The Protection of the Insured-Investor

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1 Introduction

The insured and investor can either be two different persons or the same person, who at the same time holds a policy and one other financial instrument. The development of the financial sector has blurred the lines between insurance and investment products. Regulation had not captured this development until recently. The term of **“***insurance-based investment products”* depicted in legal texts of insurance regulation has marked the beginning of a new chapter in financial regulation which demonstrates a more horizontal, cross-sectorial character, either implicitly or explicitly. Recent European regulatory initiatives have been intensifying in this regard, deepening the intersection between different sectors of financial services regulation, namely insurance and investment services.

Insurance-based investment products (hereinafter, *IBIPs*) consist of two components: the component of life insurance and the component of investment, the latter being investment units (“unit-linked insurance”), indexes (“index-linked insurance”) or other types of investment. In September 2010, a report titled *“Study on the Costs and Benefits of Potential Changes to Distribution Rules for Insurance Investments Products and other non-MiFID Packaged Retail Investment Products*” (hereinafter the *Study*) was published, commissioned by DG Internal Market and Services to investigate the costs and benefits to industry of potential changes to the distribution rules for IBIPs and other packaged retail investment products that are not governed by MiFID-like rules.

The Study segmented IBIPs available in the market at the time and for the purposes of its cost-benefit analysis, into four groups of life investment insurance products, as follows:[1]

> 1. A life insurance investment product which involves *the policy holder purchasing “units” of a fund.* It is commonly referred to as *unit-linked life insurance policy* (issued with or without a guarantee). Thereby, the value of the policy at maturity is dependent upon the growth of the fund in which the policy is invested and there is no guarantee to the value of the policy when it matures, i.e. investment risk is borne by the policyholder and market values directly determine outcomes for the policyholder.
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> 2. A life insurance investment product where *the policy’s cash value is tied to the performance of a financial index* (e.g. FTSE 100). This type is referred to as index-linked insurance policy.
>
> 3. A life insurance investment product where benefits are partly guaranteed and partly dependent on the evolution of assets chosen by the policyholder, usually UCITS. Then the amount paid by the insured-investor is partly invested in guaranteed assets (for the purpose to pay the fix life insurance sum, plus interest,

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1 Study on the Costs and Benefits of Potential Changes to Distribution Rules for Insurance Investments Products and other non-MiFID Packaged Retail Investment Products, Europe Economics, 29.09.2010, p.4., available at: http://ec.europa.eu/finance/consultations/2010/prips/docs/costs_benefits_study_en.pdf.

provided in the policy) and partly in assets on the account and risk of the policyholder.

4. A life insurance investment product where *the policyholder has some rights to participate in the profits of the insurance firm in addition to some guaranteed minimum return*. The profits to the investor can result from:

The Study[2] verified that the most common life insurance investment products in the EU (even though the list was not exhaustive) tend to be unit-linked products. The aforementioned types have evolved through contractual agreements rather than provided by national legal provisions, as long as of course the rights of the insured are not hindered.

Undoubtedly, contractual freedom and financial engineering will keep forming financial products entailing characteristics of both insurance and investment. In this context, following extensive consultations and studies, the European Commission steadily refined a possible legal definition for insurance-based investment products, focusing on their actual outcome for the client, the economic result of such products, rather than their exact contractual form. Thus, by now, the meaning of "insurance-based investment products" is defined in several European legal texts,[3] as follows:

Insurance Distribution Directive 2016/97 (*IDD*) defines the term of IBIPs as meaning an insurance product which *offers a maturity or surrender value* and where that maturity or surrender value is *wholly or partially exposed, directly or indirectly, to market fluctuation*, and does *not include* non-life policies, life insurance policies which cover only death, incapacity due to injury, sickness or

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2 P.34.

3 To be noted that Directive 2009/138/EC on the taking-up and pursuit of the business of insurance and reinsurance (*Solvency II Directive*) also makes reference, in art.132 para 3, to a type of IBIPs i.e. unit-linked and index-linked insurance policies: "...Where the benefits provided by a contract are directly linked to the value of units in a UCITS as defined in Directive 85/611, or to the value of assets contained in an internal fund held by the insurance undertakings, usually divided into units, the technical provisions in respect of those benefits must be represented as closely as possible by those units or, in case where units are not established by those assets. Where the benefits provided by a contract are directly linked to a share index or some other reference value other than those referred to in the second subparagraph, the technical provisions in respect of those benefits must be represented as closely as possible either by the units deemed to represent the reference value or, in the case where units are not established, by assets of appropriate security and marketability which correspond as closely as possible with those on which the particular reference value is based".

disability, pension products, occupational pensions schemes[4] and individual pension products.[5]

Similarly, *Regulation 1286/2014 on key information documents for Packaged Retail and Insurance-based Investment Products* (*PRIIPs Regulation*) defines insurance-based investment products as insurance products which offer a maturity or surrender value and where that maturity or surrender value is wholly or partially exposed, directly or indirectly, to market fluctuations (art.4 para 2 of PRIIPs Regulation).[6]

In life insurance, where the insurance sum is guaranteed (fix sum) for the insured, it is the insurer who holds the status of the investor (thus, no special protection is required, apart from prudential regulations for insurance undertakings such as Solvency II Directive[7]), while when it comes to IBIPs, where the insurance is expressed in investments, it is the insured who bears the investment risk and therefore holds a status of (or similar to) an investor.

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4 Reference is made to the pension schemes which are regulated by the Directive 2003/41 or Solvency II Directive.

