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EIOPA's Strategy towards a comprehensive risk-based and preventive framework for conduct of business supervision

1. Introduction

- 1.1. This paper sets out EIOPA's Strategic Approach to developing a comprehensive risk-based and preventive framework for conduct of business supervision on a European level.
- 1.2. The paper starts by setting the framework in the context of EIOPA's legal remit, strategic goals and the "policy story" behind the framework, and then goes on to outline EIOPA's strategic approach, the tools it proposes to use to implement this framework and the data needs to complement these tools.

2. The conduct of business supervision framework as part of EIOPA's Legal Remit and Strategic Goals

The importance of conduct of business supervision and the interaction with prudential supervision

- 2.1. Conduct of business risk can be described as the risk to consumers, insurance undertakings and the insurance market as a whole that arise from insurance undertakings and/or insurance intermediaries conducting their business in a way that does not ensure fair treatment of consumers. Poor conduct outcomes may result from the characteristics of the insurance products themselves, as well as from the distribution models chosen for bringing them to the market.
- 2.2. A strengthening of conduct of business supervision is important for consumers, for insurance undertakings and for the market as a whole, as it promotes the orderly functioning of markets resulting in a level playing field, a healthy competitive environment, increased consumer confidence and financial stability. For supervisors, an effective and efficient conduct of business supervisory framework contributes to a credible deterrence of market mis-conduct and allows for pre-emptive and proactive supervision by acting before a developing issue becomes widespread.
- 2.3. The development of a consistent European framework will support EIOPA in achieving its goals of **ensuring a high, effective and consistent level of regulation and supervision** taking account of the varying interests of all Member States and the different nature of financial institutions. Furthermore, it will **foster coherent application of rules** for financial institutions and markets across the EU, **promote a coordinated EU supervisory response** and act preventively when a conduct of business risk emergences in one or several jurisdiction before it spreads to other Member States. Given that EIOPA's Founding Regulation¹ refers to "fostering protection of policyholders, pension scheme members and beneficiaries", the framework will, as a first step, primarily focus on retail consumers.

¹ Regulation 1094/2010 Of the European Parliament and of the Council of 24 November 2010; available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0048:0083:EN:PDF>.

Legal basis

- 2.4. The development of a risk-based and preventive framework for conduct of business supervision is based fully in line with several legal provisions of EIOPA's Founding Regulation, in specific, Articles 1, 8, 9, 29 and 35.
- 2.5. These provisions are complemented with specific European sectoral legislation; for instance, Article 27 of Solvency II² states that supervisory authorities should be provided with all the necessary means to achieve their objectives, *namely the protection of policyholders and beneficiaries*. Moreover, Articles 15 and 16 of the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation³ specifically require EIOPA to monitor the market, in this case for insurance-based investment products, and where appropriate, temporarily restrict or prohibit such products in the EU.

Interaction with the other European Supervisory Authorities

- 2.6. EIOPA will continue to foster coordination and cooperation with the other European Supervisory Authorities (ESAs) on similar frameworks to establish a level-playing field for conduct of business, ensure cross-sectoral consistency and assess the impact of cross-sectoral product intervention.
- 2.7. IOPA and the other ESAs will continue to build on past and current work under the auspices of the Joint Committee. This was stated in the European Commission's Report on the operation of the ESAs and the European System of Financial Supervision (ESFS) that, *"to ensure a framework consistent across sectors and appropriate coordination of the ESAs' activities, more use could be made of the Joint Committee (JC). This could be achieved for instance, by the exchange of best practices between the authorities which would allow for better definition and clarification of their relevant competences in line with the legal basis"*. Examples of past coordination and cooperation, that are illustrative of good practices to be carried forward, include several regulatory measures such as the Guidelines on Complaints-Handling (which was explicitly referred to in the ESFS Report) and the Guidelines on Product Oversight and Governance Arrangements, which are focused on retail conduct risks in particular, and the Guidelines on the convergence of supervisory practices relating to the consistency of supervisory coordination arrangements for financial conglomerates.

