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EU acts to increase legal protection for life investors

PHILIP WOOLFSON and **GUY SOUSSAN** consider moves from the European Union to strengthen disclosure and conduct of business rules in life insurance



IN MAY 2007, the Economic and Financial Affairs Council (Ecofin), requested that the European Commission review the regulatory framework for retail investment products. The Commission responded with several initiatives, culminating last April with the release of a Communication on packaged retail investment products (PRIPs).

This article summarises the legal and regulatory implications of this Communication and recent, important developments.

The Communication noted: "A substantial body of Community law already exists to protect investors. However, legal requirements on product transparency, sales and advice differ according to the legal form of the product and the distribution channel. This situation does not provide a coherent basis for the protection of the retail investor or for the balanced development of the market for packaged retail investment products. The level of protection for the retail investor should not vary according to the legal form of these products."

The Commission therefore explores three questions on the Community law rules.

Regulatory patchwork

First, is the European legal framework fit for purpose? The Communication summarises disclosure and selling rules under Community law for PRIPs. The result is a patchwork, in which, for example, the Market in Financial Instruments Directive (MiFID) sets a benchmark on product information rules applicable to manufacturers, issuers or intermediaries for EU-harmonised investment funds, other forms of funds and securities generally. Conversely, life insurance policies are subject to a separate regime set out in the Consolidated Life and Insurance Mediation Directives and structured term deposits appear to fall outside the EU product information rules.

Selling rules (cf. conduct of business) are also subject to different rules depending on the product in question; e-commerce and

distance-marketing rules can also cut across the various sectors.

Second, the Communication asks whether changes in EU legislation could improve outcomes. Member states have varied in their responses to gaps in Community law. These responses can have negative effects, eg by introducing excessive "gold-plating" and rendering cross-border provision of financial services more difficult.

The Commission calls for "... a systematic and co-ordinated response to the risk that is associated with the fragmented regulatory framework..."

This leads to the Communication's third question, ie what does the Commission propose? The Communication refers to a "horizontal approach" to mandatory disclosures and selling practices. In the Commission's opinion this approach promotes consistent outcomes regardless of the legal form of the product or the distribution channel employed.

Drawing on experience in the fund sector, the Communication then considers "key investor disclosures" (KID) and principles for regulation of selling practices, and concludes new horizontal legislative measures would have to repeal and replace all relevant existing measures. This is ambitious, and the Commission has therefore been treading carefully since last spring, not least in the context of an issues paper prepared for a technical workshop held last month.

Life insurance and the scope of new measures

At present, life insurance disclosures and selling practices are mainly covered by the relevant provisions of the Consolidated Life Directive, eg, the list of pre-contractual disclosures set out in Annex A of the Directive (cf. "Key Facts" in UK parlance), and cooling-off and cancellation rights. These rules apply to both "traditional" or with profits-type contracts, and unit-linked contracts.

From the life insurance perspective, the most contentious issue is the scope of any new legislation, ie, which classes of insurance are within scope and which are not? The Commission appears to have an open mind.

Certain market players seek exclusion of traditional contracts from a new PRIPs regime. The Association of British Insurers (ABI), supported by the Dutch and cross-border life sectors, have emphasised that the Commission should focus on the economic purpose of a product (eg, capital accumula-

tion), rather than its legal form, and that traditional products should therefore be included in new legislation.

As the ABI has argued: "... From the perspective of the consumer, the economic function of these products is the same as any other retail investment product so they should be subject to the same disclosure and sales practices rules". (See also ABI opinion, *Insurance Day*, 26 October 2009)

At last month's workshop, most participants called for the inclusion of traditional life contracts within the scope of new legislation. Conversely, certain pensions and annuities would require separate consideration.

Remuneration and conflict of interest

Remuneration and how it should be disclosed in intermediated and direct sales is another sensitive topic. The Insurance Mediation Directive does not regulate the form of remuneration. Member states may therefore set their own rules (including, for example, a ban on commission-based remuneration).

The Commission is aware of the need to remove conflict of interest arising from "commission bias" (the FSA's Retail Distribution Review has reached comparable conclusions). This objective might, however, have unintended consequences, for example, a concentration of independent financial adviser (IFA) services on wealthier clients who are willing to pay a fee for insurance-based investment advice.

The Commission's Issues Paper highlights the difficulties, eg, distinguishing intertwined costs, but also argues investors must receive clear and effective disclosures of remuneration arrangements and of all charges, commission or fees paid.

The risk remains that a plethora of national rules, which, in the name of the client's best interests, will hinder cross-border competition unnecessarily.

Advice regime

The third key issue is the nature of advice to consumers, ranging from independent advice (cf. IFAs), to more restricted advice (cf. tied agents), simplified advice for straightforward investments, and even non-advised sales.

The Communication outlines several principles, building on MiFID rules as a benchmark (conduct of business, inducements and conflicts of interest); provision of advice and transmission of orders are also distinguished.

The principles require fair



treatment of the investor, ie, products should correspond to the profile and needs of the investor. Non-advised sales may still need an assessment of adequacy of the product and, in all cases, conflicts of interest must not adversely affect the investor (or, at least, be adequately disclosed). Those assessing the suitability of products must fully understand those products and their features.

To argue about fair treatment of investors would be churlish and self-defeating. The recent debate has instead focused on how to provide timely, clear and relevant information that also fosters comparison of the key features of products.

Sector representatives at the October workshop were concerned "too much information may harm you" and the risk what works for one product, for example, an investment fund subject to KID, may not be suitable for another, such as a life insurance contract where, in order to guarantee an investment return or capital, the insurer must meet solvency requirements, which are unknown to the asset-management sector.

Next steps

To complicate matters, new legislation on PRIPs must also be co-ordinated with reviews of the Distance Marketing and Insurance Mediation Directives and of MiFID.

The Communication envisaged publication, by the end of this year, of a first outline of the new measures. At the October workshop, the Commission promised public consultation on an Orientation Paper "... in the coming months".

Whatever the timing, the life insurance sector will need to monitor this subject and be ready to intervene to avoid outcomes which harm consumers as much as the industry itself.

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