5 *See* Article 2 para 1(17) of IDD according to which 'insurance-based investment product' means an insurance product which offers a maturity or surrender value and where that maturity or surrender value is wholly or partially exposed, directly or indirectly, to market fluctuations, *and does not include***:**

i. Non-life insurance products, as listed in Annex I to Solvency II Directive (Classes of non-life insurance),

ii. Life insurance contracts where the benefits under the contract are payable only on death or in respect of incapacity due to injury, sickness or disability,

iii. Pension products which, under national law, are recognized as having the primary purpose of providing the investor with an income in retirement, and which entitle the investor to certain benefits,

iv. Officially recognized occupational pensions schemes falling under the scope of Directive 2003/41or Solvency II Directive,

v. Individual pension products for which a financial contribution from the employer is required by national law and where the employer has no choice as to the pension product or provider.

6 Art.2 para 2 of PRIIPs provides that the Regulation *shall not apply* to the following products: a) non-life insurance products as listed in Annex I to Directive 2009/138; b) life insurance contracts where the benefits under the contract are payable only on death or in respect of incapacity due to injury, sickness or infirmity; c) deposits other than structured deposits as defined in point (43) of Article 4(1) of Directive 2014/65; d) securities as referred to in points (b) to (g), (i) and (j) of Article 1(2) of Directive 2003/71; e) pension products which, under national law, are recognised as having the primary purpose of providing the investor with an income in retirement and which entitle the investor to certain benefits; f) officially recognised occupational pension schemes within the scope of Directive 2003/41 or Directive 2009/138; individual pension products for which a financial contribution from the employer is required by national law and where the employer or the employee has no choice as to the pension product or provider.

7 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance, as amended and in force, available at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32009L0138

2 Insurance or Investment?

Even though, as already highlighted above, IBIPs confer the status of both an insured and an investor to a person, the latter was not protected both by the insurance and investment services regulation, thus creating a regulatory “gap”. It was only recently that regulatory provisions have come to reflect such reality and correct this misalignment.

More specifically:

Purely investment products fall under the scope of investment services regulation, the landmark piece of legislation here being Directive 2004/39/EC (*MiFID*, now partly recast by Directive 2014/65 – *MiFID II* - and partly replaced by Regulation 600/201 – “*MiFIR*”)[8] which created a single market for investment services and activities aiming to ensure, inter alia, a harmonized and high level of protection for investors in financial instruments, the latter not including however IBIPs (as listed in Annex I Section C of MiFID II, including shares, bonds, money-market instruments, units in collective investment schemes etc.). Further, insurance undertakings traditionally fall outside the scope of investment services regulation, such as MiFID.[9]

Despite the hybrid nature of IBIPs and the fact that they are excluded from the scope of investment services regulation, never in the past were they regulated by special EU rules; Member States were free to choose whether or not to introduce special rules for such products, In 2012, the European Court of Justice ruled, in the context of the case C-166/11,[10] that contracts which are ‘unit-linked’ or ‘linked to investment funds’ qualify as insurance contracts, thus falling outside the scope of the Directive under examination,[11] namely Directive

8 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (OJ L 145, 30.4.2004, p. 1) (MiFID). In June 2014, the European Commission adopted new rules revising the MiFID framework. These consist of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (MiFID II) and Regulation 600/2014 on markets in financial instruments and amending Regulation 648/2012 (“MiFIR”). Hereinafter, where reference is made to MiFID, this will include reference to both MiFID II and MiFIR, unless explicitly otherwise stated.

9 It should be noted, though, that the content of the exemption has been slightly amended in the case of MiFID II, so that it will now apply to “insurance undertakings or undertakings carrying out the reinsurance and retrocession activities referred to” in the Directive 2009/138 (Solvency II) **“**when carrying out the activities referred to in that Directive**”** (art.2 para 1(a) MiFID II).

10 Case *Ángel Lorenzo González Alonso v Nationale Nederlanden Vida Cía de Seguros y Reaseguros SAE,* Judgment of the Court of 1 March 2012, para 29. Reference for a preliminary ruling from the Audiencia Provincial de Oviedo [ECLI identifier: ECLI:EU:C:2012:119].

11 “A contract concluded away from business premises, under which life assurance is offered in return for payment of a monthly premium to be invested, in varying proportions, in fixed-rate investments, variable-rate investments and financial investment products of the company offering the contract falls outside the scope of Directive 85/577 to protect the consumer in

85/577 to "protect the consumer in respect of contracts negotiated away from business premises" (article 3(2)(d) thereof)[12] in conjunction with art.1 of the Directive 79/267[13] and point III of the annex attached thereto, along with art.2 para 1 (a)-(b) of Directive 2002/83.[14]

The practical consequence of such ruling was that in case of cancellation of unit-linked insurance contract the provisions of the aforementioned insurance legislation would apply instead of consumer law provisions included in Directive 85/577. On the other hand, the Court actually confirmed what was already stated in European legal texts since 1979, i.e. that insurance linked to investment funds are regarded as a class of life insurance. No special rules were introduced for the class III of life insurance categories on insurance contracts linked to investment funds, apart from the provisions on technical reserves.

It became apparent that IBIPs were often made available to customers as potential alternatives or substitutes to financial instruments[15] (the latter being the subject of specific and detailed sectorial regulation[16]) for satisfying similar investor needs, and therefore raising comparable investor protection challenges. Thus, the need for *a consistent* European *regulatory approach* concerning the distribution of different financial products was now clear. Besides, a *de facto* alignment with MiFID of national provisions on disclosure requirements and professional requirements for unit-linked life insurance products, was already noted by former CEIOPS.[17] For example, the UK Financial Conduct Authority, amongst others, had already extended most of its conduct of business rules (COBS) to insurance-based investment products in the UK, although the latter were not subject to MiFID, since such products were viewed as essentially

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respect of contracts negotiated away from business premises, in accordance with Article 3(2)(d) thereof."

12 Article 3 para 2(d) of Directive 85/577 to protect the consumer in respect of contracts negotiated away from business premises: "2. This Directive shall not apply to: … (d) insurance contracts; (…)".