Strategic goals

- 2.8. One of EIOPA's main Strategic Goals is "to ensure transparency, simplicity, accessibility and fairness across the internal market for consumers". This is based on the requirement under its empowering Regulation for EIOPA to "take a leading role in promoting transparency, simplicity and fairness in the market for consumer financial products or services across the internal market". **This "leading role" closely complements the need for EIOPA to take a proactive role in intervening early to tackle tangible risks of consumer**

² Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009; available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:335:0001:0155:en:PDF>.

³ Regulation 1286/2014 of the European Parliament and of the Council of 26 November 2014; available at <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R1286&qid=1450195857264&from=EN>.

detriment, which is a fundamental element of the proposed comprehensive risk-based and preventive framework for conduct of business supervision.

- 2.9. EIOPA's empowering Regulation also provides that, as one of its key tasks in the area of consumer protection, that EIOPA should "develop common methodologies for assessing the effect of product characteristics and distribution processes on the financial position of institutions and on consumer protection". **This provides a clear basis for the tools needed to implement the framework.**

3. Policy Context

- 3.1. There has been **significant reputational and financial damage** as a result of consumer mis-selling scandals in Europe. Moreover, there has been a material **loss in consumer confidence**, compounded by existing information asymmetry and lack of financial education on the part of consumers.
- 3.2. There is a clear need for a **more consumer-centric culture** in firms – senior management need to take on more responsibility to prevent poor product oversight and misaligned incentives for sales staff.
- 3.3. **Traditional approaches** to conduct of business regulation & supervision, focussed on point of sale (disclosure and selling practices) and a tick-box approach, **have proved insufficient** to prevent mass mis-selling. In addition, the **growing digitalisation of financial services** (e.g. comparison websites, social media, automated advice) poses new risks for consumers and poses specific challenges in terms of ensuring conduct regulation keeps pace with those new risks.
- 3.4. Conduct issues not only harm individual consumers, but can have wider prudential impact as seen with the Payment Protection Insurance mis-selling scandal. Indeed, at national level, there are different approaches to addressing conduct risks with differences in priority setting and levels of resources allocated. These divergences in models and practices across the EU only help to reinforce the current fragmented situation. The **interrelationship between conduct and prudential issues** plays a key part, on the one hand, regarding the sometimes conflicting goals and tension between the two, and, on the other hand, the fact that the ultimate objective of a prudential framework such as Solvency II, is the protection of policyholders. **Moreover, poor conduct of business – such as mass mis-selling – can have a systemic impact on the market, i.e. contribute to the development of systemic risk.** The overall aim of such a conduct of business supervisory framework is to avoid or to become early enough aware of consumer detriment to be still in a position to act.
- 3.5. Some National Competent Authorities (NCAs) have long standing experience and broad mandates, including comparably huge resources, undertaking consumer surveys, extensive thematic reviews, sophisticated monitoring frameworks (e.g. including mystery shopping, etc.).
- 3.6. At the other end of the scale, there are examples of NCAs only recently embarking on the topic of conduct risk as a new and evolving theme. Irrespective of the underlying differences in national market structures, the consequence is that similar issues may be treated in different ways to the detriment of consumers and at the risk of lack of convergence across the EU.

- 3.7. Considering the highly fragmented situation across the EU, the different NCA's approaches, current status and available resources for addressing conduct of business supervision in Member States, convergence across the EU should take these differences into account. However, this does not imply moving at the pace of the least developed approach. A satisfactory balance must be struck in considering the cost of applying certain measures in smaller markets. The application of the **proportionality principle** of EU legislation as enshrined in Article 5(1) of the Treaty on European Union allows the national dimension of actions envisaged to be taken into account.
- 3.8. Developments at international level such as the on-going work at the International Association of Insurance Supervisors (IAIS) on conduct of business risk reveal the increasing importance of an adequate monitoring of retail risks. The Joint Committee has also produced a document entitled "Conduct risk in the banking and insurance sectors", which highlights the need to protect consumers from unfair and abusive practices. It also analyses the interlinkages between conduct risk and the financial soundness of insurance undertakings and the stability of the financial system as a whole (i.e. systemic risk). In this line, the Financial Stability Board has also noted that *"one of the key lessons from the crisis was that reputational risk was severely underestimated ..." and "... could become a source of financial instability."*⁴
- 3.9. EIOPA's approach to consumer protection is to be focussed on the **whole product life cycle with a greater emphasis on preventive, risk-based conduct supervision**. In view of this, EIOPA's perspective should be broadened to the entire value chain and strengthen the focus on risks and their prevention by focussing on key areas such as common language, methodology and indicators that are both qualitative and quantitative.
- 3.10. EIOPA's strategy going forward will continue to focus both on prudential and conduct of business supervision. Ensuring that insurance undertakings are soundly managed, have robust governance procedures and have a robust solvency position in order to make sure that they can fulfil all their commitments is being tackled by Solvency II. In addition to the specific tools underlined in this document, consumer protection is also being addressed in the context of the PRIIPs Regulation, the Insurance Distribution Directive (IDD) and Product Oversight and Governance arrangements more generally.

