitable to the needs of the identified target market(s) and for the customers whom they will advise to purchase them.

Both **insurance undertakings and distributors must have in place adequate governance principles and arrangements**, in particular concerning the responsibilities of each party. A clear segregation of functions is key to avoid duplication of functions but, most importantly, to ensure that key activities are not neglected by both parties. For instance, confusion between manufacturers and distributors may lead to required disclosure of product features and risks not being relayed effectively between them, at the detriment of adequate disclosure to customers.

Finally, the responsibilities of insurance undertakings when products are being sold by distributors may be extended to include the **responsibility to ensure that distributors are also demonstrating good conduct and achieving good customer outcomes**. This is an extra line of defense in terms of consumer protection.

Insurance undertakings that do not have the required expertise or that do not ensure adequate oversight over distributors are more likely to expose their customers to third party activities risks. Effective due diligence and ongoing supervision will help to mitigate risks from third party arrangements and is an extra line of defense in terms of consumer protection. **A proactive approach to oversight of distributors may help identifying and correct conduct issues** as they arise and before they result in harm to consumers. Such proactive approach should allow to assess (i) if the service being provided by distributors is adequate, (ii) if the sale processes are not giving rise to any misrepresentations of a product's features or (iii) if the products continue to be sold to the target market for which they were intended.

SALES

Significant consumer detriment may arise at the point of sale from the interactions between customers and distributors. This can result from aspects inherent to the nature of the insurance business,³⁴ in particular:

- Information asymmetry;
- Mis-selling resulting from misleading information and other unfair practices;
- Mis-selling resulting from unsuitable products.

³⁴ And, in many cases, inherent in the nature of financial service provision more broadly.

INFORMATION ASYMMETRY

Information asymmetry arises from the imbalance of power, information and resources between customers and providers, often placing customers at a disadvantage.³⁵ **Insurance undertakings and distributors tend to have better knowledge of the characteristics of the products they sell and may even have better understanding of the risk profile of their customers** than the customers themselves. For instance in health insurance, insurance undertakings may be best placed to identify potential health problems based on medical screenings. Moreover, insurance undertakings and distributors may also be at a greater advantage since customers generally place a certain degree of trust in the sales person to provide fair personalized advice as well as adequate and clear disclosure regarding products or services being sold.

Although information asymmetry between buyers and sellers is usual in most industries, **the fact that the insurance industry is not a homogenous sector and mostly supply driven³⁶ can magnify the consequences of information asymmetry**. The most straightforward regulatory response to address information asymmetry has been a continuous emphasis on disclosure, pushing insurance undertakings and intermediaries to provide customers with (more and more) information that is clear and easy to understand and empowers informed decision making from consumers (e.g. PRIIPs KID and the IPID). However, in many circumstances, disclosure may fall short of achieving desirable outcomes, especially if not informed by behavioral findings. Disclosure does not necessarily ensure that customers read or understand the information made available while the risk of information overload³⁷ can negatively impact the decision process. Furthermore, while behavioral studies can address some of these shortcomings by ensuring that the format, manner, and timing of disclosure address consumers' biases and respond to their behaviors, limitations remain.

³⁵ Although information asymmetry can run in the opposite direction as well.

³⁶ *Per se* consumers are not necessarily inclined to buy insurance products.

³⁷ Information overload occurs when too much information about an issue is provided, leading to difficulties in understanding the issue and effectively making decisions.

MIS-SELLING RESULTING FROM MISLEADING INFORMATION AND OTHER UNFAIR PRACTICES

Mis-selling is a problematic practice by sales staff consciously misrepresenting or misleading customers about the characteristics of a product or service in an effort to make a sale.

Various tactics can be used to attempt to take advantage of human behavior and mislead customers about the characteristics of a product or service.

A rudimentary malpractice is to provide insufficient or inadequate disclosure to customers. This may include hiding important statements and features of products (e.g. inadequate transparency in fees and charges) but also providing unbalanced illustrations of benefits. In this regard, clarity and timing of disclosure are critical.

Clarity of disclosure should help avoiding situations where customers misinterpret information and fail to understand and assess products, taking into account personal risks and preferences. Clarity can be enhanced through the use of comprehensible, concise and rigorous language, using words and expressions of everyday language³⁸ and avoiding vague or ambiguous expressions and over-technical terms (specifically regarding exclusion or limitation clauses), if possible.