13 Directive 79/267 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct life assurance (OJ 1979 L 63, p. 1).

14 Consolidated Directive 2002/83 concerning life assurance.

15 *See* para 87 of the recital of Directive 2014/65 on markets in financial instruments and amending Directives 2002/92 and 2011/61.

16 Directive 2004/39 on markets in financial instruments amending Directives 85/611 and 93/6 and Directive 2000/12 and repealing Directive 93/22 (OJ L 145, 30.4.2004, p. 1) (*MiFID*). In June 2014, the European Commission adopted new rules revising the MiFID framework. These consist of Directive 2014/65 on markets in financial instruments and amending Directive 2002/92 and Directive 2011/61 (*MiFID II*) and Regulation No 600/2014 on markets in financial instruments and amending Regulation No 648/2012 (*MiFIR*). Hereinafter, where reference is made to MiFID, this will include reference to both MiFID II and MiFIR, unless explicitly otherwise stated.

17 Report on National Measures regarding Disclosure Requirements and Professional Requirements for Unit-Linked Life Insurance Products, which are additional to the Minimum Requirements of the CLD and IMD, Committee for European Insurance and Occupational Pensions Supervisors (CEIOPS), CEIOPS-DOC-20/09, 2 July 2009.

falling in the same relevant market as MiFID- (and now MiFID II) investment products, often regarded as substitutable to them.[18]

Interestingly, the need to introduce appropriate requirements for IBIPs, in order to "deliver consistent protection for retail clients and ensure a level playing field between similar products" was made explicit, not in a piece of insurance regulation, but instead in one of the most important European legal acts as regards investment services, i.e. MiFID II.[19]

Still, however, the material provisions in relation to IBIPs were incorporated into Directive 2002/92 on insurance mediation (*IMD*) as amended in this regard by MiFID II (article 91 of MiFID II amending Directive 2002/92 introducing special provisions regarding IBIPs and in particular Chapter IIIA "Additional customer protection requirements in relation to insurance-Based investment products" (commonly referred to as "IMD 1.5."), since it was concluded that "different market structures and product characteristics make it more appropriate that detailed requirements are set out in the ongoing review of Directive 2002/92/EC" rather than setting them in MiFID II extending its scope to cover IBIPs as well. Such policy decision has been implemented since, giving rise to special provisions regulating IBIPs enacted in legal texts such Directive 2016/97 on insurance distribution[20] (*IDD*), repealing IMD and IMD 1.5, as well as Regulation 1286/2014 on key information documents for Packaged Retail and Insurance-based investment products (*PRIIPs Regulation*). Those special provisions, though, resemble the Provisions of MiFID to such an extent (for the purposes of leveling the playing field across financial sectors and protecting consumers of financial services) that a trend towards a "MiFIDization"[21] of the insurance regulation reveals, at least when it comes to insurance-based investments. In other words, despite the sectorial character of IDD being a piece of insurance regulation, it undoubtedly endorses and ultimately "mirrors" MiFID-like provisions, thus constituting an example of horizontal, cross-sectoral legislation, at least when it comes to IBIPs. An example of a full-fledged explicitly cross-sectorial legislation is the PRIIPs Regulation covering banking, investment and insurance products, instead of limiting its scope of application to one of these sectors.[22]

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18 FCA, "Developing our approach to implementing MiFID II conduct of business and organizational requirements", March 2015, Discussion Paper DP15/3, p.10 et seq.

19 According to Recital 87 of MiFID II: "Investments than involve contracts of insurance are often made available to customers as potential alternatives or substitutes to financial instruments subject to this Directive. To deliver consistent protection for retail clients and ensure a level playing field between similar products, it is important that insurance-based investment products are subject to appropriate requirements".

20 Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution (recast), available at: http://eur-lex.europa.eu/legal-content/en/-TXT/?uri=CELEX%3A32016L0097

21 *P. P. Marano*, The "Mifidization" :the sunset of life insurance in the EU Regu-lation on Insurance?, p.2 et seq., available at: https://papers.ssrn.com/sol3/papers.cfm? abstract_ id=2832952.

22 *V. Colaert*, The Regulation of PRIIPs: Great Ambitions, Insurmountable Chal-lenges? , p. 2, available at: https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2721644.

IBIPs as a subset of packaged retail investment products

As already mentioned above, an insurance-based investment product (IBIP) is defined as being “an insurance product which offers a maturity or surrender value and where that maturity or surrender value is wholly or partially exposed, directly or indirectly, to market fluctuations”. Such definition is included both in the IDD and PRIIPs Regulation. Further, both texts endorse almost the same exceptions to the scope of their application when it comes to IBIPs.[23] Of course, such alignment is not a coincidence. Unit-linked policies and other insurance-based investment products of same nature, are a subset of and thus, fall under the scope of packaged retail investment products (PRIPs).[24] The former UK FCA[25] refers to insurance-based investments as covering products packaged under insurance contracts, such as unit-linked and with profits policies, investment bonds, personal pensions provided by insurers, and annuities.[26]

IBIPs being a subset of PRIPs.[27] bear the same basic characteristics of PRIPs:[28]

- They may take a variety of legal forms which provide broadly comparable functions for retail investors,
- They offer exposure to underlying financial assets, but in packaged forms, which modify that exposure compared with direct holdings,
- Their primary function is capital accumulation, although some may provide capital protection,
- They are generally designed with the mid-to long-term retail market in mind, and
- They are marketed directly to retail investors, although may also be sold to sophisticated investors.

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23 Article 2 para 1 (17) of IDD and article 2 para 2 of PRIIPs Regulation.