4. EIOPA's Strategic Approach to preventive, risk-based conduct supervision

- 4.1. A key element of the proposed supervisory approach is "Smart regulation", focussing on outcomes and moves away from a legalistic, "tick-box" approach. Indeed, regulation and supervision go hand-in-hand. More specifically, the proposed framework should be based on a two pronged approach, which is:
- Risk-based, i.e. identifying the depth and scale of issues and focussing priorities and resources where they matter most in order to build a common European supervisory perspective and approach, with constant monitoring and "dynamic" capacity to respond to innovation and change; and

⁴ Thematic Review on Risk Governance, Financial Stability Board, February 2013; available at http://www.financialstabilityboard.org/wp-content/uploads/r_120404.pdf.

- Preventive, i.e. anticipating consumer detriment early, rather than just reacting following the emergence of problems – solve the problems of the future, rather than the past. This can only be done through a forward-looking approach, which concentrates on how to best identify and tackle, in a timely and effective manner, emerging risks for consumers. Market monitoring, data gathering and the ability to read data intelligently are crucial to this approach.
- 4.2. Central to both of these aspects is the development of strong relationships between supervisors and firms, rooted in firm's internalisation of a consumer-centric culture, with supervisors routinely capable of challenging firms on their culture as well as their "bottom line". A focus on the whole product life cycle will be captured to some extent by EIOPA's preparatory Guidelines on Product Oversight and Governance, which establish requirements for manufacturers of insurance products to design and bring to the market products that meet the needs of a defined target market, as well as provisions on firms distributing such products regarding product distribution arrangements and preparatory steps before products are distributed.
 - 4.3. It is expected that the development of the framework for conduct of business supervision will predominantly rely on EIOPA's internal resources where EIOPA will ensure planning, coordination, information sharing and, ultimately, a consistent European framework. The Committee on Consumer Protection and Financial Innovation (CCPFI) has been involved in the development and implementation of the tools being used under the framework. Moving forward, the CCPFI will continue to play an important role in the development of the framework.
 - 4.4. EIOPA's commitment to allocate resources for the development of a conduct of business supervision framework and the effective implementation of the tools envisaged is set out in EIOPA's Multi-Annual Work Programme 2015-2017.
 - 4.5. Ensuring strong cooperation between EIOPA and NCAs is also key to the implementation of the framework for conduct of business supervision. NCAs have a privileged understanding of their own markets and first-hand knowledge of conduct of business risk in their jurisdictions. In addition, some NCAs have well established conduct of business supervisory practices. NCAs will have an active participation in the development and implementation of the proposed framework by expressing their views, sharing their experiences and information among other NCAs and EIOPA and supporting the practical work.
 - 4.6. Considering that the framework relies on both quantitative and qualitative data provided by NCAs and that resources for data collection and submission will put a strain on NCAs and supervised entities, the collection of data will be goal-oriented and gradually implemented. Data collection will, at an early stage, focus primarily on product-specific data that can generate tangible signals of consumer detriment.
 - 4.7. In addition, EIOPA will target a streamlined process for data collection which will avoid multiple data collections within a short timeframe and make use of data that is already or will be available on a regular basis (e.g. under the Solvency II reporting framework for lines of business level information).