How information is provided to potential customers should take into account the product itself and the characteristics of the target market. Some products may require additional disclosures and more detailed explanations to adequately support decision making by customers. For instance, where products such as pension products provide for various investment options, the range of choices may in itself be bewildering. In view of these complexities, standard disclosures alone may be insufficient to address conduct risk arising from information asymmetry. Additional measures to assist consumers in their choices (e.g. investment simulators, personalized advice, etc.) may be needed. For instance, product information may need to be customized for each target market – a one-size-fits-all approach may put vulnerable consumers at higher risk. Similarly, for the same target market, more complex products, may require more detailed disclosure than “simpler” products.

Tailoring product disclosure is important in selecting what information should be provided to whom and help avoid situations where all information is made available

to customers, resulting in “excessive disclosure”. Information overload does not contribute to more clarity for consumers and can, in fact, have the opposite effect, not necessarily positively influencing their capacity to take an informed decision.

The timing of disclosure can also have an impact on the capacity of customers to make informed decisions. Product information must be provided in good time before the conclusion of an insurance contract. This implies that information should be provided well in advance of when a decision from the customer is expected or necessary, allowing customers to “process” the information. This may seem as a common and basic business practice but there have been situations where customers who purchased PPI were only given the products’ terms and conditions after closing the contract³⁹ or, in the case of ancillary insurance, terms and conditions may only be given at the time of paying for the main product or service.

MIS-SELLING RESULTING FROM UNSUITABLE PRODUCTS

One of the most frequently arising mis-selling issues is related to eligibility conditions, leaving consumers unable to claim benefits. **Mis-selling can occur when individual situations are not covered by the policy when they entered into the contract;** not because their individual situation evolved during the contract. Often, this results from distributors failing to check whether the given policy is suitable to customers given their specific and personal situation. For instance, in the case of the PPI scandal, intermediaries often sold products to consumers who were not eligible to claim benefits at all, including selling unemployment cover for self-employed.

Mis-selling issues related to eligibility are more likely to occur for products with complex or imprecise exclusions, for instance, in medical insurance where customers may be unable to claim benefits because of pre-existing medical conditions. The use of exclusions by insurance undertakings may be justified by legitimate business interests but these must be clearly and adequately communicate to customers. Customers should also study exclusions thoroughly to avoid potentially unpleasant surprises and to properly assess how products fit their demands and needs.

Even where customers are eligible to claim benefits, customers can still be sold unsuitable products.

38 Provided that the use of legal or technical terms is not essential.

39 Background Note on Payment Protection Insurance, p. 21; available at: https://eiopa.europa.eu/Publications/Opinions/EIOPA_PPI_Background_Note_2013-06-28.pdf.

Box 6 Customer information for the assessment of suitability under the IDD

The IDD provisions require distributors of IBIPs to perform a suitability assessment when making recommendations to buy IBIPs or when recommendations are made during the life-time of IBIPs (e.g. switching between IBIPs, holding or selling). These recommendations must consider relevant information about the customer, in particular:

- **The customer's investment objectives:** risk tolerance, intended holding period and purpose of the investment;

- **The customer's financial situation:** ability to bear losses, source and level of regular income, assets held including liquid assets, investment and property and regular financial commitments;
- **The customer's relevant knowledge and experience:** level of education, current and past profession, types of financial services, transactions and investment products or financial instrument the customer is familiar with, the nature, number, value and frequency of the customer's transactions in IBIPs or financial instruments and the period over which they have been carried out.

This can result from distributors being focused only on assessing consumers' eligibility and failing to adequately assess customer needs or identifying when products are not suitable for the consumer.⁴⁰ To avoid such risk, distributors should collect and use relevant information from consumers to assess the suitability of products (see box 6).

Poor business practices may result in customers not being able to understand and assess products taking into account personal risks, situations or preferences. They may end up purchasing products they do not necessarily need, products with characteristics that significantly differ from the consumer's perception or products they cannot afford over the medium to long-term.

SALES INCENTIVES (AT THE POINT OF SALE)

The most common model for remunerating insurance distributors is to pay sales commissions (also referred to as sales incentives) based on the number and/or the value of sales. These **commission-based remuneration models are one of the most important determinants of behaviour and can be a source of conduct risk**.

A commission-based remuneration model for distributors may create conflicts of interest in the sales process, resulting from a misalignment between, on the one hand the interests of insurance undertakings and distributors and, on the other, the interests of customers. To achieve sales targets, sales staff may push sales of products that

pay the highest commission and inappropriately steer customers to particular products. These products may not be those that best meet customer needs and can result in poor customer outcomes. Customers may purchase products they do not need or that they cannot afford over the medium to long-term.