24 Packaged products are distinguished from non-packaged, such as investments in single equities or unstructured bonds, since the process of packaging investments adds an additional layer of complexity and cost that may make the key characteristics of the investment less transparent to the end investor. Other examples of PRIPs are investment funds such as undertakings for collective investment in transferable securities (UCITS) and re-tail structured products.

25 Financial Conduct Authority.

26 FCA , op.cit. Applying MiFID II rules to insurance-based investment products and pensions, p.12.

27 Communication from the Commission to the European Parliament and the Council, “Packaged Retail Investment Products, SEC(2009) 556,557.

28 Communication from the Commission to the European Parliament and the Council, “Packaged Retail Investment Products, SEC(2009) 556,557.

As highlighted by EIOPA[29] this *"packaging" of products makes PRIPs, and thus IBIPs, increasingly complex and reduces transparency*. Risk profiles and costs incurred can be difficult for the individual investor to understand and assess whether a product is right for him, compared to many other consumer goods. For the latter, the assessment of quality and whether the goods perform according to the consumers' expectations can often be made right away. By contrast, the quality of financial products can be very hard to assess. For instance, with long-term PRIP investments investors might not realise how the investment is performing or whether they have been miss-sold a financial product until a considerable number of years have passed. In addition, consumers typically will not be able to learn from experience given the infrequency with which they often buy PRIPs.

Besides, retail investors "suffer" from *behavioral biases* (e.g. they tend to focus more on the "reward" or performance scenarios of an investment product than the effect of costs etc), while *information asymmetry* between manufacturers/distributors of such packaged products and retail investors adds on to *complexity and costs, reducing transparency* of key investment information: "Retail investors are often confused about the true nature of their investment. Especially purchasers of structured products are often uncertain whether or not they are exposed to the risks of stocks and shares*"*.[30]

The European Supervisory Authorities[31] have examined[32] potential risks related to PRIPs and their manufacturers which resulted in a long list of risk types, amongst which market risk, counterparty and credit risk, foreign-exchange, legal risk and operational risk were included. The list was further divided into three main types of risk: *market, credit and liquidity risk.*[33]

- *Market Risk.*[34] PRIPs are by definition indirect investments: their value is dependent on the value of underlying asset(s) or reference values, such as equities, commodities, real estate, bonds, interest rates, foreign exchange rates, etc. The market risk of a PRIP can therefore be defined as the risk of

29 EIOPA Discussion Paper on Key Information Documents for Packaged Retail and Insurance-based Investment, JC/DP/2014/02, p.17.

30 Consumer Decision-Making in Retail Investment Services: A behavioral Economics Perspective, 2010 (Executive Summary), p.6.

31 The three ESAs are the European Banking Authority (EBA), the European Securities and Markets Authorities (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) and they are part of the European System of Financial Supervision (ESFS).

32 EIOPA Discussion Paper on Key Information Documents for Packaged Retail and Insurance-based Investment, JC/DP/2014/02, p.24.

33 Recital, para 5, Commission Delegated Regulation 2017/653 supplementing Regulation 1286/2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs) by laying down regulatory technical standards with regard to the presentation, content, review and revision of key information documents and the conditions for fulfilling the requirement to provide such documents.

34 EIOPA Discussion Paper on Key Information Documents for Packaged Retail and Insurance-based Investment, JC/DP/2014/02, p.25.

changes in the value of the PRIP due to movements in the value of the underlying assets or reference values. Market risk includes interest rate risk, Foreign Exchange risk, equity risk and commodity risk, either alone or combined together, as well as inflation risk.

- *Credit Risk.*[35] Credit risk is generally perceived as the risk of loss on a given asset in relation to issuer´s credit events (such as default). Bearing in mind the extremely wide spectrum of PRIPs, with very distinctive natures, ranging from derivatives to structured products (including structured deposits), life insurance and funds, it is preferable to define the PRIP´s credit risk as the risk of loss on investment arising from the debtor´s failure to meet some/all his contractual obligations. The debtor could include the issuer of the PRIP.

- *Liquidity Risk.*[36] The PRIP´s liquidity risk relates to factors determining whether an investor can redeem his investment at the moment that the investor wishes to redeem the product, such as a product with a fixed term, before a scheduled maturity date, or a product creating exposures to assets that may be or become illiquid (such as real estate, participations in long term projects). Liquidity risk can be relevant at the level of both the underlying investment of the PRIP and the PRIP itself. A PRIP may invest in assets for which markets may become illiquid, thereby impacting the liquidity of the PRIP itself. Especially in relation to *insurance-based products those are not transferable in principle, thus liquidity is only provided in such cases by the manufacturer.* In this case, the main question of a retail consumer would not be ‘how fast can I exit the product’ but rather ‘under what conditions (e.g. how much will it cost me) can I exit the product’.

3 Special Provisions for Insured-Investors

It is unquestionable that packaged retail investment products are important investment tools for retail investors, who seek to achieve returns on their accumulated capital, as well as for the promotion of efficient capital markets and the economy in general.[37] On the other hand, it is rather straightforward that PRIPs, and IBIPs, in particular, entail risks for consumers (see above). Such risks call for action by the regulators. As already noted, regulatory initiatives have “targeted” IBIPs. The main underlying purpose for such regulatory action is to mitigate information asymmetries, align divergent European and national regulatory responses regarding products offering similar economic content but using different legal forms, creating a level playing field for such products regardless of their legal form or originating institution and, ultimately, restore investor confidence.