5. Why is such a comprehensive European framework needed?

- 5.1. Firstly, EIOPA's Founding Regulation requires EIOPA to promote "transparency, simplicity and fairness in financial products/services **across the internal market**". This establishes from the outset a pan-European approach.
- 5.2. Secondly, in addition to an existing general market monitoring obligation for EIOPA, the PRIIPs Regulation will introduce a very important market monitoring obligation **in relation to Insurance-Based Investment Products (IBIPs)** for both for NCAs and for EIOPA. It will require the NCAs to monitor their national markets with a view to assessing whether they would need to issue national restrictions and prohibitions against the marketing, distribution or sale of certain IBIPs with certain specified features or against a type of financial activity or practice of an insurer. In the situations where such national measures have either not been issued or where they have proven inefficient, EIOPA is required to assess whether a restriction or prohibition by EIOPA should be issued. Therefore, in order to enable the compliance with the requirements under the PRIIPs Regulation for both NCAs and EIOPA, a European monitoring framework will need to be put in place.
- 5.3. In this manner, **exploring issues that go beyond purely one national market** where those issues have a **cross-border element** to them or where they **arise in several national markets**, helps to **build a coordinated understanding** across those markets and is thereby beneficial for European consumers. It goes without saying that, in cross-border situations, EIOPA will give due consideration to the split of home/host competencies under existing EU Directives. In the same vein, it would not only help NCAs to comply with the above-mentioned monitoring obligation but also to establish state-of-the-art conduct risk regimes where this is not already the case.

6. What tools are already being used and which tools will be needed in the future to implement this comprehensive framework?

- 6.1. The following existing and upcoming tools are envisaged, which arguably follows a holistic approach, composed of complementary elements and which are envisaged to be used as building blocks allowing a continuous development and sophistication.

Consumer Trends Reports/Ad hoc surveys

- 6.2. The annual Consumer Trends Reports and ad hoc surveys (for example, on the sale of mobile phone insurance) provide a snapshot of existing cases of consumer detriment in the insurance and pensions markets through quantitative and qualitative exchanges of consumer protection information between EIOPA and NCAs. In addition to NCAs' input, EIOPA also uses other sources of information, such as input from stakeholders (IRSG – Insurance and Reinsurance Stakeholder Group, OPSG – Occupational Pensions Stakeholder Group, PensionsEurope, Insurance Europe and BEUC – Bureau Européen des

Unions de Consommateurs), research papers, and information about trends that is reported in the media.

- 6.3. In addition, Consumer Trends Reports are also a valuable tool in detecting trends of consumer detriment and emerging risks. Evolving trends on similar issues may not be reported by national authorities at the same time. As some of the trends highlighted in previous Reports take time to evolve in the different European markets, an emerging trend in a small number of Member States in one year allows to assess if the risk has the potential to develop in other Member States or if it is based on the specific features of the concrete national market.

Deep and effective market monitoring both for general and product intervention purposes

- 6.4. There is a general requirement for EIOPA under its Founding Regulation Article 9(2) to “*monitor new and existing financial activities*”, which is linked to a power for EIOPA to issue warnings in the event that a financial activity poses a serious threat to its statutory objectives. In addition, there is a new requirement under the PRIIPs Regulation for EIOPA to “*monitor the market for insurance-based investment products marketed, distributed or sold in the Union*” and for NCAs required to monitor their national markets for insurance-based investment products. Furthermore, the IDD states in Article 1 that “*Member States shall ensure that competent authorities monitor the market, including the market for ancillary insurance products which are marketed, distributed or sold in, or from, their Member State*” and that EIOPA may facilitate and coordinate such monitoring.
- 6.5. EIOPA would have to **identify market areas** that need to be monitored and **have the appropriate tools** to carry out such monitoring, but this can only work through **encouraging sharing** of data/analysis.
- 6.6. It will also be important to monitor the **potential for innovation to spread** into other sectors. Product intervention can have a **cross-sectoral impact** so close co-operation between the ESAs will be required.