These remuneration models can also result in an unnecessary replacement of insurance policies, a risk known as churning and particularly relevant for life insurance and saving products. The magnitude of the risk may vary by type of distributor – it may be reduced in the case of tied agents who, because they only sell one brand, cannot move customers between brands.

Replacing one insurance policy with another can be in a consumer's best interest. For example, the new policy may be better suited to the consumer, or may be cheaper. However, **the move may be driven by what distributors will earn in commissions, and there may be no clear benefit to customers**. In some cases, the switching from an existing policy to a new policy may even be harmful for customers. Customers may lose some benefits they might have received under their original policies or they may have claims denied that might have been accepted under their original policies due to changes in cover or policy exclusions.

Some changes may not be perceived immediately but may impact the customer during the product's life. For example, policies may be cheaper in the short-term but can be far more expensive in the medium or long-term, the quality of client service may be poorer, customers may find it harder to make claims in the future or the new issuer may be in a less strong financial position.

⁴⁰ In the case of PPI, this included, for instance, selling PPI for very small loans or credit card users who generally repay the outstanding balance in full every month.

The above consumer protection issues can be significant and increased by the fact that customers normally find it difficult to assess whether a replacement policy is better or worse due to the inherent challenge of quantifying various policy features, let alone being able to assess the quality of service or the financial soundness of undertakings.

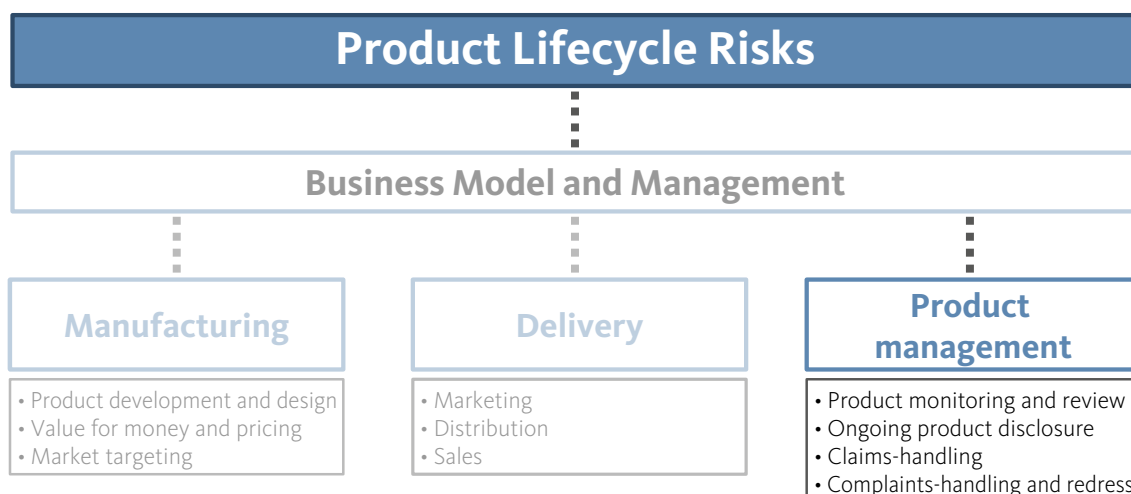
DIRECTED OFFER

An aspect that may lead to consumer detriment are cases where distributors are bound by agreements to sell insurance products from one or a limited number of insurance undertakings (e.g. tied agents). These arrangements carry increased conduct risks as they incentivise sales of what is on offer, irrespective of how well the offer fits with the needs of the consumer.

This risk is particularly relevant as consumers of financial products tend to be relatively passive and fail to shop around, using heuristics (such as, for instance, brand and familiarity) in the place of a full assessment of the market. In addition, in the absence of a clear disclosure on the nature and criteria used by the distributor for the products on offer or existing distribution agreements, customers may be drawn to the wrong conclusions – for instance that a distributor who is selling without advice is providing personalised advice or that the distributor has pre-selected the most relevant or “good value” propositions for them.

These practices also raise serious concerns about how effectively distributors (and insurance undertakings) are adequately targeting their offering to customers. A limited range of products must be reflected in a narrower and well defined target market and supported by an effective assessment of the customer's needs and, as relevant, financial situation.

7. PRODUCT MANAGEMENT RISKS



Product management risks are those risks that customers face from the time they enter into a contract until all obligations under the contract have been satisfied. The drivers of conduct risk identified and described below are the following:

- Product monitoring and review;
- Ongoing product disclosure;
- Claims-handling;
- Complaints-handling.