Reference to IDD and PRIIPs Regulation has already been made: the IDD is a piece of (minimum harmonization) sectorial, insurance regulation, which aims

35 EIOPA Discussion Paper op. cit. p.25-26.

36 EIOPA Discussion Paper op. cit. p.26.

37 Communication from the Commission to the European Parliament and the Council, op. cit (note 23), SEC (2009) 556,557, p.5&13.

at harmonising national provisions concerning insurance and reinsurance distribution. IDD also regulates the distribution of IBIPs, which should though be "aligned with Directive 2014/65". According to the regulatory objectives of IDD, "the minimum standards should be raised with regard to distribution rules and a level playing field should be created in respect of all insurance-based investment products".[38] Areas to be aligned referred to rules pertaining to *conflicts of interests*, *general principles provision of information to customers* and *possible restrictions* on the remuneration of insurance intermediaries.[39]

On the other hand, PRIIPs Regulation aims at improving the transparency of PRIPs, including IBIPs, offered to retail investors. In particular, PRIIPs Regulation obliges PRIP (and IBIP) manufacturers — such as fund managers, insurance undertakings, credit institutions or investment firms — to draw up the key information document for the packaged retail products that they manufacture, in order to provide retail investors with the information necessary and in a comprehensible format for them to make an informed investment decision and compare different products.[40]

4 Special Provisions in the Insurance Distribution Directive (IDD)

IDD includes a separate chapter (Chapter VI) devoted to IBIPs, titled *"Additional Requirements In Relation To Insurance-Based Investment Products*". According to article 26 thereby (Scope of additional requirements), said chapter and its special provisions apply to IBIPs only, *however they apply in addition and on top of the requirements set for typical, non-investment, insurance products* provided in articles 17 (*General Principles*), 18 (*General information provided by the insurance intermediary or insurance undertaking*), 19 (*Conflicts of interest and transparency*) and 20 (*Advice, and standards for sales where no advice is given*) of IDD. Such IBIPs-oriented additional requirements refer to *conflicts of interest* (art. 27 and 28 IDD), *inducements and client information* (art. 29 IDD) and *assessment of suitability and appropriateness* (art.30 IDD). Thus, and more specifically:

5 Conflicts of Interest in the Context of IBIPs

As a general principle, insurance distributors of both insurance products and IBIPs have to act honestly, fairly and professionally in accordance with the best interests of their customers (art.17 para 1 IDD). On the basis of such mandate, insurance intermediaries and insurance undertakings when distributing IBIPs are

38 The goal for regulatory consistency in these areas between investment products and IBIPs was also delegated to the respective European Supervisory Authorities, namely ESMA and EIOPA (see para 87 of the recital of MiFID II).

39 *See* para 88 of the recital of MiFID II.

40 *See* para 12 and 15 of the recital of PRIIPs Regulation.

required to *prevent conflicts of interest (CoI)*, when those adversely affect (damage) their clients' (or potential clients') interests. Such CoI may occur (i) between a "relevant person"[41] or any person directly or indirectly linked to the insurance distributor by control and a customer or potential customer, when they have distinct interest in the outcome of insurance activities and/or the former's interest may influence the outcome of insurance activity to the detriment of the latter, (ii) between customers of the insurance distributor for the same reasons as above under (i).[42]

Importantly, such damage to (potential) clients' interests, as a result of CoI, would occur in cases where the insurance distributor, be it an insurance intermediary or insurance undertaking, is likely to make a financial gain or avoid a financial loss to the detriment of the customer, *as long as such situation results specifically in a detrimental impact for the customer.* Similarly, it is not sufficient that one customer to whom the insurance intermediary or insurance undertaking owes a duty may make a gain or avoid a loss without there being a concomitant detrimental impact to another such customer**.**[43]

How are CoI to be prevented, then? First of all, effective organizational and administrative arrangements have to be maintained and operated by the insurance distributors (art. 27 IDD). Articles 4 and 5 of Delegated Regulation (EU) 2017/2359 *with regard to information requirements and conduct of business rules applicable to the distribution of insurance-based investment products* provide guidance and a list of possible measures and procedures that should normally be taken into consideration to manage CoI. Such list is non-exhaustive, since such measures and procedures may not be appropriate for all insurance distributors given the variety of business models in this industry.[44]

IDD also deals with the situation where organisational or administrative arrangements to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to customer interests will be prevented (art.28 para 2 of IDD). In such a case, according to IDD, the insurance intermediary or insurance undertaking shall clearly and in writing disclose to the customer the general nature or sources of the conflicts of interest, in good time before the conclusion of an insurance contract. However, it should always be reminded that disclosure of CoI only constitutes the exemption to the principle of prevention of CoI though an effective CoI policy. In other words, disclosure in cases of CoI should be a measure of last resort, when the existing arrangements are not sufficient, while it cannot be exempt from the obligation to maintain and operate effective organizational and administrative arrangements, since the latter remain the most effective means of preventing damage to

41 As defined in art. 2(1) of Commission Delegated Regulation 2017/2359 supplementing Directive 2016/97 with regard to information requirements and conduct of business rules applicable to the distribution of insurance-based investment products.

42 Art.3 para 1 of Commission Delegated Regulation 2017/2359, op.cit.

43 Para 3 of the recital of the Commission Delegated Regulation 2017/2359, op.cit.

44 Para 4 of the recital of the Commission Delegated Regulation (EU) 2017/2359, op.cit.

customers and, on the other hand, over-reliance on disclosure may result in a lack of effective protection of the customer's interests.[45]

6 Inducements

Third-party payments and benefits such as fees, commissions or non-monetary benefits may negatively influence insurance distributors as regards their customer's best interests, by incentivizing them to recommend or sell a particular insurance-based investment product when another product may better meet the customer's needs.[46]

The definition of inducement is given, not in IDD but in its Delegated Regulation 2017/2359. According to art.2 (2) therein, 'inducement' means *"any fee, commission, or any non-monetary benefit provided by or to such an intermediary or undertaking in connection with the distribution of an insurance-based investment product, to or by any party except the customer involved in the transaction in question or a person acting on behalf of that customer"*. Interestingly, the aforementioned Delegated Regulation places the provisions on inducements in the same chapter with those on conflicts of interest (Chapter II, "Conflicts of Interest and Inducements"). Besides, both concepts derive from the general principle depicted in art.17 para 1 IDD, i.e. that insurance distributors of both insurance products and IBIPs have to act honestly, fairly and professionally *in accordance with the best interests of their customers*.