Thematic Reviews

- 6.7. Thematic reviews can be used to **target a specific financial activity or product** causing consumer detriment or creating a barrier to the effective functioning of a retail market/delivery of good consumer outcomes. They allow investigation by EIOPA into a specific risk, leading to a **deeper analysis than through normal tools**.
- 6.8. They can help to **explore issues that go beyond purely one national market** either because those issues have a **cross-border element** to them or, due to the fact that they **arise in several national markets, building a coordinated understanding** across those markets would be beneficial for European consumers.
- 6.9. The aim would be to facilitate the roll-out of thematic reviews at national level coordinated by EIOPA, but **not seek to repeat similar reviews already carried out at national level**.
- 6.10. Evidence gathered from a thematic review would enable EIOPA to further bolster the reasoned analysis used for its policy proposals. As a starting point,

individual reviews with clearly defined purposes and scopes, not necessitating big exercises comparing different underlying data, will be launched.

- 6.11. Topics for thematic reviews can be selected, for example, using the Consumer Trends Reports as a source, **because a number of complaints have been received on a specific financial activity or product** leading to harm for consumers, as well as market developments on conduct-related trends that would support a deeper analysis through a thematic review. A proposed methodology for carrying out thematic reviews has been developed by the CCPFI. The topics for thematic reviews will be presented to the Board of Supervisors for adoption.

Retail Risk Indicators

- 6.12. Retail risk indicators follow a holistic approach, seeking to cover different products or practices of the insurance sector at the same time and in recurring intervals.
- 6.13. Classic examples of retail risk (or conduct risk) indicators are: claims ratios, combined ratios, commission levels and lapses/surrender ratios. These indicators aim, for example, to measure profitability (claims and combined ratios), or distribution practices and profitability (commission levels) or consumer mobility (lapses) in relation to certain insurance products and/or distribution practices. Although some of these indicators are already used by several NCAs for prudential supervision purposes, they may also provide valuable information from a consumer protection perspective. For instance, high lapse ratios may indicate, from a prudential supervision perspective, a threat to the financial soundness of an insurance undertaking, but may also reveal conduct of business issues relating to misleading information being provided to consumers, high sales incentives or poor controlling mechanisms of distribution channels. As these indicators can be interpreted in different ways, the identification of risks for consumers will be based on the joint assessment of all the indicators.
- 6.14. These indicators make it possible to:
- Pre-emptively assess the effects of product characteristics and distribution processes on consumer protection; and
 - Determine whether the consumer detriment in question is purely a national problem, or if it is a common problem in several EU countries and hence a coordinated action would be desirable. It is about bringing added value through a European overview of consumer protection risks.

7. Using the tools to facilitate supervisory convergence and an outcomes-focussed approach to supervising conduct of firms

- 7.1. In order to ensure that the above-mentioned tools are effectively implemented, in particular the roll-out of national thematic reviews, a "post-implementation review" would help to strengthen consistency in supervisory outcomes and a risk-based approach at national level, focussing resources where they are most needed. This could, for example, help identify which best practices had been

developed by some NCAs in carrying out thematic reviews, which might be beneficial for other NCAs.

- 7.2. As regards ensuring an outcomes-focussed approach for supervision of conduct of firms, this could, for example, be implemented through incorporating the preparatory Product Oversight and Governance Guidelines in the Supervisory Review Process. This would guide NCAs in reviewing whether an insurer's risk management and governance meets the standards set down in the preparatory Product Oversight and Governance Guidelines.

8. A staggered approach to collection of data on consumer detriment

- 8.1. Such a framework for conduct of business supervision cannot take place in the dark. Going forward, an enhanced process for collecting data is needed in order to facilitate the implementation of the above-mentioned framework. In this respect, a staggered approach is proposed with the following steps:
- Continued striving to enhance the quality of the complaints data collected under the Consumer Trends framework;
 - A trial exercise in the CCPFI on gathering information on emerging risks to consumer protection using retail risk indicators; and
 - At a later date, a move to obtaining more product-specific approach for retail risk indicators and not least leveraging from the data to be collected under the Solvency II reporting framework on line of business level information.

9. Review of Implementation

- 9.1. In order to ensure a robust and effective implementation of this framework, EIOPA will submit a review of the implementation of the strategy to the Board of Supervisors in Spring 2017.