The absence of suitable post-sales customer services, “selling and moving on” practices or post-sales customer services whose main focus is on cross-selling and up-selling can lead to adverse outcomes for consumers. Adequate post-sales customer service should aim at ensuring that characteristics, interests and needs of customer are taken into account during the product’s life.

Sound product management requires undertakings to be both proactive and reactive to consumers. Proactive product management includes taking action at own initiative without customers requesting it – this includes product monitoring and review as well as the provision of ongoing product disclosure. Reactive product management includes the activities that undertakings take as a reaction to specific events – this includes interaction with customers such as handling claims and complaints.

PRODUCT MONITORING AND REVIEW

Considering how products are working in practice after the sale is key to assess the benefits to customers.

This requires more than assessing if products are selling well. An assessment and monitoring of products sold should consist of a structured and regular⁴¹ practice and lay the grounds for subsequent action, if required. Action may include, for instance, (i) introducing modifications to products, (ii) withdrawing products from the market in most extreme cases or (iii) compensating customers who have suffered losses as a result of wrongdoing, if appropriate. Such action, if necessary, should be swift and proportionate to the conduct risk involved.

Ideally, **the purpose of product monitoring and review by insurance undertakings should go beyond only addressing negative aspects that emerge from the assessment – product enhancements may also be considered.** These could be triggered by an assessment of the product *per se*, but could also result from a comparison against peer products.

⁴¹ The frequency of the review of insurance products should take into account the size, scale, contractual duration and complexity of the product.

When monitoring an insurance product, various elements should be considered, including:

- The consistency of products with the identified target market;
- The appropriateness of the distribution strategy;
- Changes in customer circumstances.

PRODUCT CONSISTENCY

Product monitoring must **assess whether products remain consistent with the needs of the identified target market**. This assessment should take into account events or trends that could materially affect the characteristics, risks covered or the guarantees of insurance products. Such events or trends could, for instance, be related to the applicable regulatory framework or to how financial markets perform.

For instance, for long-term investment and pension products, ongoing product monitoring should aim to assess if products remain aligned with the initial investment objectives, including the expected performance and the level of risk foreseen. This requires a continued assessment of the product's performance in absolute terms and in relative terms in relation to appropriate and meaningful market indices and benchmarks, peers or the stated investment objectives.

Where the customer is knowingly taking a certain level of risk, it is not so much a question of insulating him from the risk as such, but also that the risk evolves in a way that is consistent with the target market and with how this was disclosed to him. The product's risk level must be continuously measured as market conditions can lead to significant changes in the risk profile of products. This can result in products no longer being aligned with the customer's risk tolerance level. For instance, for pension products, an assessment of expected versus real risk and return levels may imply changes to the initial asset allocation of default investment options or of lifestyle/lifecycle models.

DISTRIBUTION STRATEGY

The assessment of whether the intended distribution strategy remains appropriate should consider the various aspects of distribution, in particular the selected channel(s) and distributors and who is purchasing the products. This should allow evaluating if products are being distributed to the target market or if they are reaching

customers outside the target market to whom the products are not intended.

Triggers of concerns and challenges here can include sales that are larger than anticipated or lower than anticipated.

CUSTOMER CIRCUMSTANCES

When changes in customers' circumstances are not adequately considered and products are not adapted to meet changing needs, consumers could face limited or unsuitable product availability. Poor or in-existent product monitoring and review may lead to the repeated sale of products without reassessing their continued relevance. This limits innovation and evolution of products. Considering that customers are in some cases passive and fail to shop around, they could get a poorer deal as time goes by.

The assessment of "continued suitability" could take into account changes in income, marital status, employment situation, tax status, etc. An adequate point in time to assess these changes could be when contacts are renewed, making the renewal step more tailor-made and a less "automatic" or routine process.

ONGOING PRODUCT DISCLOSURE

Not providing, or providing unclear and misleading information, throughout the life of products (i.e. information provided in addition to pre-contractual information) may put at risk the fair treatment of customers. Without adequate information, customers may fail to take action in their best interest, such as changing product, changing provider, or terminating the contract.

The risk of inertia may be amplified if customers simply ignore the information provided to them. Adequate consideration of the most appropriate delivery channel, considering the objectives, constraints and imperatives for communicating to affected customers may help in mitigating this risk.