IDD restricts the possibility for insurance undertakings and insurance intermediaries to receive third-party payments or benefits in connection with the distribution of insurance-based investment products in order to strengthen the protection of customers and increase clarity as to the service they receive.[47] More specifically, IDD requires that an inducement does not have a detrimental impact on the quality of the relevant service (art. 29 para 2 of IDD). In order to proceed to such an assessment, Delegated Regulation 2017/2359, provides that insurance intermediaries and insurance undertakings shall perform an *overall analysis taking into account* on the one hand, *all relevant factors which may increase or decrease the risk* of detrimental impact on the quality of the relevant service to the customer and, on the other hand, any *organizational measures* taken *to prevent the risk* of detrimental impact. Such analysis may take place on the basis of non-exhaustive criteria listed in art.8 para 2 of said Delegated Regulation. It is explicitly clarified that the purpose of these criteria is to provide guidance to

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45 Para 5 of the recital of the Commission Delegated Regulation (EU) 2017/2359, op.cit.

46 European Commission Request for EIOPA Technical Advice on possible delegated acts concerning the IDD, pp.7 (Brussels, 24.02.2016_ FISMA.D4/AK/RW/et/Ares(2016) 843849).

47 European Commission Request for EIOPA Technical Advice on possible delegated acts concerning the Insurance Distribution Directive, pp.7, op.cit.

market participants on when detrimental impact might occur and do not amount, in any way, to a de facto prohibition on the receipt or payment of inducements.[48]

MiFID includes rules on inducements, thus IDD respective provisions should be aligned, since insurance-based investment products are likely to be marketed as potential alternatives or substitutes to investment products subject to MiFID II. However, it should be noted that there are some differences between the approach proposed in the IDD and the approach set out in MiFID II, reflected in the different terminology used within the assessment of inducements.[49] More specifically, MiFID II requires that the inducement is designed to enhance the quality of the relevant service to the client,[50] while the IDD requires that the inducement does not have a detrimental impact on the quality of the relevant service.[51] The former FCA has already pointed out in this regard that "while the concepts are broadly aligned, they could be viewed as setting different standards".[52]

Last but not least, as provided in art. 29(1)(c) of the IDD, pre-contractual information delivered to clients or potential clients includes the disclosure of all costs and related charges, including the cost of advice and also encompassing any third party payments.[53]

7 Assessment of Suitability and Appropriateness

Article 30 of IDD "Assessment of suitability and appropriateness and reporting to customers" is the most obvious MiFID-like provision of IDD and is complementary to art.20 of IDD "Advice, and standards for sales where no advice is given".[54] Art.20 of IDD introduces *a "demands and needs" test* prior to the conclusion of insurance contracts, meaning that "the insurance distributor shall specify, on the basis of information obtained from the customer, the demands and the needs of that customer and shall provide the customer with objective information about the insurance product in a comprehensible form to allow that customer to make an informed decision". Such provision of information should have the result that "any contract proposed shall be consistent with the customer's demands and needs for the insurance product". Similarly, "where advice is provided prior to the conclusion of any specific contract, the

48 EIOPA Press Release _ EIOPA ADVISES ON THE IMPLEMENTATION OF THE INSURANCE DISTRIBUTION DIRECTIVE_ February 2017.

49 European Commission Request for EIOPA Technical Advice on possible delegated acts concerning the Insurance Distribution Directive, pp.7, op.cit.

50 Article 24(9)(a) of MiFID II.

51 Article 29(2)(a) of IDD.

52 FCA_ Insurance Distribution Directive Implementation – Consultation Paper 3_ Consultation Paper CP17/33***_September 2017.

53 European Commission Request for EIOPA Technical Advice on possible delegated acts concerning the Insurance Distribution Directive, pp.7, op.cit.

54 Art.30 para 1 IDD: "Without prejudice to Article 20(1),…(…)".

insurance distributor shall provide the customer with a personalized recommendation explaining why a particular product would best meet the customer's demands and needs".

When it comes to IBIPs, on top of the aforementioned "demands and needs" test, *a "suitability and appropriateness" test* is to be conducted by insurance distributors, depending on whether an advised or non-advised sale takes place.[55] The suitability assessment set out in art. 30(1) of IDD and the appropriateness assessment set out in art. 30(2) of IDD are *different in scope* with regard to the distribution activities to which they relate, and have *different functions and characteristics.*[56] depending whether advised or non-advised sales take place, of non-complex or (*a contrario*) complex IBIPs.

IDD requires firms to assess *either* the suitability *or* appropriateness of an IBIP for the customer depending on whether advice (a personal recommendation) is provided:

> For *advised sales*, the firm must assess whether the IBIP is *suitable* for the client (*suitability test*, art.30 para 1 IDD). Importantly, such assessment is not one-off, i.e. when initially buying an IBIP, but it is rather an obligation that "follows" the product and applies to all personal recommendations made during the life-time[57] of that product.[58] The need for a suitability assessment is particularly strong as regards decisions to switch the underlying investment assets or to hold or sell an IBIP[59].

The link between the IBIP and the suitability assessment is so close that even when the *advice is provided through an automated or semi-automated system*, the insurance distributor still remains responsible for performing suitability assessment.[60]

As a result of performing the *suitability test*, insurance distributors shall, prior to the conclusion of the contract, provide the customer with a *suitability*

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55 "It should also be clarified that the assessments of suitability and appropriateness are without prejudice to the obligation, for insurance intermediaries and insurance undertakings, to specify, prior to the conclusion of any insurance contract, on the basis of information obtained from the customer, the demands and needs of that customer" (recital, para 7, of the Delegated Regulation 2017/2359).