To ensure a fair treatment, **information should be provided at regular intervals but also on an *ad hoc* basis, whenever relevant**. For instance, customers should be provided on a regular basis (e.g. quarterly or annually) with information on the performance or status of invest-

ment or pension products.⁴² *Ad hoc* communications on products should include those situations where significant changes to products are introduced during the life of the products. Such relevant information includes changes in scope and levels of cover, terms and conditions, exclusions and limitations, fees and costs, etc.

Customers could also gain from the **provision of information that goes beyond regulatory requirements or contractual commitments**. For instance, providing general information regarding state pension systems or taxation for pension scheme members and beneficiaries or offering specific information – at least upon request – based on changes in customers’ lives, habits, and conditions.

CLAIMS-HANDLING

An efficient and expeditious claims-handling and settlement process is important for customers. However, during the claims-handling and settlement process, customers can face various issues leading to detriment. Customers can suffer, for instance, from (i) unreasonably long and burdensome claims-handling procedures, (ii) unjustified delays and (iii) insufficient explanation of reasons for the rejection of a claim – at a time when they are typically in a vulnerable or stressful situation.

In addition to poor claims administration processes, unfair claim rejections, low compensation amounts and unnecessary delays in payments of claims can *per se* lead to negative customer outcomes due to their financial impact.

Such practices can result from a purposeful action from undertakings in an attempt to push down aggregate claims costs but also from legitimate efforts as a protection against fraud.⁴³ In other cases, long and burdensome claims-handling processes are a result of a large number of parties intervening in the claims-handling process. Consumers may receive poor advice or may be unable to identify the competent entity to which they should make the claim.

For instance, in motor insurance, it is common for undertakings to use outsourcing arrangements. In some circum-

stances, the entire claims-handling process, from FNOL⁴⁴ to the final settlement, can involve several entities with whom customers must interact at the various stages (e.g. hotline service providers, third party administrators, loss evaluators, auto repair shops, or loss adjusters). Such arrangements should not be detrimental to a customer.

To ensure the fair treatment of customers throughout the claims-handling process or even improve it, customer outcomes could be closely monitored through claims monitoring and claims performance management information. Business intelligence tools can be used to collect and analyse relevant data for this purpose. Relevant metrics to evaluate consumer outcomes may consider (i) the number of successful claims, (ii) rejected claims, (iii) the number of claims still open at the end of the year and (iv) average settlement and payment periods.

Improvements to claims-handling could impact other stages of the product lifecycle, such as the product development stage or when products are reviewed. For instance, a simplified product design may lead to a streamlined and timely claims-handling process. On the other hand, a large number of exclusions generally can cause a high claim rejection rate. Insurance contracts could also establish in the terms and conditions deadlines for the payment of compensation and impose limits for additional documentation in order to overcome lengthy procedures. Even if such procedures cannot be reflected in terms and conditions, these could be included in internal policy and procedure manuals.

COMPLAINTS-HANDLING & REDRESS

Customers dissatisfied with insurance products and services should **have a legitimate expectation of the complaint being correctly handled**. However, the way complaints are handled can lead to consumer detriment, adding to the detriment at the origin of the complaint. For instance, consumers may face significant barriers (e.g. overly complex complaints processes) to express their dissatisfaction and file a complaint, see legitimate complaints rejected or endure long processing periods.

⁴² E.g. individual benefit statement.

⁴³ For instance, undertakings may require a police report for home insurance policies when a customer files a theft claim.

⁴⁴ First Notice of Loss.

CULTURE, GOVERNANCE AND PROCESSES

Consumer detriment in complaint-handling can result from a **culture which essentially views complaints negatively**⁴⁵ or from a **failure in processes and governance**. EIOPA's Guidelines on Complaints-Handling by Insurance Undertakings and on Complaints-Handling by Insurance Intermediaries⁴⁶ highlight the need for complaint management policies to consider how insurance undertakings interact with complaining customers. The Guidelines consider, among other aspects, the procedures to inform customers on the complaints-handling process and the procedures for responding to complaints.

Poor governance principles leading to poor complaints-handling can result from a poor endorsement and distribution of the complaint management policy. Senior Management can fail to take an active and leading role in the definition, implementation and in monitoring compliance to the policy, as well as in making sure that it is made available and explained to all relevant staff.

From a consumer perspective and, to some extent, from an undertaking perspective, **one of the major risks is that complaints go unheard**. This can result from an ineffective complaint identification – e.g. failing to take account expressions of dissatisfaction in identifying product failings. This is a particularly relevant aspect as expressions of dissatisfaction can come from a variety of sources in addition to formal complaints to undertakings or other relevant parties. Other sources include customer service calls, customer reviews, or social media.

Complaints could also go unheard if complaints fail to reach the right institution. For instance, if a complaint is received by an insurance intermediary for which the insurance undertaking is responsible and the insurance intermediary does not (i) handle the complaint on behalf of that financial institution, (ii) inform the customer or (iii) direct the complaint to the relevant undertaking.

ESCALATION

Poorly handled complaints are a lost opportunity for customers and for undertakings. While it is important to address the specific concerns of any particular customer, **determining the potential scale of the problem is relevant**. It is critical to assess whether other customers or products may have been affected and if complaints are indicative of recurring or systemic problems. Failure in identifying the root cause of complaints may jeopardize taking action to prevent further similar complaints from reoccurring.

Investigating customer complaints and escalating them internally may lead undertakings to introduce modifications to the product, to the distribution arrangements or to the sales processes. In most extreme cases, undertakings may opt to withdraw products from the market. However, cases where complaints are escalated and lead to such measures from undertakings do not seem to be common (see box 7).

Box 7 Complaints impact on product design – Mobile Phone Insurance

EIOPA's study of consumer protection issues arising from the sale of Mobile Phone Insurance (MPI)⁴⁷ indicates that complaints seem to play a limited role in designing MPI products.

Results indicate that only three insurance undertakings that participated in EIOPA's thematic review, out

of a total of fifty, reported having modified their MPI products because of the complaints about them.

Furthermore, only in one instance, the undertaking providing MPI terminated the relationship with a distributor due to complaints and another undertaking stopped offering MPI due to the large amount of complaints received.

⁴⁵ E.g. with repercussions in individual performance management and remuneration policies.

⁴⁶ Available at: https://eiopa.europa.eu/Publications/Guidelines/EIOPA_Complaints_Handling_GL_EN.PDF#search=EIOPA%20complaints%20handling%20gl and https://eiopa.europa.eu/Publications/Guidelines/GLs_Complaints_Handling_Intermediaries_Original_EN.pdf#search=GLs%20Complaints%20Handling%20Intermediaries%20Original%20EN.

⁴⁷ Available at: <https://eiopa.europa.eu/Publications/Reports/EIOPA-BoS-15-235%20-%20Mobile Phone Insurance Report.pdf>.

This is significant, as complaints are a critical indicator for insurance undertakings and/or distributors as to how well their overall processes are working. From a perspective of fair treatment, complaints are to be expected and valued as a highly material feedback very directly from customers themselves. It can be expected that firms that do not pay attention to complaints may be more exposed to conduct risk.

REDRESS

Redress instruments and schemes are a valuable instrument for achieving effective consumer protection where consumers have been harmed by poor conduct. They compensate customers monetarily for damages they have experienced and may also serve as an effective deterrent to market mis-conduct. To be fully effective, such instruments and schemes should be accessible, affordable, fair, timely and efficient. Where complaints are not efficiently resolved by the undertaking or distributor, consumers' interests are better served where access to independent redress scheme is available.

8. CONCLUSION AND NEXT STEPS

The mapping of conduct risk throughout the product lifecycle is intended to **provide clarity on the different ways by which conduct risk can arise and be identified**. *Per se*, the conduct risks identified in the framework are not unknown to EIOPA and NCAs. These have in the past been singled out by supervisors and, in some cases, been subject to supervisory scrutiny.

In addition, **recent major regulatory changes at the European level in the conduct area seek to address many of these risks**. For instance, risks related to product manufacturing have been considered by Product Oversight and Governance requirements under the IDD; risks relating to transparency of products and services for customers by IDD and PRIIPs Regulation; and complaints, redress and sanctions by IDD.

While the framework is not intended to set out supervisory processes at national level, it should, nonetheless, **support NCAs identifying conduct and consumer**

protection risks sufficiently early and sufficiently clearly for the preventative goals of effective conduct supervision, further enhancing market monitoring and conduct risk assessment and **driving forward practical supervisory convergence**. It provides a catalogue of risks to consider in practical supervisory work.

Going forward, EIOPA expects the framework to **contribute to the effective implementation of** EIOPA's Conduct Supervision Strategy. EIOPA anticipates further work in linking the identified conduct risks with the tools for assessing their impact and supervisory importance, leveraging readily available data as far as possible. This can be anticipated to evolve into more systematic ongoing conduct risk monitoring as an integral part of practical supervision both at national and European levels. This includes, for instance, the **development of periodic conduct risk dashboards** as a platform for high-level debate and convergence on the evolving conduct risk landscape.

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