56 Recital, para 7, of Delegated Regulation 2017/2359.

57 To ensure an appropriate standard of advice with regard to the long-term development of the product, insurance intermediaries or insurance undertakings should include in the suitability statement, and draw customers' attention to, information on whether the recommended insurance-based investment products are likely to require the customer to seek a periodic review of their arrangement (Recital, para 11, of Delegated Regulation 2017/2359).

58 Since such situations may imply advice on financial transactions which should be based on a thorough analysis of the knowledge and experience and the financial situation of the individual customer (Recital, para 8, of Delegated Regulation 2017/2359).

59 Recital, para 8, of Delegated Regulation 2017/2359.

60 Recital, para 10, of Delegated Regulation 2017/2359.

statement on a durable medium specifying the advice given and how that advice meets the preferences, objectives and other characteristics of the customer.[61]

> For *non-advised (execution-only) sales*, the customer's investment knowledge and experience should be assessed to determine whether the IBIP provided is *appropriate* for them (*appropriateness test*, art.30 para 2 IDD).

Non-advised sales, where the transaction can be carried out without advice relating to the merits of the transaction, i.e. on the basis of execution-only, may occur, for example, in the case of:

- Experienced customers who are familiar with the risks and rewards of various types of investment would normally not need any advice about whether a particular investment product is suitable to them.[62]

- Internet-based or telephone-based execution-only services, whereby once the customer has registered an account with an execution-only service, an order to trade a financial instrument can either be made by phone or online.[63]

- The customer requires a sale without advice and the conditions of Article 30(3) IDD[64] are not met (see below).

- In cases where a suitability assessment cannot be performed because the necessary information about the customer's financial situation and investment objectives cannot be obtained. In such case, the customer might agree to proceed with concluding the contract as a sale without advice. However, an assessment of appropriateness should be required, in order to ensure that the customer has the necessary knowledge and experience in order to understand the risks involved (unless the conditions of Article 30(3) IDD are met).[65]

As a result of the application of such *appropriateness test* and where the insurance distributor concludes that the product is not appropriate for the

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61 Article 14 of Delegated Regulation 2017/2359, European Commission Request for EIOPA Technical Advice on possible delegated acts concerning the Insurance Distribution Directive, pp.9, op.cit.

62 European Commission Request for EIOPA Technical Advice on possible delegated acts concerning the Insurance Distribution Directive, pp.9, op.cit.

63 European Commission Request for EIOPA Technical Advice on possible delegated acts concerning the Insurance Distribution Directive, pp.9, op.cit.

64 Art. 30 para 3 IDD: "Without prejudice to Article 20(1), where no advice is given in relation to insurance-based investment products, Member States may derogate from the obligations referred to in paragraph 2 of this Article, allowing insurance intermediaries or insurance undertakings to carry out insurance distribution activities within their territories without the need to obtain the information or make the determination provided for in paragraph 2 of this Article where all the following conditions are met:.

65 Recital, para 12, of Delegated Regulation 2017/2359.

(potential) customer, on the basis of the information received, the former shall warn the (potential) customer to that effect.[66]

> *Non-advised sales of IBIPs with a non-complex investment element (art.30 para 3 IDD)*: a sub-category of non-advised sales, where insurance distributors are allowed to carry out insurance distribution activities within their territories *without the need for an appropriateness test, as long as member states have opted to derogate* from such obligation (as permitted by IDD), subject to conditions listed in art.30 para 3 IDD being met (*non-complex underlying investment, passive marketing, client information on the waiver of protective provisions, conflict of interests policy in place*). Interestingly, the condition/concept of "non-complex" products is defined in a dual manner: a) by reference to MiFID II and b) in an autonomous manner ("other non-complex insurance-based investments for the purpose of this paragraph", art.30 para 3 (i)(ii) IDD) on the basis of the criteria listed in art.16 of Delegated Regulation 2017/2359. According to the latter, the provision of guarantees can play an important role in this context for the assessment of a product as "non-complex". Where a IBIPs provides a *guarantee* at maturity that covers at least the total amount paid by the customer, excluding legitimate costs, such guarantee limits significantly the extent to which the customer is exposed to market fluctuations and, thus, may qualify as a non-complex product for the purposes of Article 30(3) IDD.[67]

To be noted that, contrary to the MiFID regime whereby a distinction is made between professional and retail clients, IDD and its Delegated Regulations do not specifically allow firms to assume that the former have the necessary knowledge and experience of the suitability and appropriateness tests.[68]

8 Special Provisions in the PRIIPs Regulation

The PRIIPs Regulation applies to *'Packaged Retail and Insurance-based Investment Products'*, which according to art.4(3) thereof, means "a product that is one or both of the following:(a) a PRIP;(b) an insurance-based investment product". In other words, in the context of PRIIPs, a PRIP is defined as a sub-set of PRIIPs, while IBIPs are referred to as a separate type of PRIIPs. To be noted that the initial Proposal for this Regulation did not distinguish between PRIPs and IBIPs (jointly referred to as PRIIPs in the enacted piece of legislation), but was rather using the term packaged (retail) investment products (PRIPs) which included IBIPs as well. However, subsequent negotiations have led to an explicit reference made to IBIPs.

The PRIIPs Regulation introduces a *new standardized key information document (KID)* to improve the retail investor's and insured/investors (in the case of IBIPs) *understanding* of packaged retail & insurance-based investment

66 Article 30 para 2 IDD.

67 Recital, para 13, of Delegated Regulation 2017/2359.

68 FCA, Insurance Distribution Directive Implementation – Consultation Paper 3, Consultation Paper CP17/33***, September 2017.

products (PRIIPs) and the *comparability* of those products.[69] Understanding and comparability by the part of retail insured/investors of information related to economic and legal features of PRIIPs and of the risks associated is crucial in order to *mitigate information asymmetries* and enable insured/investors to make informed decisions. Of course, disclosure of information has been already provided in European sectoral financial regulation, however when it comes to packaged retail products and in our case IBIPs, such disclosures seem rather uncoordinated, lucking comparability and do not ultimately lead insured/investors to make informed investment choices, i.e. upon understanding associated risks and costs. Losses suffered as a result of such lack of transparency undermine insured/investor confidence[70] and thus, liquidity of financial markets. Besides, rebuilding such confidence of retail insured/investors in the market has been both a major regulatory goal, and a challenge, in the aftermath of the financial crisis.[71]

Regulatory divergence in relation to disclosure and transparency across the financial services spectrum is alleviated by the PRIIPs Regulation uniform and directly applicable provisions for a standardized document applying horizontally to all participants in the PRIIPs market. These rules refer not only to the format and the content of the KID, which is drawn up by PRIIP manufacturers, but also to the provision of such standardized document by both its manufacturer and those selling or advising on those products.[72]

Despite the wide range of types and legal forms that a PRIIP may take, KID represents an effort to counterbalance the –often overwhelming- amount and diversity of information that retail insured/investors would have to process in order to take an informed decision by introducing common standards that allow the latter to understand and compare the *key features, risks, potential future performance* and *costs of PRIIPs*. For example, behavioral studies and consumer testing have highlighted that retail insured/investors can understand monetary figures more easily than percentages.[73]

In practice, each KID will need to be no more than three pages long and contain specified information, presented in a pre-determined sequence. Broadly,

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69 Recital, para 1, Commission Delegated Regulation (EU) 2017/653 of 8 March 2017 supplementing Regulation (EU) No 1286/2014 of the European Parliament and of the Council on key information documents for packaged retail and insurance-based investment products (PRIIPs) by laying down regulatory technical standards with regard to the presentation, content, review and revision of key information documents and the conditions for fulfilling the requirement to provide such documents.

70 According to the former FCA, the changes made to their disclosure framework aims to advance the objectives of securing and appropriate degree of protection for consumers and promoting effective competition in the interest of consumers (FCA's disclosure rules following application of PRIIPs op.cit.

71 Recital, para 2, PRIIPs Regulation

72 Para 1, COMMUNICATION FROM THE COMMISSION, Guidelines on the application of Regulation 286/2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs) (2017/C 218/02).

73 Recital, para 12, Commission Delegated Regulation 2017/653, op.cit.

firms will need to answer in an accurate, fair, clear and not misleading manner the following questions about the PRIIP:[74]

- What is this product?
- What are the risks and what could I get in return?
- What happens if the PRIIP manufacturer is unable to pay out?
- What are the costs?
- How long should I hold it and can I take money out early?
- How can I complain?
- Other relevant information.

KID is explicitly provided as a means of pre-contractual information[75] and thus, it has to be provided in sufficient time prior to being bound by a contract or offer related to a PRIIP. Given that the personal characteristics of each insured/investor may vary (in terms of experience, knowledge, needs etc.), what constitutes sufficient time may vary as well per insured/investor. For that reason, it is on the person advising on, or selling, a PRIIP to determine the time that those retail insured/investor will need to consider the contents of the KID.[76]

To be noted that when it comes to insurance undertakings/manufacturers and distributors of IBIPs, it is to be noted that information contained in the KID as per the PRIIPs Regulation is additional to the provision of certain information required as a result of art.185 of the Solvency II Directive (Information for policy holders), even though some overlaps exist.

Interestingly, *in relation to IBIPs only*, the PRIIPs Regulation not only regulates the format/content and distribution of KID, but also delegates to EIOPA and competent national authorities the authority to take temporary *product intervention measures* (Chapter III, Market monitoring and product intervention powers).[77] Those include the prohibition or restriction of (a) their marketing, distribution or sale or of (b) a type of financial activity or practice of an insurance or reinsurance undertaking, as long as certain conditions are met and especially in cases of *significant insured/investor protection concern* or *threat to the orderly functioning and integrity of the financial markets* or to the *stability of the financial system.*[78]

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74 FCA's disclosure rules following application of PRIIPs Regulation op.cit.

75 To be reminded, rules that implement MiFID, AIFMD or the Prospectus Directive and certain other rules which are outside the scope of the PRIIPs Regulation will continue to apply.

76 Recital, para 25, Commission Delegated Regulation 2017/653, op.cit.

77 Recital, para 4, PRIIPs Regulation.

78 Art. 16 para 2(a) PRIIPs Regulation re EIOPA intervention powers and art.17 para (2) a PRIIPs Regulation re national competent authorities' interventions powers.

9 Conclusions

There is a rising trend in financial regulation, precipitated after the financial crisis, to move from legal forms to economic substance and blur the strict lines between different financial sectors. Legal provisions tend to be aligned across the financial services framework, such as IDD and MiFID II, pieces of legislation include in their scope of application products from different financial sectors, such as the PRIIPs Regulation, while consumers of financial products tend to have more than one capacity, such as the holders of IBIPs who qualify as both insured and investors at the same time. In this context and contrary to the past, the latter benefit from a wide range of provisions, which mainly aim to insure that insured/investors make an informed decision when purchasing a financial product, being aware of their main characteristics such as risks, costs and potential returns. Of course, all these pieces of European legislation, at the time that this article was being written, have just or are about to enter into force in member states. It is only upon their application thus, that we will be able to conclude that they have succeed their purpose of increased transparency and enhanced financial services consumer confidence.